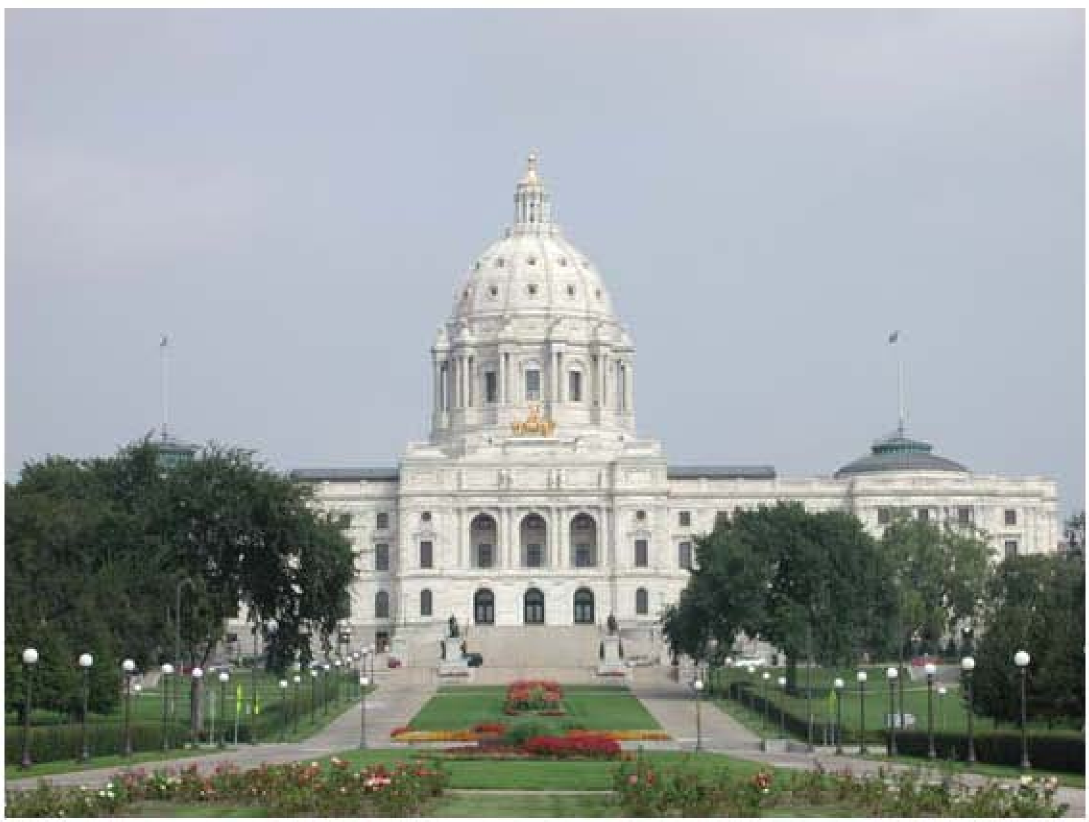
O L A **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

Financial Audit Division Report

Department of Finance

Fiscal Year 2005



March 16, 2006 **06-11**

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Michael Hassing, CPA	Audit Director
Laura Peterson, CPA	Auditor
Patrick Phillips, CPA	Auditor
Steven Johnson, CPA, CISA	Auditor
Scott Tjomsland, CPA	Auditor
Laurinda Zavala	Auditor
Mark Bahnsen	Intern

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, 2006:

Peggy Ingison	Commissioner
Lori Mo	Assistant Commissioner Accounting and Information Services
Barb Ruckheim	Financial Reporting Director

Report Summary

Key Conclusions:

- Although we issued an unqualified audit opinion on the State of Minnesota's basic financial statements for the year ended June 30, 2005, we concluded there are weaknesses in the state's financial reporting process as described below.

