OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Minnesota Higher Education Services Office

Fiscal Years 2001 through 2003

MAY 20, 2004 **04-22**

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.

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

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

Representative Tim Wilkin, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Susan Heegaard, Director
Minnesota Higher Education Services Office

We have audited selected areas of the Minnesota Higher Education Services Office (MHESO) for the period July 1, 2000, through June 30, 2003. Our audit scope was limited to state financial aid grants and loans, and contracts. The Report Summary highlights our overall audit conclusions. The specific audit objectives and conclusions are contained in the individual chapters of this report.

We selected MHESO for audit based on our annual assessment of state agencies and programs. We used various criteria to determine the entities to audit, including the size and type of each agency's financial operations, length of time since the last audit, changes in organizational structure and key personnel, and available audit resources.

We conducted our audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of MHESO's internal controls relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission, as our criteria to evaluate agency controls.

The standards also require that we plan the audit to provide reasonable assurance that MHESO complied with financial-related legal provisions that are significant to the audit. In determining MHESO's compliance with legal provisions, we considered requirements of laws, regulations, contracts, and grant agreements.

To meet the audit objectives, we gained an understanding of MHESO's financial policies and procedures. We considered the risk of misstatements in the accounting records and noncompliance with relevant legal provisions. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined a sample of evidence supporting the agency's internal controls and compliance with laws, regulations, contracts, and grant provisions.

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

End of Fieldwork: February 24, 2004
Report Signed On: May 18, 2004

Room 140, 658 Cedar Street, St. Paul, Minnesota 55155-1603 • Tel: 651/296-4708 • Fax: 651/296-4712
E-mail: auditor@state.mn.us • TDD Relay: 651/297-5353 • Website: www.auditor.leg.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
Brad White, CPA, CISA	Audit Manager
Tony Toscano	Auditor-in-Charge
Kathy Fisher, CPA	Auditor

Exit Conference

We discussed the results of the audit with the following staff of the Minnesota Higher Education Services Office at an exit conference on May 10, 2004:

Susan Heegaard	Director
Tim Geraghty	Director of Financial Services
Danette Jerry	Financial Services Manager

Report Summary

Key Conclusion:

The Minnesota Higher Education Services Office (MHESO) properly allocated and monitored state financial aid paid to post-secondary institutions and trade schools and had appropriate oversight of the contractor hired to manage its student loan program. However, we identified some isolated concerns with contracting practices.

Finding and Recommendation:

- MHESO did not always document contractor selection and concerns were raised with contract length, estimated payments, and obligation dates. (Finding 1, page 9)

- The office should seek clarification of statutory language requiring that Minnesota College Savings Plan assets be held in the state treasury. (Finding 2, page 10)

The audit report contained 2 audit findings relating to internal control or legal compliance. The office resolved all findings included in our prior audit report.

Audit Scope:

<u>Audit Period:</u>
Fiscal Years 2001-2003

<u>Selected Audit Areas:</u>
- Financial Aid Grants
- Student Educational Loan Fund (SELF)
- Contracts

Agency Background:

The MHESO administers state financial aid grant and loan programs. The office issued over $133 million of state grants in fiscal year 2003. Outstanding loan balances totaled $433 million at June 30, 2003.

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Chapter 1. Introduction

The Minnesota Higher Education Services Office (MHESO) has several core responsibilities including:

- administration of state financial aid grant and loan programs;
- negotiation and administration of statewide interstate tuition reciprocity programs;
- publication and distribution of information about academic and financial preparation, including financial aid;
- approval, registration, and licensure of private colleges and career schools; and
- oversight of statewide library service programs that improve access to information and support cost-effective library operations.

