STATEWIDE AUDIT
DEPARTMENT OF FINANCE
MANAGEMENT LETTER
YEAR ENDED JUNE 30, 1985

FEBRUARY 1986

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Mr. Jay Kiedrowski, Commissioner
Department of Finance
309 State Administration Building
St. Paul, Minnesota 55155

Dear Commissioner Kiedrowski:

We have reviewed certain accounting procedures and controls for your department, as part of our statewide audit of the State of Minnesota's fiscal year 1985 financial statements and material federal programs. The scope of our work has been limited to:

- those aspects of your department which have material impact on any of the state's various funds and account groups shown on the financial statements;
- the centralized responsibilities relating to federal funds in the areas of cash management and indirect costs;
- the general EDP controls over Finance systems; and
- the status of prior audit recommendations.

We emphasize that this has not been a complete financial and compliance audit of all programs within your department. However, the Single Audit coverage satisfies the federal government's financial and compliance audit requirements for all federal programs administered by your department in fiscal year 1985. The federal government is ultimately responsible for determining resolution of Single Audit recommendations. The appropriate federal program agency staff will contact your agency to review your efforts toward corrective actions for 1985 and prior years. They will also notify you of their final resolution.

The main text of this management letter contains both our recommendations developed during this audit and a prior audit recommendation which has not yet been fully implemented. The prior audit recommendation repeated in this text is denoted under the caption "PRIOR RECOMMENDATION PARTIALLY IMPLEMENTED." Attached to your management letter is a summary of the progress on all audit recommendations developed during our financial audit of Minnesota's fiscal year 1984 financial statements.

The recommendations included in this letter are presented to assist you in improving accounting procedures and controls. Progress on implementing these recommendations will be reviewed during our audit next year.

<u>Verification of statewide indirect cost fund distributions and follow-up on unpaid reimbursements to the General Fund should be improved</u>.

The Statewide Cost Allocation Plan is prepared in accordance with Minn. Stat. Section 16A.127, Subd. 2. The plan allocates central service costs to the user agencies. Once the plan is approved, the Department of Finance distributes the allocation to the appropriate funds in each agency. This distribution is based upon each fund's operating expenditures (object codes 0XX to 4XX) within the agency. The fund distribution is critical since it specifically determines the amounts to be paid by non-General Fund activities.

For fiscal year 1985, the Statewide Cost Allocation Plan accurately allocated total statewide indirect costs to the state agencies. However, in two instances the fund distribution calculation was inaccurate. Mathematical errors in the preparation of the distributions resulted in the Department of Agriculture Special Revenue Fund activity being undercharged $4,062.

Minn. Stat. Section 16A.127, Subd. 3 requires all activities funded from non-General Fund receipts to transfer the appropriate share of statewide indirect costs to the General Fund or obtain a waiver of the payment requirement. Subd. 5 requires transfers from Federal Funds based on the amount recovered, using the approved indirect cost rate. A Finance memorandum distributed with the fiscal year 1985 statewide indirect cost billings indicated that payment should be made for all funds, except those specifically waived, by June 30, 1985.

As of December 31, 1985, certain agencies had not paid their required statewide indirect cost reimbursements and had not received a waiver from Finance. The Department of Health, the Iron Range Resources and Rehabilitation Board, and the State Auditor's Office, owed a total of $125,512 for non-General Fund activities in fiscal year 1985. The State Auditor's Office also has not paid their statewide indirect cost allocation of $46,210 for fiscal year 1984. In addition, the Departments of Health and Natural Resources, which have federally approved indirect cost rates, have not transferred the statewide indirect costs recovered from federal activities to the General Fund. Although the actual amounts recovered from federal programs are based on a department's approved rate, the federal fund allocations to these agencies, which should approximate collections, totalled $200,000.

Effective control over statewide indirect cost collections requires follow-up on unpaid billings. This should include telephone calls, second billings, and development of an appropriate mechanism to resolve payment disputes. These follow-up efforts will become more critical in fiscal year 1986 with the implementation of Finance Operating Policy and Procedure 06:03:22 which requires quarterly payments of reimbursements to the General Fund.

RECOMMENDATIONS:

1. *To improve control over statewide indirect cost collections, the Department of Finance should:*

   - *implement procedures to review the calculation of fund allocations each year to ensure an accurate distribution among funds;*

- *correct the inaccurate fund distributions and collect the additional amount due to the General Fund for fiscal year 1985; and*

- *develop formal follow-up procedures to enforce timely payment of statewide indirect cost reimbursements to the General Fund.*

<u>The Department of Finance does not verify the adequacy of collateral pledged to secure repurchase agreements</u>.

