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OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Report on Internal Control Over Statewide Financial Reporting

Year Ended June 30, 2010

February 18, 2011 **Report 11-02**

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Legislative Audit Commission

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Mr. James Schowalter, Commissioner
Department of Management and Budget

In auditing the State of Minnesota's basic financial statements for the year ended June 30, 2010, we considered the state's internal controls over financial reporting and tested the state's compliance with significant legal provisions impacting the basic financial statements. This report contains our findings and recommendations on internal control over the state's financial reporting process taken as a whole. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the State of Minnesota's internal controls or compliance. In addition, our work may not have identified all significant control deficiencies or instances of noncompliance with legal requirements.

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 *Government Auditing Standards*, issued by the Comptroller General of the United States.

We consider all five of the deficiencies included in the report, which relate to the preparation of the basic financial statements, to be material weaknesses. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

Individual agency responses to our findings and recommendations are presented in the accompanying section of this report titled, *Agencies Responses.* We did not audit the responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the State of Minnesota's management, the Legislative Audit Commission, and federal grantor agencies; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit the distribution of this report, which was released as a public document on February 18, 2011.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: December 20, 2010
Report Signed On: February 14, 2011

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Report Summary

Conclusion

The State of Minnesota's financial statements were fairly stated in all material respects. However, the state continued to have weaknesses in internal control over financial reporting, as noted below.

Our audit report contains five findings related to controls over the preparation of the state's financial statements. Each finding includes concerns from our previous audit that have not been fully resolved.[1]

Findings

- Prior Finding Partially Resolved: Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements. (Finding 1, page 3)
- Prior Finding Partially Resolved: Several agencies allowed employees to have inappropriate access to state business systems or perform incompatible duties without establishing mitigating controls. (Includes prior audit findings not resolved for three agencies.) (Finding 2, page 6)
- Prior Finding Partially Resolved: The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements. (Includes prior audit finding not resolved for one agency.) (Finding 3, page 9)
- Prior Finding Partially Resolved: The Department of Management and Budget did not always prepare accurate footnote disclosures to the financial statements. (Includes prior audit finding not resolved for one agency.) (Finding 4, page 13)
- Prior Finding Partially Resolved: The Department of Human Services did not reconcile child care assistance subsystem data to the state's accounting system and did not reconcile the healthcare accounts payable reports to the Medicaid Management Information System data warehouse. (Finding 5, page 14)

Audit Scope

We audited the state's financial statements for the fiscal year ended June 30, 2010. Our audit encompassed work at many large state agencies that managed financial activities that were significant to the financial statements.

Background

The Department of Management and Budget is responsible for preparing the state's annual financial statements, which are included in the *State of Minnesota's Comprehensive Annual Financial Report*. To prepare the statements, the department uses information from a variety of sources, including information provided by other agencies. The issues contained in this report relate to weaknesses in internal controls in the state's financial reporting process as a whole.

[1] Office of the Legislative Auditor's Financial Audit Division Report 10-01, *Report on Internal Control Over Statewide Financial Reporting*, issued February 11, 2010.

Financial Statement Findings and Recommendations

Finding 1

Prior Finding Partially Resolved: Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements.

Several agencies did not have a comprehensive internal control structure for their financial reporting processes to ensure that they would prevent or detect and correct a material misstatement of the state's financial statements on a timely basis. A comprehensive internal control structure is essential to accurate financial reporting and safeguarding of state resources because the state prepares its financial statements in an environment that has a high risk of error. The financial reporting environment is high risk because of several factors, including, 1) the state's primary accounting system cannot generate accurate financial statements without significant manual calculations and adjusting entries,[2] and 2) the Department of Management and Budget relies on personnel in other state agencies to accurately account for many unique financial transactions according to a complex set of governmental accounting principles. Because the Department of Management and Budget has ultimate, statutory responsibility to prepare the state's annual financial reports, it must rely on the internal control structures of other agencies to provide complete and accurate financial information for inclusion in the state's financial reports. The state's policy on internal control requires each agency head to develop and maintain an effective internal control structure.[3]

During fiscal year 2010, some agencies made sufficient progress in the development of their comprehensive internal control structures to substantially resolve their prior audit findings, as follows:

- The departments of Management and Budget, Employment and Economic Development, and Human Services fully assessed and documented their financial reporting risks.

- Throughout the year, the Department of Management and Budget worked with agencies on financial reporting issues and also conducted training on governmental accounting and internal controls.

[2] On July 1, 2011, the state will implement a new accounting system (SWIFT) that may provide data that is more easily adaptable to the needs of financial reporting.
[3] Department of Management and Budget Policy 0102-01.

