OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Management Letter

Department of Finance
Fiscal Year Ended June 30, 2003

MARCH 19, 2004 **04-18**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota state government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of representatives and senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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All OLA reports are available at our Web Site: http://www.auditor.leg.state.mn.us

If you have comments about our work, or you want to suggest an audit, investigation, or evaluation, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Jeanine Leifeld, CPA, CISA	Audit Manager
Chris Buse, CPA, CISA, CISSP	Audit Manager
Michael Hassing, CPA	Audit Director
Mark Mathison, CPA, CISA	IT Audit Director
Patrick Ryan	Team Leader
Doreen Bragstad, CPA	Auditor
Kathy Fisher, CPA	Auditor
Susan Mady	Auditor
Ellen Sibley, CPA	Auditor
April Snyder	Auditor

Exit Conference

We discussed the findings and recommendations in this report with the following representatives of the Department of Finance at the exit conference held on March 10, 2004:

Peggy Ingison	Commissioner
Anne Barry	Deputy Commissioner
Lori Mo	Assistant Commissioner, Accounting Services and Information Technology
Barb Ruckheim	Financial Reporting Director
Ron Mavetz	Director, Agency Assistance
Everett Hageman	General Accounting Supervisor

Report Summary

Key Audit Conclusions

- We issued an unqualified audit opinion, dated December 5, 2003, on the State of Minnesota's basic financial statements for the year ended June 30, 2003. In accordance with *Government Auditing Standards*, we also issued our report, dated December 5, 2003, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants. In March 2004, we will issue our report on compliance with requirements applicable to each major federal program and internal control over compliance in accordance with the U.S. Office of Management and Budget's Circular A-133.

Key Findings and Recommendations

- Three state agencies submitted erroneous or incomplete accounting information to the Department of Finance; some of the exceptions could have resulted in material errors in the state's financial statements. We recommended that the Department of Finance work with the affected agencies to ensure they prepare accurate information for financial reporting. We also recommended that the department enhance its process for determining liabilities to be reported in the financial statements. (Finding 1, page 3)

- The Department of Finance has not ensured that state departments properly account for financial activities in agency funds. As a result, we posted audit adjustments of $14.5 million to correct agency fund financial statement amounts. We recommended the department develop a policy for state agencies to follow to properly account for agency fund activities. (Finding 2, page 4)

- A component of the state's accounting system (the Contract Financial Management Subsystem) erroneously reports information that understated liabilities in the state's financial statements by up to $9 million. We recommended that the department ensure that the correct information in CFMS is used so that liabilities are accurately recorded in the state's financial statements. (Finding 3, page 5)

Management letters address internal control weaknesses and noncompliance issues we identified during our audit of the state's financial statements and federally funded programs. The scope of our work in the Department of Finance was limited to those activities administered by the department that were material to the State of Minnesota's basic financial statements and federal financial assistance programs for the fiscal year ended June 30, 2003. Our work in the Department of Finance focused primarily on preparation of the state's basic financial statements as well as certain of the department's statewide financial management responsibilities relating to cash and debt management, payroll, and the state's accounting system.

Representative Tim Wilkin, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Peggy Ingison, Commissioner
Department of Finance

We have performed certain audit procedures at the Department of Finance as part of our audit of the basic financial statements of the State of Minnesota as of and for the year ended June 30, 2003. We also audited the state's compliance with applicable requirements governing the administration of federal awards for the year ended June 30, 2003, as described in the U.S. Office of Management and Budget's *Circular A-133 Compliance Supplement.* We emphasize that this has not been a comprehensive audit of the Department of Finance.

The Department of Finance is responsible for statewide financial planning and reporting. The department prepares the *Comprehensive Annual Financial Report* that contains the state's basic financial statements. The department also prepares the *Financial and Compliance Report of Federally Assisted Programs* (Single Audit report) each year. The department manages the state's main accounting systems, coordinates the sale of state general obligation bonds, enters into master lease purchase agreements for state agencies, processes payments of some appropriations and grants, and provides guidance to other state agencies in areas of financial management.

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.

Conclusions

We issued an unqualified audit opinion, dated December 5, 2003, on the State of Minnesota's basic financial statements for the year ended June 30, 2003. In accordance with *Government Auditing Standards*, we also issued our report, dated December 5, 2003, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants. In March 2004, we will issue our report on compliance with requirements applicable to each major federal program and internal control over compliance in accordance with the U.S. Office of Management and Budget's Circular A-133.

As a result of our financial statement audit, we identified some internal control weaknesses over financial reporting that we discuss in the following findings.