MHESO is primarily funded by General Fund appropriations. The Legislature appropriated $160,527,000, $164,959,000, and $150,845,000 for fiscal years 2001, 2002, and 2003, respectively. MHESO is also authorized to issue revenue bonds to provide funding for Student Educational Loan Fund (SELF) loans. A CPA firm annually audits the financial statements of the Minnesota Higher Education Services Office and provides an independent auditor's report. For fiscal year 2003, the MHESO received an unqualified opinion indicating financial statement balances were fairly presented in conformity with accounting principles generally accepted in the United States of America.

During the time period covered by our audit, MHESO was under the leadership of Dr. Robert Poch. Based on legislative changes made last year, the director is now a cabinet-level position and serves as the Governor's chief advisor on higher education policies and issues. In February 2004, Governor Tim Pawlenty appointed Susan Heegaard to the director position.

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Chapter 2. State Financial Aid Grants

Chapter Conclusions

The Minnesota Higher Education Services Office (MHESO) properly allocated and monitored state financial aid provided to eligible post-secondary educational institutions and trade schools. We noted improved cash management practices for the state grant program. The office also issued licenses to qualified post-secondary education institutions and conducted periodic internal audits of institution-determined student eligibility.

Audit Objectives

Our audit of work-study, childcare, and state grants focused on the following questions:

- Did the office properly allocate and effectively monitor state grant, work-study, and childcare amounts paid to eligible post-secondary institutions?

- Did the office have processes ensuring eligibility of post-secondary institutions receiving state financial aid and independent verification of student eligibility determined by those institutions?

Background

MHESO received General Fund appropriations to finance state financial aid grants, work-study, and childcare grants. The state grant program provides aid to eligible Minnesota residents attending post-secondary educational institutions in the state. Eligible institutions include the University of Minnesota, MnSCU two-year and four-year institutions, and private two-year and four-year colleges and universities. Students at several private trade and career schools are also eligible.

The office advances state grant funds to post-secondary institutions based on their estimated state grant awards for each term. The institutions determine student eligibility for state grants, calculate the award amounts, and disburse the funds to the students. The office requires institutions to submit electronic reports of state grant expenditures on a monthly basis. The office imports the data into its mainframe database, which contains a series of edits to verify certain aspects of student eligibility and grant amounts. The office accepts grant disbursements that pass the edits and uses the information to monitor the cash on hand at institutions and request the return of advances, if necessary.

Minnesota Higher Education Services Office

Our previous audit, Legislative Audit Report 01-45, raised concern about cash management practices for the state grant program. The office responded to this concern, in July 2003, by modifying its policies to limit initial advances to 90 percent of the amount estimated. The office disbursed the full grant amount if the school had transmitted its actual student awards for the upcoming academic year.

The office also allocated funding to the schools for the state childcare grant program and the state work-study program. Initial childcare advances were calculated based on the schools student population and family sizes, while work-study allocations were based on previous utilization of funds by the various institutions.

MHESO received General Fund appropriations to finance state financial aid grants, work-study, and childcare grants. During the audit period, the office disbursed the grant amounts shown in Table 2-1.

Table 2-1
State Grant Expenditures by Type
Fiscal Years 2001, 2002, and 2003

	FY 2001	FY 2002	FY 2003 (Note 1)
State Grants	$115,749,764	$125,619,336	$133,590,250
Work-Study Program	12,887,617	12,262,074	0
Childcare Grants	4,697,162	4,637,634	1,084,355
Total	$133,334,543	$142,519,044	$134,674,605

Note 1: Due to a projected deficiency in money available for state grants, Laws of Minnesota (2002), Ch. 374, Art. 4, Sec 2 authorized the transfer of work-study and childcare grant appropriations to the state grant program.

Source: MHESO State Financial Aid Fund Balances and Spending History Report dated December 3, 2003.

Minn. Stat. Chapter 141 outlines the requirements for licensure of institutions. The office is responsible for screening the institutions and ensuring they meet the standards necessary for students to receive state financial aid grant funding. Besides a review of an institution's curriculum, the office performs an evaluation of its financial viability. Once licensed, an institution is able to package and award state financial aid grants for its students.

