



Department of Management and Budget

Federal Compliance Audit

Year Ended June 30, 2016

March 24, 2017
REPORT 17-08

Financial Audit Division

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Office of the Legislative Auditor Financial Audit Division

The Financial Audit Division at the Office of the Legislative Auditor (OLA) performs three types of audits of entities within the state's executive and judicial branches:

- **Financial Statement** audits determine whether an entity has prepared its Comprehensive Annual Financial Report in accordance with governmental accounting principles. The division provides audit opinions on the financial reports for the State of Minnesota, the state's three large public pension plans, and the Minnesota Sports Facilities Authority.
- **Federal Grant Compliance** audits determine whether the state has complied with federal requirements for many of its largest federal programs. Often called the *Single Audit*, the federal government requires these audits as a condition of receiving federal grants.
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The Financial Audit Division has a staff of about 35 auditors, many of whom are licensed CPAs and hold other certifications. The division conducts its audits in accordance with *Government Auditing Standards* established by the Comptroller General of the United States.

One requirement of the audit standards is a periodic review of the division's system of quality control by audit peers from across the country. The division's most recent peer review report is available at: www.auditor.leg.state.mn.us/fad/pdf/fadpeer.pdf

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In addition, OLA may conduct a **Special Review** in response to allegations and other concerns brought to the attention of the Legislative Auditor. The Legislative Auditor conducts a preliminary assessment in response to each request for a special review to determine what additional action, if any, OLA should take.



OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

March 24, 2017

Senator Mary Kiffmeyer, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

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 16, 2017. This audit was conducted by Tracy Gebhard, CPA (Audit Director) and Tracia Polden (Auditor).

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

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor



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Report Summary

We audited the Department of Management and Budget's oversight and administration of the state's federal programs. The department's oversight and administration includes cash management, allocation of statewide indirect costs, oversight of internal service fund rates, and the preparation of the state's Schedule of Expenditures of Federal Awards for fiscal year 2016.¹ 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.

Our first objective was to determine whether the Department of Management and Budget complied, and had adequate controls to ensure compliance, with federal program requirements in its oversight and administration of the state's federal programs. We interviewed staff at the Department of Management and Budget to understand how the department ensured compliance with federal requirements. We tested the department's internal controls and transactions to ensure compliance with federal requirements.

Our second objective was to determine whether the Department of Management and Budget had resolved one issue from our previous audit.

Conclusion

Except as explained in the audit finding in this report, we concluded that the Department of Management and Budget complied with federal requirements over cash management, allocation of statewide indirect costs, oversight of internal service fund rates, and the preparation of the state's Schedule of Expenditures of Federal Awards for fiscal year 2016. We also concluded that the department had controls to ensure compliance.

Audit Finding

- For fiscal year 2016, the Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs. This is a repeat finding from our previous audit.² (Finding 1, page 7)

¹ 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."

² Office of the Legislative Auditor, Financial Audit Division Report 16-09, *Department of Management and Budget* (Finding 1), issued March 24, 2016.



Department of Management and Budget

Federal Program Overview

The Department of Management and Budget, as the manager of the state's financial affairs, has high-level responsibility for the state's compliance with federal program requirements under the federal Single Audit Act.³ The objective of the Single Audit is to provide the federal government with assurance about the state's management and use of federal grant money. The audit encompasses both financial and compliance components.

Each year, the federal Office of Management and Budget issues a *Compliance Supplement* to provide specific audit requirements for its largest federal programs, including the ones we audited at the Department of Management and Budget. The *Compliance Supplement* identifies important compliance requirements that the federal government expects to be considered as part of our audit. The supplement provides detailed explanations, discussions, and guidance about standard requirements that recipients must comply with when receiving and using such federal grant money.

The Department of Management and Budget has responsibility for the following federal program requirements:

- Cash management of federal funds;
- Allocating statewide indirect costs to state agencies;⁴
- Approving rates charged to state agencies for internal services, such as information technology services; and
- Preparing the state's Schedule of Expenditures of Federal Awards.⁵

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.

Our audit covered each of the four areas listed above. In the following section, we describe, in more detail, the department's responsibility for approving rates

³ Title 2 *Code of Federal Regulations* Part 200 – Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, subpart F – Audit Requirements.

⁴ Examples of statewide indirect costs include costs related to the state's accounting, personnel, and payroll systems, and the department's Financial Reporting, Cash Management, and Human Resources divisions.

⁵ The Schedule of Expenditures of Federal Awards is an annual summary required as part of the Single Audit of the state's expenditures of federal grant money.

charged to state agencies for internal services, such as information technology services.