Minn. Stat. Section 11A.24 authorizes the State Board of Investment (SBI) to purchase various types of short-term securities, including repurchase agreements. A repurchase agreement is a type of short-term investment that consists of two simultaneous transactions. First, the state purchases securities (collateral) from a bank or dealer for cash. At the same time, the selling bank or dealer agrees to repurchase the collateral security at the same price, plus interest, at an agreed upon future date.

Section 11A.24, Subd. 4(e) establishes the requirements for types of collateral which may be pledged for repurchase agreements. Prior to a 1985 amendment, which became effective May 24, 1985, the statute provided that repurchase agreements were limited to securities guaranteed or insured by the United States government or its agencies. The 1985 amendment expanded SBI's investment authority to include repurchase agreements collateralized by letters-of-credit or any other securities authorized in Section 11A.24. SBI's internal policies, which were formally adopted by the board on October 2, 1985, require that the collateral for repurchase agreements have a market value equal to no less than the dollar amount of the transactions, and if more than three years from maturity, have a value of 103 percent of the transaction.

In most instances, the collateral securities are not physically delivered to the state, but remain segregated in a separate account maintained by the bank or securities dealer. Because the state does not take possession of the collateral, it is important that other controls be initiated to ensure security of the investments.

The Department of Finance has certain responsibilities in the system to account for and control investment transactions of the state. The investments for retirement fund assets are processed through the state's master custodian, State Street Bank of Boston. These transactions are subject to certain controls inherent in the master custodian's system. Finance has a limited role in reviewing these investments. For all other funds, Finance is involved in processing and verifying investment activity. While SBI authorizes and initiates the various purchase or sale transactions, Finance maintains the bank account records and performs a control function in verifying the proper recording of all transactions authorized by SBI.

Finance has additional responsibilities relating to repurchase agreements. Shortly after the date of purchase, Finance receives a confirmation of the transaction from the bank or dealer indicating terms of the agreement, including purchase date, maturity date, interest rate, and type of collateral. To verify that transactions initiated by SBI are properly recorded and adequately secured, the Department of Finance should monitor receipt of these confirmations and compare the information to the purchase memos prepared by SBI at time of purchase.

We tested 250 repurchase agreements entered into prior to the change in restrictions on collateral and during the time frame the State Treasurer's Office was responsible for processing investment transactions. Thirty-two of these transactions involved securities not authorized in the statute, such as commercial mortgage loans, bank mortgage loans, or other non-government securities. In addition, we were unable to find confirmations from the broker supporting 18 of the transactions. The inability to locate the confirmations may have been due to a poor filing system or may mean that the repurchase agareements were not properly secured. Although Finance was not responsible for these functions during the period reviewed, the examples cited show the need for improved controls in this area. In order to ensure the safety of these investments, the securities offered as collateral should be checked for compliance with the statutes. In addition, the market value of the securities should be periodically monitored. The trading of repurchase agreements, in general, has come under heavy scrutiny recently. Some dealers have been known to offer low coupon (therefore low market value) securities as collateral, or pledge non-existent securities or the same securities to more than one investor or more than one purchase transaction.

RECOMMENDATION:

2. *The Department of Finance should compare repurchase agreement confirmations from the dealers to the purchase memos received from SBI, and ensure that the collateral pledged is in compliance with statutory requirements and policy guidelines.*

<u>PRIOR RECOMMENDATION PARTIALLY IMPLEMENTED: Inadequate controls exist over insurance premium collections of the Employee Insurance Trust Fund (EITF)</u>.

The EITF was created in October 1983 under the authority of Minn. Stat. Section 43A.31. The Department of Employee Relations has contracted with Blue Cross and Blue Shield of Minnesota, Delta Dental of Minnesota, and the Minnesota Mutual Life Insurance Company to provide insurance coverage on a "minimum premium" approach to funding. The Department of Finance established the EITF to hold these premiums until money is needed for the payment of benefit claims or costs. The implementation of the EITF has produced some key administrative and financial advantages to the state; however, certain internal control weaknesses exist which increase the chance of problems or errors occurring.