The office employed a team of internal auditors who examined each institution's packaging and awarding practices. They conducted audits on a rotating basis and issued formal reports to management addressing any concerns or compliance problems. The internal auditors also assisted with financial analysis of new institutions or schools that apply for licensure.

There were no written findings as a result of our work in this area.

Chapter 3. Student Educational Loan Fund (SELF) Program

Chapter Conclusions

The Minnesota Higher Education Services Offices (MHESO) properly administered the Student Educational Loan Fund (SELF) Program. Its control activities provided assurance regarding student eligibility and required documentation for loans issued. For the items tested, the office ensured that borrowing was within loan limits, and signed promissory notes were obtained and cosigned.

The office provided appropriate oversight of the contractor that manages student loan balances. The office ensured that total monthly cash flows from loan activity reconciled with detailed student loan balances maintained by the contractor. MHESO's control activities helped ensure proper loan repayment, timely deposit of loan principal and interest payments, and collection of defaulted loans.

Audit Objectives

Our review of the Student Educational Loan Fund (SELF) Program focused on the following questions:

- Did MHESO properly administer the SELF Program by ensuring eligibility of loan recipients, enforcing borrowing limits, and obtaining signed promissory notes from borrowers?
- Did the office provide adequate oversight of the contractor hired to manage student loan accounts?
- Did the office ensure timely repayment of loan balances?

Background

MHESO distributes SELF loans to post-secondary students who have exhausted all eligibility for certain other forms of financial aid. Funding for SELF loans is generated by the sale of revenue bonds. The MHESO sold $75 million of revenue bonds during fiscal year 2003. Principal and interest repayments generate funds to repay the bonds and increase the SELF funds uncommitted fund balance available for further borrowing. During the 2003 Legislative Session, MHESO was required to transfer $30 million of its uncommitted SELF fund balance to the state's General Fund to assist in balancing the state's budget deficit.

Eligibility for a SELF loan is determined at the university, college, or trade school. An eligible student must be enrolled at least half time, possess satisfactory academic progress, not be in default or delinquent in payment on any other student loan, and have a credit worthy cosigner. The loan is reviewed and approved at MHESO. Undergraduate loans are limited to $4,500 per year for a student in post-secondary grade levels 1 and 2, and $6,000 for grade levels 3, 4, and 5 with a cumulative maximum debt of $25,000. The maximum loan amount for graduate students is $9,000 per year with a cumulative maximum of $40,000.

Table 3-1 shows the total student loan balances by type at June 30, 2001, 2002, and 2003.

Table 3-1
SELF Loan Receivables
June 30, 2001, 2002, and 2003

	2001	2002	2003
Student Educational Loan Program (SELF)	$314,539,919	$371,372,209	$429,571,579
Graduated Repayment Income Protection (GRIP)	4,977,364	4,019,034	3,010,801
Guaranteed Student Loans (GSL)	1,433,732	1,038,569	749,175
Total	$320,951,015	$376,429,812	$433,331,555

Note: The Guaranteed Student Loans (GSL) and Graduated Repayment Income Protection (GRIP) loans are no longer distributed to students but are still being recovered. GSL was a federally guaranteed program that was discontinued in 1988. The GRIP program, discontinued in 1995, makes the monthly loan payment to the lender for medical students graduating with high loan amounts. These borrowers make smaller loan repayments to MHESO upon graduation and higher loan repayments later in their career.

Source: Higher Education Services Office.

MHESO contracted with Firstmark Services, a loan servicing organization, to distribute loans to the borrowers and collect loan interest and principal payments. Firstmark Services invoiced the borrowers for interest and principal payments. Borrowers paid interest quarterly while attending school and monthly for the first 12 months after graduation or after dropping to half-time enrollment. Principal payments begin 12 to 36 months after termination from school. Interest and principal payments are received by Firstmark Services and recorded in the borrower's account. MHESO monitors the detailed loan activity managed by Firstmark Services. MHESO paid the organization an approximate annual fee of $4.8 million, as discussed in Chapter 4.