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Department of Finance

1. Three state agencies submitted erroneous or incomplete accounting information to the Department of Finance; some of the exceptions could have resulted in material errors in the state's financial statements.

The Department of Finance oversees and coordinates the reporting of financial activity in the state's financial statements and schedule of federal expenditures. To meet these responsibilities, it informed state agencies of applicable accounting requirements, provided checklists and memorandums documenting the requirements, and analyzed various financial transactions recorded in the state's accounting systems. Even with this guidance, we found the following errors in the accounting information submitted by the departments of Transportation (MnDOT), Employment and Economic Development (DEED), and Public Safety (DPS) that negatively impacted the accuracy of the state's financial reporting process.

- Our audit of infrastructure and right-of-way capital outlay expenditures at MnDOT resulted in the following audit adjustments.

  -- MnDOT did not use capital asset codes in the state's accounting system to ensure that $161 million in expenditures would be capitalized on the state's financial statements.

  -- Capital outlay expenditures were overstated in the General Fund and understated in the Trunk Highway Fund by $56 million for infrastructure and right of way costs that should have been transferred between the two funds pursuant to 2003 Laws of Minnesota, 1st Special Session, Chapter 19, Article 4, Section 2.

  -- MnDOT processed $1.3 million in expenditure corrections that erroneously increased rather than decreased capital outlay; capitalized approximately $600,000 in right of way costs that should not have been capitalized; and excluded $200,000 in right of way costs that should have been capitalized.

- We noted several inaccuracies with the financial statement and federal program accounting information submitted by DEED, including the following:

  -- The Unemployment Insurance (UI) Fund's financial statements included a negative cash balance of $11 million that should have been reclassified as a loan payable to the federal government.

  -- DEED did not provide sufficient information for the Department of Finance to efficiently report operating transfers involving the UI Fund. The Department of Finance identified and worked to resolve this problem while balancing the interfund activity to be reported in the state's financial statements. The UI Fund received $2.8 million from other state funds and transferred $53 million to other state funds. Since the UI Fund is not accounted for in the state's accounting system, DEED must provide supplemental information to ensure proper financial reporting of transfer activity between the UI Fund and other state funds.

-- The Department of Economic Security reported both accumulated federal expenditures and annual federal expenditures to the Department of Finance for the Single Audit report. The Department of Finance erroneously included the accumulated totals, rather than the annual totals, resulting in an audit adjustment totaling over $200 million. DEED also erroneously included a state match of $16.4 million in its federal expenditure amounts.

- The Department of Public Safety (DPS) erroneously certified encumbrance liabilities to the Department of Finance for inclusion in the state's financial statements. As a result, the department overstated the accrued liability in the state's Federal Fund and government-wide financial statements for fiscal year 2003 by approximately $25 million. The Department of Finance provided instructions and a report of outstanding encumbrances to DPS as of September 8, 2003. However, DPS did not understand the financial reporting implications of the report and certified the entire amount as a prior year obligation, instead of only certifying the amount related to the goods and services the department had received as of June 30, 2003.

The Department of Finance appropriately delegates responsibility to all state agencies for the proper reporting of financial activities. The department is, however, ultimately responsible for the accurate presentation of the information in the state's financial statements.

Recommendations

- *The Department of Finance should work with the departments of Transportation, Employment and Economic Development, and Public Safety to help ensure they provide accurate information to be included in the state's financial statements.*

- *The Department of Finance should compare unliquidated encumbrances near the end of the financial reporting process to amounts certified by state agencies and follow up on unusual variances.*

2. The Department of Finance has not ensured that state departments properly account for financial activities recorded in agency funds.

The Department of Finance has not sufficiently analyzed the state's agency funds to determine to what extent the funds contain internal clearing account activities that should be reported in other funds when preparing the state's financial statements. In fiscal year 2003, we submitted audit adjustments totaling $14.5 million to clear out agency fund financial amounts that should have been recorded in other state operating funds. We also found that the Department of Revenue had not cleared out balances of approximately $4.6 million that had accumulated over a number of years from its local and state sales tax clearing account.

Department of Finance

State departments use agency funds to account for a variety of financial activities. According to generally accepted accounting principles, an agency fund is a fiduciary fund used to account for assets held by a governmental unit in a trustee or safekeeping capacity, or as an agent for third parties. A common use of agency funds is to temporarily account for financial activities that ultimately should be reported in other state operating funds. Several of the state's agency funds have a mix of third party and internal activity. For example, agency funds include state and local sales taxes, resident and guardianship deposits, the state's central postage operation, revenue recapture collections, and collections for mineral and timber sales on state land. Once clearing account activity is eliminated from agency funds, the agency funds should consist only of assets held on behalf of third parties.