Insurance premiums are collected from various payroll centers, including Central Payroll, the University of Minnesota, and other manual payroll systems, through the Minnesota Mutual Life Insurance Company. Current accounting procedures for EITF premium revenues include only a determination that the amount wire transferred from Minnesota Mutual was received and deposited into SWA. No control procedures exist at Finance to ensure that all insurance premiums are being collected and that there are no unpaid or omitted pay periods for a payroll center.

Effective internal controls over EITF premium revenues would require records detailing the timing and amount of insurance disbursements due from each payroll center. This would provide the ability to independently identify omitted insurance premiums in addition to follow up of significant variances between pay periods. The Department of Finance did monitor premiums from each insurance carrier at fiscal year-end to properly accrue revenue for fiscal year 1985.

RECOMMENDATION:

3. *The Department of Finance should establish appropriate control procedures to ensure that all insurance premium funds are collected by the Employee Insurance Trust Fund.*

<u>The method used for calculating bank depository account collateral deficiencies does not comply with the calculation prescribed pursuant to Minn. Stat. Section 9.031, Subd. 5</u>.

On July 1, 1985, the responsibility for maintaining records of collateral at state depository banks was transferred from the State Treasurer's Office to the Department of Finance. In previous management letters to the State Treasurer's Office, we have recommended that the method of calculating bank depository account collateral deficiencies be changed to comply with statutory requirements.

Minn. Stat. Section 9.031, Subd. 5 provides that:

> "The executive council shall prescribe the maximum amount that may be deposited in each depository. In no case shall the amount of the deposit exceed:
>
> (1) the penalty on the bonds;
> (2) 90 percent of the market value of the bonds; or
> (3) the penalty on the bonds plus 90 percent of the market value of the collateral, if both are furnished."

The Department of Finance's collateral status report is programmed to report collateral deficiencies by adding all account balances for a given bank, and subtracting the sum of FDIC insurance ($100,000 per account) and the collateral pledged by the bank. This total is compared to the par value of the pledged bonds and the exceptions are reported. This method is not correct for two reasons:

- the FDIC amount should only be applied to each individual account and not summed and applied to the total of all accounts; and

- the 90 percent of market value requirement should be used, not the par value.

The use of par value rather than the market value and the summation of the FDIC amounts for all accounts applied to the total may result in material unreported collateral deficiencies.

At certain times, large deposits are made at depository banks causing the collateral normally on hand to become insufficient. If the depository bank does not increase the collateral for the account, or if the Department of Finance does not immediately transfer the funds from the depository account, these deposits will be inadequately protected. The use of the collateral status report alone does not accurately indicate if sufficient collateral is maintained at a depository bank, based on the current statutory requirements. Additional analysis should be performed for bank accounts with large daily deposits where the effect of deficiencies in the collateral status reports may be material.

RECOMMENDATION:

4. *The Department of Finance should reprogram the collateral status report so it will accurately analyze the adequacy of collateral pledged for depository accounts or consider alternative approaches to monitor and document the actual cash balances and level of collateral at depository banks.*

<u>The Input Review Unit does not examine all transactions in the daily batch audit program</u>.

The majority of state agencies enter their own disbursement transactions in the Statewide Accounting System (SWA). The supporting documentation for these transactions is then submitted to the Department of Finance in disbursement batches. Each day, the Input Review Unit of the Department of Finance selects a random sample of 100 disbursement transactions for review of supporting documentation. The objectives of this audit function are to review the invoice coding block preparation procedures, batch preparation procedures, and financial accounting presentation for compliance with generally accepted accounting principles, Minnesota statutes and Statewide Accounting policies.

The input review takes place about one week after the transactions were entered, when all batches should be received in Finance. If an agency is late in submitting the supporting documentation the transaction is marked "not found" and never followed up on. In order to ensure themselves of the validity of transactions selected for review, the department should verify the documentation for all items included in the sample. The fact that support is not available for certain transactions should raise more questions as to their propriety.

RECOMMENDATION:

5. *The Input Review Unit should verify the existence and propriety of supporting documentation for all items included in the daily sample of disbursement transactions.*

Thank you for the cooperation extended our staff during this audit.

Sincerely,

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

Attachment

February 20, 1986

DEPARTMENT OF FINANCE

Attachment

STATUS OF PRIOR AUDIT RECOMMENDATIONS
AND

PROGRESS TOWARD IMPLEMENTATION

The Department of Finance should work with state agencies to improve reporting for federal grant financial activity.

1. The Department of Finance should continue to work with the state agencies to improve methods of accounting for federal grant activity so that financial statements are accurately prepared.

Recommendation Implemented.