Because of the outsourced arrangement, we evaluated MHESO's oversight of the contractor hired to manage individual student loan accounts. The primary control activity included reviewing cash outflows for new loans and cash inflows for loan interest and repayments. In addition, defaulted accounts presented for write-off were monitored. This control activity helped ensure that the contractor's detailed loan activity agreed with the total outstanding SELF loan receivable balance.

MHESO is responsible for pursuing loans in default. When Firstmark Services determines that a loan is in default, the information is transferred to MHESO for further action. MHESO provides the borrower with one last chance to make payment. If payment is not made, MHESO files a claim against the borrower's or cosigner's tax refunds. If satisfactory arrangements are still not made, the loan is referred to the Minnesota Collection Enterprise or outside collection agencies to assist in recovery. The default loan balance at June 30, 2003, was $11,612,140.

There were no written findings as a result of our work in this area.

Chapter 4. Contracts

Chapter Conclusions

Generally, MHESO's control activities ensured compliance with state contract guidelines. In addition, payment controls ensured proper encumbrance of funds and payment for work performed. However, we noted a variety of isolated instances such as one contract that exceeded a five-year period and two contracts that did not have contractor selection documentation. In addition, one contractor submitted estimated invoices for payment or lacked itemized details supporting work completed. A more extensive problem was noted with incorrect coding of obligation dates in the state's accounting system.

The office properly captured program responsibilities and outsourced relationships in written contractual agreements with external parties. However, MHESO should seek clarification of the statutory language regarding deposit of Minnesota College Savings Plan assets in the state treasury.

Audit Objective

Our review of professional-technical contracts, educational program contracts, and other outsource contractual arrangements focused on the following question:

- Did MHESO have appropriate controls to ensure compliance with contracting requirements?

Background

MHESO provides financial and educational services to help students attend post-secondary education. Many of the services require the Higher Education Services Office to contract with other entities and outside vendors for professional technical services. MHESO spent approximately $39 million during the audit period for a variety of contractual services.

Student Educational Loan Fund (SELF)

MHESO contracts with Firstmark Services to provide student loan servicing. The office authorizes the student loans and sends funding with the award data electronically to the contractor. Firstmark Services disburses loan payments to student borrowers through the post-secondary schools. The contractor also is responsible for collecting the principal and interest due on the loans and remitting collections to MHESO, as discussed in Chapter 3. The office pays the contractor an approximate annual fee of $4.8 million.

Minnesota College Savings Plan

The Minnesota College Savings Plan was developed as a way to encourage individuals and families to save for post-secondary education. A parent, grandparent, or other individual can establish an account for an account beneficiary who will attend college in the future. Earnings in the account are tax deferred while invested and tax free when distributed for qualified higher education expenses.

Minnesota Statutes Chapter 136G establishes the Minnesota College Savings Plan and designates the director of MHESO as the plan administrator. MHESO entered into a management agreement with TIA-CREF Tuition Financing Inc. to handle administration of the plan. The cost of the agreement is paid by the account holders through an annual fee of 0.65 percent. As of June 30, 2003, total plan assets were approximately $127 million. An independent audit is performed annually to provide assurance to MHESO and investors.

MINITEX

MINITEX is a library resource-sharing program created by the Legislature in 1971 with the mission of facilitating resource sharing among libraries and reducing the cost of providing access to information for residents throughout Minnesota, North Dakota, and South Dakota. The office received General Fund appropriations to operate the program for post-secondary educational institutions in Minnesota. The office contracted with the Department of Education, public libraries in Minnesota, and public libraries in North and South Dakota to participate in the program.