Internal Service Fund Rates

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.⁶ Among the internal services for which the department approves rates are the state's information technology services. The Office of MN.IT Services (MN.IT) 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.⁷ (A break-even rate is an amount designed to recover the estimated cost of providing the service.) In addition, federal compliance requirements state that billing rates "must be based on the estimated costs of providing the services."⁸

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.⁹ 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.

Objective, Scope, and Methodology

Our audit had two objectives:

- To determine whether the Department of Management and Budget complied with and had adequate internal controls to ensure compliance with federal program requirements in its oversight and administration of the state's federal programs.

⁶ *Minnesota Statutes* 2014, 16A.126.

⁷ Department of Management and Budget Policy 0108-01, *Internal Service Rate Approval*.

⁸ *Title 2 U.S. Code of Federal Regulations*, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Appendix V.

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

- To determine whether the Department of Management and Budget had resolved one issue from our previous audit.¹⁰

As part of our audit, we examined rates used to bill state agencies for services provided by other state agencies. Our review included:

- The department's process to approve rates for these internal services;
- The consistency of information in the department's 2016 Statewide Cost Allocation Plan with financial information in the state's *Comprehensive Annual Financial Report*;¹¹
- The billing rates for services in fiscal year 2016 were consistent across state agencies;
- The reasonableness and accuracy of the retained earnings balances;¹² and
- Whether costs used to determine rates were allowable under federal regulations.¹³

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 Uniform Guidance, *Compliance Supplement*.

Conclusion

Except as explained in the audit finding in this report, we concluded that the Department of Management and Budget complied with federal requirements over cash management, allocation of statewide indirect costs, oversight of internal service fund rates, and the preparation of the state's Schedule of Expenditures of Federal Awards for fiscal year 2016. We also concluded that the department had controls to ensure compliance.

¹⁰ Office of the Legislative Auditor, Financial Audit Division Report 16-09, *Department of Management and Budget* (Finding 1), issued March 24, 2016.

¹¹ The *Comprehensive Annual Financial Report* for the State of Minnesota includes financial statements for the state's internal service funds. The report can be found here: <https://www.mn.gov/mmb/accounting/reports/comprehensive-annual.jsp>.

¹² *Title 2 U.S. Code of Federal Regulations*, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Appendix V, Section G, 2, states that "... retained earnings of up to 60 calendar days cash expense for normal operating purposes is considered reasonable". Excessive retained earnings could indicate that federal programs may be overcharged.

¹³ *Title 2 U.S. Code of Federal Regulations*, Part 200, Sections 200.420 thru 200.475 identify costs that are allowable, such as rent, personnel, or professional and technical services, and those cost that are not allowed, such as bad debt, or capital outlay costs.

Status of Prior Audit Finding

The Department of Management and Budget did not fully resolve the audit finding from the prior audit report.¹⁴ The audit finding is repeated in this report.

Additional Reporting

The finding in this report will be included in the 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 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.

¹⁴ Office of the Legislative Auditor, Financial Audit Division Report 16-09, *Department of Management and Budget* (Finding 1), issued March 24, 2016.

Finding and Recommendations

For fiscal year 2016, the Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs. This is a repeat finding.¹⁵

Finding 1

The Department of Management and Budget approved fiscal year 2016 billing rates for certain information technology services that were higher than the break-even rates calculated for those services. The Office of MN.IT Services (MN.IT) used the 2016 approved rates to bill other state agencies for information technology services it provided.¹⁶ State agencies used money from federal grant programs, along with state money, to pay MN.IT for these information technology services.

For example, MN.IT's 2016 billing rate for mainframe services was nearly 27 percent higher than the break-even rate the office calculated was necessary to cover the estimated cost of providing those services. The fiscal year 2016 billing rate was reduced from the rate for fiscal year 2015, which was 47 percent higher than break-even. 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.)¹⁷

During our 2015 audit of the Office of MN.IT Services billings for information technology services,¹⁸ MN.IT management told us they overcharged for some services to offset other services where it set rates below break-even. 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

¹⁵ Office of the Legislative Auditor, Financial Audit Division Report 16-09, *Department of Management and Budget* (Finding 1), issued March 24, 2016.

¹⁶ 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.

¹⁷ 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.

¹⁸ 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.”¹⁹

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.”²⁰ In addition, state statutes require state agencies to reimburse MN.IT for the “cost” of all services provided,²¹ and state policy requires that state agencies set billing rates for internal services “as close to the break-even rate” as possible.²²

The Department of Management and Budget identified the issue and began working with MN.IT in August 2013. Since then the department and MN.IT have taken or will take the following steps to move rates closer to break-even.

- For fiscal year 2015, the department required MN.IT to revise the proposed billing rates that were set higher than break-even. The department stated, “Those revisions reduced by \$1 million the revenue associated with four over recovering rates.”
- For fiscal year 2016, the department approved billing rates that were set 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...”²³
- For fiscal years 2018 and 2019, MN.IT proposed an additional adjustment to billing rates and the department has approved billing rates that it states will achieve 100% break-even across all information technology services in order to meet fiscal and audit requirements.