2. The department should clarify the guidelines for preparation of federal grant financial statements particularly relating to calculation of accruals and match. The department should reconsider the requirement that local match be included in the financial statements.

Recommendation Implemented. The Department of Finance, with approval of the U.S. Department of Agriculture, Office of Inspector General, revised the reporting format for federal program financial statements.

State agencies are not consistently pursuing or accounting for federal reimbursements for indirect costs.

3. The Department of Finance should establish a formal policy relating to the the recovery of departmental indirect cost reimbursements from federal and other dedicated revenue sources. The policy should identify those situations where agencies will not be required to seek reimbursement for these costs.

4. The Department of Finance should request an Attorney General's opinion whether there is specific statutory authority for agencies to retain indirect cost recoveries and use the funds for administrative expenditures.

5. The department should develop uniform guidelines for control and use of reimbursements received for agency administrative costs paid from the General Fund.

Recommendations Implemented. The Department of Finance has adopted Operating Policy and Procedure 06:03:22 which establishes a formal policy governing indirect cost reimbursements.

The Department of Finance does not receive adequate documentation supporting reimbursements to the General Fund for statewide indirect costs.

6. The department should develop a system for monitoring indirect cost reimbursements to the General Fund. The agencies should be required to document the specific federal programs for which reimbursement was received and the basis for the calculation of amounts received.

Recommendation Implemented. The Department of Finance Operating Policy and Procedure 06:03:22 requires agencies to submit a standard payment document identifying specific programs and calculation of the indirect cost payment to the General Fund.

Weaknesses exist in the documentation and methods for preparation of the Statewide Cost Allocation Plan.

7. The Department of Finance should retain adequate documentation for all adjustments to the allocation basis for the Statewide Cost Allocation Plan.

Recommendation Implemented. Weaknesses existed in the fiscal year 1985 Statewide Cost Allocation Plan which was prepared prior to our last audit. Improvements were made in the allocation basis utilized in the fiscal year 1986 Statewide Cost Allocation Plan.

Department of Finance monitoring of federal indirect cost proposals prepared by state agencies requires improvement.

8. The Department of Finance should ensure that an indirect cost proposal or waiver request, and a copy of the final negotiated indirect cost rate agreement, are obtained from all state agencies receiving federal funding.

9. The department should work with the various state agencies and apppropriate federal agencies to ensure that final federal approval is obtained for agency indirect cost plans and that provisional indirect cost rates are approved for use during any interim period prior to final approval.

10. The department should verify that current statewide cost allocations are properly included in departmental indirect cost plans prior to approval.

Recommendations Implemented. The Department of Finance has improved monitoring of indirect cost plans, rates, and federal approvals. The status of indirect cost plans and approvals are reviewed each year as part of Operating Policy and Procedure 06:03:23 on federal fund applications. As a part of the review process, Finance determines that current allocations are properly included in the departmental indirect cost plans.

<u>The federal cash management procedures at various state agencies require improvement</u>.

11. The Department of Finance should continue to work with state agencies to improve procedures for estimating future cash needs to ensure that federal requirements, as presented in U.S. Treasury Circular 1075, are being followed.

12. The department should continue to monitor future developments in federal cash management policy and review the various changes in state procedures which would be necessary to implement the suggested options.

Recommendations Implemented. The Department of Finance has worked with the various state agencies to improve procedures over cash management. Developments in federal policies have been monitored and the progress of various pilot projects throughout the country have also been monitored. The U.S. Department of Agriculture, Food and Nutrition Service, which has been assigned responsibility for resolving cash management issues, in November 1985 approved the state's progress in this area.

<u>There are inadequate controls over the insurance premium collections and benefit payments of the EITF</u>.

13. The Department of Finance should establish appropriate control procedures to ensure that all insurance premium funds are collected by the Employee Insurance Trust Fund.

RECOMMENDATION NOT IMPLEMENTED. See current recommendation #3.

14. The Departments of Finance and Employee Relations should establish internal control procedures to periodically compare benefits (claims) paid by the insurance carriers to an effective insurance policy. This could be performed by examining detailed claims or by evaluating the insurance carrier's system.

Recommendation Implemented.

<u>No control procedures exist to ensure that contractual limitations are not exceeded</u>.

15. The Department of Finance should establish control procedures to recalculate the contractual maximum limitations and ensure that the limitations are not being exceeded.

Recommendation Implemented. Finance is now recalculating and monitoring contractual maximum limitations utilizing additional data provided from each insurance carrier.