- The Department of Management and Budget performed and documented detailed assessments of procedures and risks related to reporting accounts receivable and accounts payable and for implementing the fund balance reporting requirements of a new accounting pronouncement.[4]

Despite this progress, these departments had weaknesses in the monitoring and review processes that allowed some significant errors to occur and not be detected, as further reported in Findings 2 and 3.

No internal control structure can completely eliminate the risk of errors; the occurrence of errors is not necessarily an indication that the overall internal control structure is deficient. As these agencies shift from the design and development of their internal control structures to the monitoring and maintenance of those structures, a key to their ongoing effectiveness will be how well the agencies monitor, modify, and update controls when the controls do not work as expected to prevent or detect errors or in response to changes in policy, personnel, and regulations.

The departments of Education, Revenue, and Transportation, the State Board of Investment, and the Minnesota State Retirement System had not made sufficient progress in their implementation of a comprehensive internal control structure for the fiscal year 2010 financial reporting period. They did not meet the target implementation dates they established when the Office of the Legislative Auditor first reported these internal control structure deficiencies in 2009.[5] The agencies had the following deficiencies:

- The Department of Education began to develop its comprehensive internal control structure by performing a review of its control environment, establishing internal control standards, creating an internal control evaluation tool, and establishing an internal control evaluation questionnaire. However, the department had not fully assessed and documented its financial reporting risks.

- The Department of Revenue made only limited progress toward developing its comprehensive internal control structure; it had not fully assessed and documented its financial reporting risks.

- The Department of Transportation began to develop its comprehensive internal control structure by establishing an executive steering committee and several teams to assess the control environment and internal controls.

[4] Governmental Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.
[5] Office of the Legislative Auditor, Financial Audit Division, Report 09-03, *Report on Internal Control Over Statewide Financial Reporting for the Year Ended June 30, 2008*, issued February 13, 2009.

However, the department had not fully assessed and documented its financial reporting risks.

- The State Board of Investment made only limited progress toward developing its comprehensive internal control structure and had not fully assessed and documented its financial reporting risks.

- The Minnesota State Retirement System began to develop its comprehensive internal control structure by drafting an outline of risks, but had not fully assessed and documented its financial reporting risks. In addition, the system deferred its target date for the development of its comprehensive internal control structure until after June 30, 2011, when it plans to hire an individual whose responsibilities will include that task.

A comprehensive internal control structure has the following key elements:

- Personnel are trained and knowledgeable about financial reporting goals and applicable policies and procedures.
- Management identifies risks associated with financial reporting and develops policies and procedures to effectively address the identified risks.[6]
- Management continuously monitors the effectiveness of the controls, identifies weaknesses and breakdowns in controls, and takes corrective action.
- Management focuses on continual improvement to ensure an acceptable balance between controls and costs.

Findings 2 through 5 identify specific deficiencies in agencies' internal control procedures that created an unacceptable risk of error. It is likely that the state will continue to have weaknesses in its financial reporting process until it operates within a comprehensive internal control structure.

Recommendations

- *The Department of Management and Budget should continue to provide training and oversight to state agencies related to the state's overall financial reporting process and work with those state agencies cited as they continue to develop comprehensive internal control structures for their financial reporting processes and responsibilities.*

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[6] For the state's financial reporting process, "management" includes the Department of Management and Budget and other departments that provide financial information critical to the state's ability to prepare its annual financial reports.

- *The departments of Education, Revenue, and Transportation, the State Board of Investment and the Minnesota State Retirement System should assess risks and develop a comprehensive internal control structure for their financial reporting processes and responsibilities.*

Finding 2

Prior Finding Partially Resolved: Several agencies allowed employees to have inappropriate access to state business systems or perform incompatible duties without establishing mitigating controls.

The departments of Revenue, Education, Human Services, the Minnesota State Retirement System and Management and Budget authorized employees to have inappropriate access to the state's accounting system or agency subsystems. Inappropriate system access is either access to incompatible business functions or access that is not necessary for the employee's specific job duties. Allowing employees to have inappropriate access to business systems or to perform incompatible functions increased the risk that errors or fraud could occur without detection and compromised the integrity of financial transactions underlying the financial statements.

The state's internal control policy requires separation of incompatible duties so no one employee has control over an entire transaction or process that could result in errors or fraudulent transactions going undetected.[7] If agencies are unable to adequately separate incompatible duties, state policies require them to develop and document their controls designed to mitigate the risk that error or fraud will not be detected.[8] These controls typically include some analysis and supervisory review of transactions processed by the employees with inappropriate access. Agency management should document these mitigating controls and monitor that these controls are performed as designed and are effective in reducing the risks.