Key Findings:

- We proposed, and the Department of Finance made, numerous audit adjustments to the state's fiscal year 2005 preliminary financial statements. This demonstrates that there are weaknesses in the state's financial reporting process, which the department needs to resolve. (Finding 1, page 3)

- The Departments of Transportation and Finance did not properly account for reimbursements of construction project costs received from local units of government. This error resulted in a prior period adjustment of $37.8 million and an additional adjustment of $24.5 million to this year's financial statements. (Finding 2, page 4)

- The Department of Finance gave seven employees broad clearances to the state's main accounting system. The level of clearance resulted in incompatible access to the accounting system without mitigating controls. (Finding 3, page 5)

Background Information:

The Department of Finance is responsible for preparing the state's basic financial statements. The department also has certain statewide financial management responsibilities relating to cash and debt management, payroll, and the administration of the state's accounting system.

The audit report contained three findings related to internal control over financial reporting and incompatible access to the state's accounting system.

Senator Ann H. Rest, 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, 2005. We also audited the state's compliance with applicable requirements governing the administration of federal awards for the year ended June 30, 2005, 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* (the Single Audit report) each year. The department manages the state's main accounting systems, coordinates the sale of state general obligation bonds, processes payments for 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 November 18, 2005, on the State of Minnesota's basic financial statements for the year ended June 30, 2005. In accordance with *Government Auditing Standards*, we also issued our report, dated November 18, 2005, 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 2006, 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.

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Department of Finance

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

Findings and Recommendations

1. The Department of Finance submitted preliminary financial statements for audit that required significant adjustments.

The number and size of audit adjustments we proposed, and the Department of Finance made, to the state's preliminary financial statements this year demonstrate that there are weaknesses in the State of Minnesota's financial reporting process. This year we proposed numerous audit adjustments resulting in significant changes to the state's preliminary financial statements. Five adjustments that reclassified revenue and expenditure amounts on the financial statements exceeded $80 million each; three of these adjustments impacted the University of Minnesota, a major component unit, and one adjustment impacted the Federal Fund, another major fund. We proposed about 20 additional adjustments that individually ranged between $10 million and $50 million. In addition, we proposed many other adjustments that each totaled between $1 million and $5 million.

We are concerned that the department's financial reporting process did not identify the necessity for the adjustments prior to our involvement. On the other hand, the department believes its final procedures to reconcile amounts within the financial statements and footnotes would have detected the need for many of the adjustments. The department acknowledges, however, that it completes many of these control procedures several weeks after it has provided the preliminary financial statements to us. Management is responsible for preparing the financial statements, and our role as auditors is to determine whether the financial statements prepared by management are fairly presented. While the extent of the audit adjustments is of significant concern, ultimately, we issued an unqualified opinion on the state's financial statements because we concluded that the adjusted statements were fairly presented in accordance with generally accepted accounting principles.

Most of the proposed audit adjustments resulted in reclassifications of revenue and expenditure amounts. The materiality of the adjustments resulting in reclassifications, which are not as critical as adjustments affecting fund balance or net assets, could lead a financial statement user to draw erroneous conclusions if the amounts had not been adjusted.

In addition to our proposed audit adjustments, we also worked with Finance and other state agency staff to make further adjustments to the preliminary financial statement amounts. Those adjustments included an accrual for tobacco settlement revenue of $85.8 million that was similar to an audit adjustment made in fiscal year 2004. We also worked with employees from the Department of Employment and Economic Development and Finance to make an adjustment of $20 million to the financial statements of the Unemployment Insurance Fund, a major fund in the state's financial statements.

There are several factors that the Department of Finance will need to evaluate in order to improve the financial reporting process. The department needs to strengthen its coordination efforts with accounting personnel in other state agencies. Sometimes, state agencies process transactions in the accounting system that need to be treated differently for financial statement presentation. The department will also need to determine if the accounting personnel in other state agencies need additional training or oversight to prepare financial statements that are materially correct and to reduce the reliance on audit adjustments.