Recommendation

- *The Department of Finance should develop a policy on the use of agency funds to ensure that:*

  -- *state agencies promptly clear out activity that should be accounted for in other funds; and*

  -- *the department obtains necessary information to eliminate internal clearing account activity from the basic financial statements, and the process ensures that ending balances in agency funds only represent assets held on behalf of third parties.*

3. The Contract Financial Management Subsystem (CFMS), a component of the state's accounting system, understated financial statement liabilities in the accounting module in fiscal year 2003.

State agencies use CFMS to process payments for professional/technical or lease-type contracts. When a state agency has not ensured that funds are available prior to incurring obligations, as required by Minn. Stat. Section 16A.15, Subd. 3, the accounting personnel record in CFMS that a violation of statute has occurred. Agency accountants also record the date when the goods or services were received, which is the date that determines when the liabilities should be included in the state's financial statements. When agencies had not verified the availability of funds in compliance with statute, CFMS erroneously recorded the payment date as the date the state incurred the liability. In fiscal year 2003, we identified about 1,100 payment transactions totaling up to $9 million that should have been included as liabilities in the state's financial statements. We limited our tests to individual transactions that the Department of Finance would not have tested centrally.

Recommendation

- *The Department of Finance should ensure that the date goods or services are received as recorded in CFMS is used to determine the state's liabilities for financial reporting.*

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Finance. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 19, 2004.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

End of Fieldwork: January 30, 2004

Report Signed On: March 15, 2004

Status of Prior Audit Issues
As of January 30, 2004

March 13, 2003, Legislative Audit Report 03-17 examined the department's activities and programs material to the State of Minnesota's *Comprehensive Annual Financial Report* and the Single Audit for the year ended June 30, 2002. Our audit work focused on the department's preparation of the state's financial statements and its centralized responsibilities. The financial statement scope included cash and debt management, capital assets, payroll, and various loan programs. The Single Audit scope covered compliance with federal requirements relating to cash management and statewide indirect costs. The report contained three findings. The first finding stated that the department did not properly secure the financial statement preparation databases and queries. The second issue reported that the department published inconsistent budgetary financial reports and that the preliminary budgetary financial statements contained significant errors and omissions. The third finding identified that the financial reporting unit did not ensure the accuracy and completeness of some financial information provided by other state agencies for inclusion in the state's financial statements. The department implemented each of the recommendations.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the metropolitan agencies, or the State Agricultural Society, the state constitutional officers, or the judicial branch.

State of Minnesota
Department of Finance

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March 12, 2004

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

Dear Mr. Nobles:

Thank you for the opportunity to discuss your findings related to the Department of Finance audit. We are committed to providing accurate financial information to state agencies, the legislature, and the public. We will continue to work toward improvements in our processes.

Recommendation

The Department of Finance should work with the departments of Transportation, Employment and Economic Development, and Public Safety to help ensure they provide accurate information to be included in the state's financial statements. The Department of Finance should compare unliquidated encumbrances near the end of the financial reporting process to amounts certified by state agencies and follow up on unusual variances.

Response

We agree. The Department of Finance staff will continue to work with the departments of Transportation, Employment and Economic Development, and Public Safety to assure that the departments provide complete and accurate information for the state's financial statements. Department of Finance staff will continue to provide specific instructions and further clarification as necessary to ensure accurate information is included in the financial statements and single audit reporting.

The Department of Finance will expand the review procedures during the financial reporting process to help assure that information submitted by agencies is reasonable. Significant unusual variances will be investigated as part of this procedure.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 1, 2004

Recommendation

The Department of Finance should develop a policy on the use of agency funds.

Response

"We agree. In January, we began a project to review all agency fund accounts. The department will revise procedures governing proper use of the agency fund, including which activity must be accounted for in other funds. During the implementation of these procedures, the department will work with agencies to clear out transactions and balances that are not appropriate for the agency fund.

The Department of Finance will also develop a policy regarding the information agencies must submit to the department for proper elimination of internal clearing account activity from the ending balance in the agency fund. The department will include a procedure that assures the agency fund's ending balance solely represent assets held on behalf of third parties.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: July 31, 2004

Recommendation

The Department of Finance should ensure that the date goods or services are received as recorded in CFMS is used to determine the state's liabilities for financial reporting.

Response

We agree. As an immediate solution, we will develop a query to identify the correct liability date for CFMS obligations. In the longer term, we will explore whether or not a system modification should be considered to address this issue.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: September 30, 2004

In addition to these recommendations, we found your staffs verbal comments helpful to our efforts to improve the quality and efficiency of financial statement preparation.

Sincerely,

/s/ Peggy Ingison

Peggy Ingison
Commissioner