¹⁹ 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.

²⁰ *Title 2 U.S. Code of Federal Regulations* Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Appendix V.

²¹ *Minnesota Statutes* 2016, 16E.14, MN.IT Services Revolving Fund.

²² Department of Management and Budget Policy 0108-01, *Internal Service Rate Approval*.

²³ Office of MN.IT Services *FY2017 Central Rates*, approved as of November 18, 2015.

However, the fiscal year 2016 rates continued to overbill agencies for some services, such as for mainframe services, which are predominantly used to administer federal programs.

As part of our audit, we quantified the amount MN.IT overcharged the federal Medical Assistance program administered by the Department of Human Services for mainframe services. Based on our analysis of the October 2015 MN.IT billings for mainframe services, we estimate that MN.IT overcharged the federal Medical Assistance program for that month approximately \$200,000. Because we believe the October 2015 billing is representative of all fiscal year 2016 monthly MN.IT billings, we estimate that MN.IT overcharged the federal Medical Assistance program by over \$2 million for the year.²⁴

Due to higher than forecasted volume for certain information technology services, MN.IT issued rebates to state agencies. In May 2016, MN.IT issued a rebate of \$2.6 million. Of the \$2.6 million rebate, the Department of Human Services received \$1.8 million. According to MN.IT management, it plans to issue another rebate totaling \$2.6 million to state agencies, including the Department of Human Services.

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 2016, the department refunded about \$2.5 million to the federal government because of the excess fund balance at the end of fiscal year 2014. In addition, in fiscal year 2017, the department refunded nearly \$4.2 million because of the excess fund balance at the end of fiscal year 2015. The department expects that in fiscal year 2018, it will again need to make a refund to the federal government because of the excess fund balance at the end of fiscal year 2016.

Recommendations

- *The Department of Management and Budget should ensure that the Office of MN.IT Services sets rates for information technology services that break-even with the costs of those services.*
- *The Department of Management and Budget and the Office of MN.IT Services should work with the federal government and state agencies to determine how to resolve overcharges.*

²⁴ We did not quantify the amount MN.IT may have undercharged the federal Medical Assistance program.





March 21, 2017

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 roles in setting and approving internal service fund 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:

For fiscal year 2016, the Department of Management and Budget approved rates for centralized information technology services that exceeded the cost of those services and overcharged federal programs. This is a repeat finding.

Recommendations:

The Department of Management and Budget and the Office of MN.IT Services should ensure that the Office of MN.IT Services sets rates for information technology services that break-even with the costs of those services.

The Department of Management and Budget and the Office of MN.IT Services should work with the federal government and state agencies to determine how to resolve overcharges.

Response:

MMB and MN.IT appreciate the Office of the Legislative Auditor's support in our work to correct over- and under-recovering billing rates. MN.IT and MMB have established a rate package for fiscal years (FY) 2018 and FY 2019 that are 100% break-even with the costs of services provided. MMB and MN.IT are committed to future rate packages that will do the same.

Despite this great work that has been done to bring the information technology services rate package into full compliance with state and federal legal requirements for FY 2018 and 2019, we recognize that we cannot change the rates that were charged for FY 2016 or FY 2017.

Since August 2013, MN.IT and MMB have been working to make adjustments to the rate packages for FY 2015, 2016 and 2017 to bring them closer to break-even while taking into consideration agencies' ability to pay. As noted in the report, for FY 2016 MN.IT monitored its product line performance and was able to reduce the over recovery through rebates. For the remainder of FY 2017, MN.IT and MMB will continue to monitor and assess each product line's performance and take actions to minimize over recovery. MN.IT has, and will continue, to adhere to OMB 2 CFR, Part 200 which specifies the four allowable methods for adjusting over billed amounts.

Also, starting in FY 2017, MNIT formed a Financial Steering Team comprised of state agency Chief Financial Officers, Chief Business Technology Officers, and MMB staff to assist MNIT with budget assumptions and rate setting methodology. In the future, we will continue to utilize this group in all our rate-setting processes.

Persons Responsible: Margaret Kelly, Assistant Commissioner MMB
Tu Tong, Chief Financial Officer, MN.IT

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".

Commissioner Myron Frans
Minnesota MMB

A handwritten signature in black ink, appearing to read "Tom Baden".

Commissioner Tom Baden
Minnesota MN.IT

cc: Margaret Kelly, Assistant Commissioner MMB
Tu Tong, Chief Financial Officer, MN.IT

For more information about OLA and to access its reports, go to: www.auditor.leg.state.mn.us.

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