Internally, the department will need to determine if it has sufficient resources, in terms of numbers of employees and appropriate job classifications, to prepare accurate financial statements. In recent years, the department has devoted fewer resources to financial statement preparation and, due to personnel turnover, has had less-experienced staff preparing financial statements. Also, the financial reporting unit needs to strengthen its quality control procedures. Some of this year's adjustments should have been identified by Finance staff since they were similar to last year. In addition, more timely procedures to analyze and follow up on significant variances between years would have identified several of the audit adjustments we proposed.

The Department of Finance has a conscientious and dedicated staff that are responsible for preparing the state's financial statements. The department has been very responsive in resolving specific findings and recommendations related to the financial reporting process in the past. However, unless the department addresses the weaknesses in the process described above, the need for significant audit adjustments to the state's preliminary financial statements will likely continue to exist.

Recommendation

- *The Department of Finance should analyze the state's financial reporting process to identify changes necessary to improve the effectiveness of the financial reporting process. The analysis should consider:*
  - *how to achieve more effective coordination with other state agency accounting personnel;*
  - *whether the department has committed sufficient resources to the financial reporting process; and*
  - *ways to improve the internal quality control procedures over financial statement preparation and the timing of those procedures.*

2. The departments of Transportation and Finance did not properly account for reimbursements of construction costs received from local units of government in the state's financial statements.

The departments of Transportation (MnDOT) and Finance did not reduce the infrastructure balance in the state's financial statements for the reimbursements MnDOT received from other governments for jointly-funded construction projects. As a result, MnDOT and the Department of Finance overstated the infrastructure asset balance in the state's preliminary financial statements by $62.3 million: $37.8 million for reimbursements in prior years and $24.5 million for reimbursements in fiscal year 2005.

Periodically, MnDOT agrees to manage and pay for the entire construction project costs involving work done for both the state and other governmental entities. For example, MnDOT may manage all aspects of a construction project involving the intersection of a state trunk highway and a county road, including improvements to the county road. In these circumstances, the local governments agree to reimburse MnDOT for the local government's share of the project costs. According to generally accepted accounting principles, the state should only report as assets those constructions costs that apply to the infrastructure assets it owns.

Recommendation

- *The departments of Transportation and Finance should work together to accurately report the infrastructure balance in the state's financial statements by reducing the balance for reimbursements received for jointly–funded construction projects.*

3. The Department of Finance gave several employees incompatible access to the state's accounting system.

The Department of Finance had seven employees with broad clearances to the state's main accounting system. These individuals have the ability to update vendor payment files, encumber funds, and process payments. In addition, these users had clearance to update the financial data for all state agencies. Generally, the functions of maintaining vendor data, encumbering funds, and making payments should be segregated to provide an appropriate level of control over expenditures. The risks of errors and improprieties increases when employees have access to incompatible functions in the accounting system.

If restricting these employees' access is not feasible, the department should establish mitigating controls to detect possible errors or irregularities. According to the department's security policy:[1] "Agencies requesting security profiles with incompatible functions should develop and adhere to a written plan which contains a description of the independent reviews to be performed." However, the department did not have the required plan addressing these seven employees' incompatible clearances. Independent reviews could be an effective control to address the level of clearance provided to these employees.

Recommendation

- *The Department of Finance should eliminate incompatible access to the accounting system, or develop and follow a written plan to mitigate the lack of control regarding incompatible access.*

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 16, 2006.

[1] MAPS Security and Access Policy #1101-07

Department of Finance

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: February 10, 2006

Report Signed On: March 15, 2006

Status of Prior Audit Issues
As of January 31, 2006

March 17, 2005, Legislative Audit Report 05-19 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, 2004. Our audit work focused primarily on the department's preparation of the state's basic financial statements as well as certain of the department's statewide financial management responsibilities related to cash and debt management, payroll, and maintaining the state's accounting system. The Single Audit scope covered the department's compliance with federal requirements relating to cash management and statewide indirect costs. The report contained three findings. First, the department did not have an adequate process for reporting capital equipment amounts in the financial statements. Second, the department did not have an adequate process for preparing the budgetary financial statements included in the State of Minnesota's *Comprehensive Annual Financial Report*. Third, the department did not accurately measure and report the state's compensated absences liability for state workers. The department substantially implemented all of the recommendations pertaining to these findings.