The office enters into a contract with the University of Minnesota to administer the program. The office also contracts with the Online Computer Library Center, located in Ohio, to provide an on-line library-sharing catalog for the MINITEX program. We reviewed the contract with the Online Computer Library Center, that began in 1979, along with annual amendments to update prices for services. MHESO pays the contractor approximately $2.2 million annually and recovers the costs from users of the system.

The Minnesota Library Information Network (MnLINK)

The office received a $12 million General Fund appropriation in fiscal year 1998 to implement MnLINK, which is a statewide virtual library. The appropriation is available to the office until MnLINK is fully implemented. MnLINK consists of two components: the Integrated Library System and the Gateway.

The Integrated Library System component is a shared library automation system for the University of Minnesota, MnSCU, Minnesota state agencies, and other participating libraries. The office signed a contract with Ex Libris-USA, Inc., to provide the Integrated Library System software.

Minnesota Higher Education Services Office

The Gateway is software that facilitates electronic access to various library resources. It connects the online catalogs of 21 Minnesota library systems so they appear as a single source of information. The Gateway allows users to simultaneously search libraries throughout the state for specified library resources. The office contracted with MnSCU to administer the operations of the Gateway central site and with 21 Minnesota library systems to operate Gateway server sites.

Findings and Recommendations

1. MHESO contracts did not always follow state contract guidelines.

MHESO needs to more consistently follow state contract requirements as follows:

- One MHESO contract contained a longer term than is allowed for in state statute. Minn. Stat. Section 16C.05, Subd. 2(3)(b) provides that *"The combined contract and amendments must not exceed five years …The term of the original contract must not exceed two years unless the commissioner determines that a longer duration is in the best interest of the state."* The contract for computerized library cataloging services was originally entered into in 1979 and has been continually amended for rate changes since then.

- Documentation for the scoring and evaluation of request for proposals was not retained for two of the three contracts requiring a request for proposal. The office advertised for contractor proposals, evaluated the proposals, and chose the vendor with the best value. However, contractor selection and evaluation scoring could not be located. The office's record retention schedule specifies that these accounting records be retained for four years.

- MHESO paid one contractor based on partial estimates or invoices lacking itemized detail. The contract required that the vendor be paid upon the submission of an itemized invoice for work actually performed, or upon completion of a specific phase of the project.

- MHESO did not always post the correct obligation dates when entering contract payments. For 23 of 38 payments tested, incorrect obligation dates were recorded in the accounting system. Obligation dates, also called record dates, identify the point of state obligation and represent the date that the goods or services were received. Failure to use the proper obligation dates could result in an understatement of liabilities in the office's financial statements.

Recommendation

- *The office should improve controls over contracting by:*
  - *renegotiating contracts before reaching the statutory time limit,*
  - *retaining contractor evaluation and selection documentation when requests for proposals were solicited,*
  - *paying contractors for work completed based on itemized invoices, and*

- *ensuring that record dates for payments accurately reflect the date that the contract services were received.*

2. Minnesota College Savings Plan assets were not held in the state treasury.

MHESO did not structure the assets of the Minnesota College Savings Plan to be held in the state treasury as required in statute. Minn. Stat. Section 136G.09, Subd. 12 states in part that "*…All assets of the plan, including contributions to accounts and matching grant accounts and earnings, are held in trust for the exclusive benefit of account owners and beneficiaries. Assets must be held in a separate account in the state treasury to be known as the Minnesota college savings plan account. Plan assets are not subject to claims by creditors of the state, are not part of the general fund, and are not subject to appropriation by the state.*"

Currently, plan assets are externally managed and invested. MHESO contracts for the administration of plan finances while the Minnesota State Board of Investment contracts for investment management. An independent auditor audits the plan's financial statements annually. We recognize that the externally managed arrangement may provide an efficient administrative structure. However, we recommend that the office seek clarification of the statute relating to the college savings plan assets and consider initiating statutory changes to conform with current practice.