The following findings were reported in the management letter to the State Treasurer's Office in fiscal year 1984. The status is included in this management letter because the recommendations relate to functions currently performed by the Department of Finance.

The State Treasurer's Office does not receive reports of principal and interest payments made to registered bond holders by the state's paying agent.

1. The State Treasurer's Office should continue to work with the paying agent to establish a formal mechanism for reporting principal and interest payments made to bond holders, and any unpaid or unclaimed balances.

Recommendation Implemented by the Department of Finance.

The method used for calculating bank depository account collateral deficiencies does not comply with the calculation prescribed pursuant to Minn. Stat. Section 9.031, Subd. 5.

2. The Treasurer's Office should reprogram the collateral status report so it will accurately analyze the adequacy of collateral pledged for depository accounts or develop other records to monitor and document the average cash balances and level of collateral at depository banks.

RECOMMENDATION NOT IMPLEMENTED. See current recommendation #4.

Written operating procedures are needed for the several working sections of the State Treasurer's Office.

3. Detailed written operating procedures should be developed for the several working sections of the State Treasurer's Office.

RECOMMENDATION WITHDRAWN. Because of the transfer of functions to the Department of Finance, this issue will be reviewed in line with new organization and structure for activities.

STATE OF MINNESOTA
DEPARTMENT OF FINANCE
309 STATE ADMINISTRATION BUILDING
SAINT PAUL, MINNESOTA 55155

612-296-5900

February 20, 1986

James R. Nobles, Legislative Auditor
and
John Asmussen, CPA, Deputy Legislative Auditor
Veterans Service Building
St. Paul, MN 55155

Jim John

Dear Mr. ~~Nobles~~ and Mr. ~~Asmussen~~:

Thank you for the opportunity to respond to the comments and recommendations in your management letter. Our response is attached.

We appreciate your assistance and recommendations. We are very pleased that, for the first time, you were able to give us an unqualified opinion on the state's annual financial statements. Thank you for your willingness to review, on a timely basis, our plans for the steps that were needed to eliminate the last qualifications from previous years.

Sincerely,

Jay

Jay Kiedrowski
Commissioner

ES/JK/GB/sks/209T

Attachment

DEPARTMENT OF FINANCE RESPONSE

1. The 1985 indirect cost billings contained two errors in the distribution by fund. Adjustments have been made. Energy and Economic Development's adjustments affected fund 30; since the amount paid is based on their agency indirect cost plan, a revised billing was not necessary. A corrected billing has been sent to the Department of Agriculture for fund 20. We will notify your office when payment is received.

   We are continuing our collection efforts for all amounts still due the general fund for 1985. Our policy continues to be that possible agency cash flow problems is not of itself sufficient reason to waive payment. Four agencies were mentioned as not having completed payment of 1985 indirect costs.

   Health - has not paid their 1985 federal recovery due to cash flow problems. We have requested they submit a memorandum outlining their proposed payment schedule.

   Natural Resources - has paid its federal indirect cost, but has outstanding amounts for funds waived in past years. They have promised to submit a waiver request for these funds.

   State Auditor - has been contacted about paying both their 1984 and 1985 billings, an answer has not been received. A memorandum will be sent requesting their payment schedule. This fund is experiencing cash flow problems.

   IRRRB - the amounts due are additional charges to the 24 and 58 funds for indirect costs billed because of activity in the Jobs and Training Department. The agency will be required to provide a written response to our billing or make payment.

   We have always followed up on past due amounts through collection telephone calls and memorandums. However, we accept your recommendation and will incorporate the steps taken to collect unpaid billings into Finance Operating Policy and Procedure 06:03:22.

2. We agree with your recommendation and implemented it on January 2, 1986.

3. The Department of Finance is keeping an on-going log of deposits by payroll center. The log is kept by payroll frequency (bi-weekly, monthly, etc.). In this way we can determine that there are no unpaid or omitted pay periods for a payroll center.

Minnesota Mutual has also agreed to give us a dollar breakdown for each payroll center. This will be entered into the log and monitored on a continuing basis. We will continue this procedure with the insurance company until the Department of Employee Relations implements their system in F.Y. 1988.

4. We agree with your recommendation. The calculation of bank collateral requirements are computer generated. Extensive computer reprogramming will be required to properly calculate the collateral deficiencies as recommended. The recommendation will be implemented upon completion of the reprogramming.

5. We agree with your recommendation and implemented it on February 4, 1986.