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 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 15, 2006

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 audit findings for the Department of Finance audit. We place a high priority on issuing financial statements with unqualified audit opinions and receiving the "Certificate of Achievement for Excellence in Financial Reporting" from the Government Finance Officers Association. We value your comments and suggestions on improvements in our processes to ensure we continue to meet these standards in financial reporting.

Recommendation

The Department of Finance should analyze the state's financial reporting process to identify changes necessary to improve the effectiveness of the financial reporting process.

Response

We are committed to issuing timely, accurate financial statements. The state's accounting system operates primarily on a modified cash basis of accounting and requires a significant amount of adjustments to get to a GAAP basis. Over time, we have made improvements in the process to capture and automate many of these adjustments. We continue to work with many other agencies to obtain the necessary information to prepare additional adjustments as necessary.

We recognize the importance of information received from other agencies. We will continue to work with agencies on improving financial reporting information accuracy. We are in the process of implementing a statewide Code of Conduct policy that supports the preparation of accurate and reliable financial statements in accordance with GAAP by increasing accountability and strengthening governance. In addition, we have recently rewritten our internal control policy to clarify the requirements for agencies to ensure proper internal controls are in place to provide reliable financial reporting information. Training is being provided on these policies to all state agencies with accounting, auditing, financial reporting, and tax filing duties. We also plan to enhance communications with agencies and continue to provide training to ensure accurate receipt of information to be included in the financial statements.

In order to issue more timely financial statements, some of the reconciliations and analytical review procedures were completed after the preliminary fund financial statements were sent to the auditors. To strengthen the process, the following changes will be implemented:

- Change the fund financial statement completion schedule to ensure adequate time to perform and document analytical reviews prior to sending the fund statements to the auditors.
- Review the documentation for the larger funds by an independent accountant to ensure fund files are complete and properly documented.
- Strengthen checklist on adjustments included in each fund file to ensure proper understanding and sign-offs on completion.
- Consider earlier preparation of note information associated with agency prepared funds and component units, as the fund is completed.
- Consider earlier review of the interfund reports prior to sending fund statements to the auditors, while recognizing that subsequent adjustments may be necessary.

The additional resources needed to accomplish these changes will likely come from timeline adjustments rather than devoting additional staff to the preparation of the financial statements.

We also recognize the financial reporting unit has experienced significant turnover in recent years. We have been and will continue to work on retention issues in this area. In addition, we are committed to adequately training and developing staff to ensure they have the skills necessary to prepare accurate and reliable financial statements.

As we look at changes in our budget process and systems, we will consider your suggestions to identify opportunities to simplify and streamline recording of transactions in the state's accounting system to reduce the need for adjustments in the financial reporting process.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: December 31, 2006

Recommendation

The departments of Transportation and Finance should work together to accurately report the infrastructure balance in the state's financial statements by reducing the balance for reimbursements received for jointly- funded construction projects.

Response

We will continue to work with the Department of Transportation to ensure the amounts reported to us for inclusion in the state's financial statements accurately reflect only the state's portion of infrastructure.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 31, 2006

Recommendation

The Department of Finance should eliminate incompatible access to the accounting system, or develop and follow a written plan to mitigate the lack of control regarding incompatible access.

Response

We have determined that eliminating the incompatible functions is preferable to implementing mitigating controls. The system access to process payments has been removed for the seven employees.

Person Responsible: Ron Mavetz, Agency Support Director

Implementation Date: Completed

Sincerely,

Peggy S. Ingison

Peggy S. Ingison
Commissioner