Recommendation

- *MHESO needs to seek clarification of the statute relating to the Minnesota college savings plan and, if necessary, work with the Legislature to change the governing statutory language.*

Status of Prior Audit Issues
As of February 24, 2004

Most Recent Audit

<u>Legislative Audit Report 01-45,</u> issued in September 2001, covered the three fiscal years ending June 30, 2000. The scope included state grants, interstate tuition reciprocity, educational resource sharing programs, and various administrative expenditures. The office resolved all six issues contained in the report.

Other Audit Coverage

The Minnesota Higher Education Services Office contracted with Deloitte and Touche, LLP, an independent CPA firm, to audit the office's financial statements. MHESO received an unqualified opinion for fiscal year 2003. As part of the audit, the firm issued an internal control and compliance report to the MHESO council. The report contained some observations on accounting and administrative matters. The office is currently working to resolve those issues.

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 and quasi-state organizations, such as the metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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Minnesota
Higher Education
Services Office

1450 Energy Park Drive, Suite 350
Saint Paul, MN 55108-5227

Telephone: (651) 642-0533
(800) 657-3866
Financial Aid: (651) 642-5067

Fax: (651)642-0675
Email: info@heso.state.mn.us
Internet: www.mheso.state.mn.us

For the Hearing Impaired
TTY Relay: (800) 627-3529

May 17, 2004

Mr. James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140, Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles:

With this letter the Minnesota Higher Education Services Office (HESO) conveys its response to the audit report prepared by your office on selected HESO financial activities. We appreciate the professional manner in which the audit was conducted and believe that our financial operations and processes are improved as a result.

Our agency will work diligently to ensure that the key findings and recommendations contained within the audit continue to be addressed responsibly.

Thank you for a positive and productive audit process.

Sincerely,

/s/ Susan Heegaard

Susan Heegaard
Director

cc: Claudia J. Gudvangen
Brad White

Higher Education Services Office

Recommendations

Finding 1. *MHESO did not always document contractor selection and concerns were raised with the contract length, estimated payments, and obligation dates.*

The Office should improve controls over contracting by:

- *Renegotiating contract before reaching the statutory time limit*
- *Retaining contractor evaluation and selection documentation when requests for proposals were solicited*
- *Paying contractors for work completed based on itemized invoices*
- *Ensuring that record dates for payments accurately reflect the date that the contract services were received*

HESO response to: *Renegotiating contract before reaching the statutory time limit*

The Office acknowledges the contract with the Ohio College Library Center exceeds the 5 year statutory limit for state contracts. The Office agrees to work with the vendor, the Attorney General's office, the Department of Administration and the University of Minnesota to research the complex issues surrounding the services provided to the Minitex program under this contract and to work towards a mutually agreeable solution.

HESO response to: *Retaining contractor evaluation and selection documentation when requests for proposals were solicited*

The Office does have a record retention policy. The Office will remind and train appropriate staff of the policy and the importance of retaining RFP responses and evaluations.

HESO response to: *Paying contractors for work completed based on itemized invoices*

The Office has reviewed the specific invoices in question for the particular vendor and agrees to require more detailed invoices from the vendor in the future.

HESO response to: *Ensuring that record dates for payments accurately reflect the date that the contract services were received*

The Office is now entering the end date instead of the begin date for services invoiced. For the incorrect dates entered due to MAPS functionality, the Office is awaiting further direction from the Department of Finance.

Higher Education Services Office

Finding 2. *The Office should seek clarification of statutory language requiring that Minnesota College Savings Plan assets be held in the state treasury.*

- *MHESO needs to seek clarification of the statute relating to the Minnesota College Savings Plan and, if necessary, work with the Legislature to change the governing statutory language.*

HESO response to: *MHESO needs to seek clarification of the statute relating to the Minnesota College Savings Plan and, if necessary, work with the Legislature to change the governing statutory language*

The Office will consult with the Attorney General's office and recommend appropriate statutory changes.