The agencies had the following system security access weaknesses:

- The Department of Revenue did not design sufficient controls to either prevent or detect $1.9 million of unauthorized tax refunds. Poor system security and other internal control weaknesses allowed one agency employee to initiate 256 inappropriate refunds from January 2005 through September 2010. The department did not sufficiently restrict the employee's computer system access to her job duties or monitor and review the refunds she processed.

- The Department of Revenue gave ten employees incompatible access to the cigarette tax system and the storage room where it stores the cigarette stamps. The department collects cigarette tax from cigarette distributors by selling

[7] Department of Management and Budget Policy 0102-01.
[8] Department of Management and Budget Policy 1101-07 and HR 045.

them cigarette stamps that they affix to each pack of cigarettes. The incompatible access allowed the ten employees to sell the stamps, enter the stamps into the system, fill orders, and conduct stamp inventory. The department typically maintained an inventory of 52 million to 127 million stamps in the storage room, valued from about $82 million to $199 million. By allowing these individuals unlimited access to the stamps and related records, the department has not reduced the risk of fraud or error to an acceptable level.

- Prior Finding Not Resolved: The Department of Education lacked a formal process to grant employees access to its internal business systems or to periodically recertify that ongoing access was appropriate. The department did not have authorized request forms on file for any of the twenty-three employees we tested. Rather, the department granted access to its various business systems through an informal request process, which did not always include specific accesses needed. Without a formal process, the department cannot ensure that employees have only the required access needed to perform their job duties.

- Prior Finding Not Resolved: Five of the twenty-three Department of Education employees in the sample that we tested during the fiscal year 2010 audit had incompatible access to the department's business systems and data. (We had identified four of these five employees as having incompatible access during our fiscal year 2009 audit.) These employees had the ability to add a vendor, establish source data, and create and/or manipulate financial information. The department did not have formalized mitigating controls to monitor the accuracy or appropriateness of these changes, which increased the risk of undetected employee errors or fraud.

- Prior Finding Not Resolved: As of June 30, 2010, the Department of Human Services had fourteen employees who had incompatible security access to the state's accounting system. The incompatible profiles allowed one employee to create purchase orders and pay invoices, three employees to create purchase orders and receive goods, and ten employees to receive goods and pay invoices through the state's accounting system. If the department believed this incompatible access was necessary to the employees' job assignments, it should have designed and documented controls to mitigate the risk of fraud or error. The department modified the access of those employees we cited in the prior audit report, but did not implement controls to prevent new incompatibilities from occurring.

- Prior Finding Not Resolved: The Minnesota State Retirement System did not have adequate documentation, including the identification of incompatible security access profiles, to help managers make informed decisions about the level of security access to grant their staff. During fiscal year 2010, the retirement system had drafted security access profiles but, as of December

2010, it had not finalized the document or required managers to use it to determine employees' system security access.

- Prior Finding Not Resolved: The Minnesota State Retirement System lacked a formal process to periodically review and recertify computer users' access. In fiscal year 2010, the agency did not review any users' access for incompatibilities. Fifty-nine Minnesota State Retirement System employees had incompatible access to the department's business system. Those employees had the ability to change an annuitant's name, address, and bank routing information. Eight of those fifty-nine employees had access to process refunds, of which two had physical access to refund checks, increasing the risk of fraud. Seven of those fifty-nine employees had access to process death records, change bank or annuitant information, and five of those seven employees also had access to update beneficiary information. Two of those fifty-nine employees had access to control the entire annuity process that includes entry, preparation, computation, approval, manager, and reviewer. No mitigating controls existed to prevent or detect inappropriate changes.

The following two bullets relate to previously issued reports for the Department of Human Services and the Department of Management and Budget that contained findings that addressed weaknesses in security access over state business systems that also impacted the state's internal controls over financial reporting:

- In November 2010, we issued a report on the results of our review of the Department of Human Services' information technology controls over its payments to medical providers.[9] The report included findings related to security access and incompatible job duties. We believe these findings are material weaknesses in the state's internal controls over financial reporting because they existed in systems that processed financial transactions that are material to the state's general and federal funds. We restate these findings and the department's responses in Appendix A to this report.

- In July 2010, we issued a report on the results of our review of the Department of Management and Budget's internal controls over its banking and vendor arrangements.[10] This was an internal control and compliance audit of disbursements from the state treasury. It specifically addressed the department's controls over the electronic payments made through the state's accounting and payroll systems and the vendor files maintained in the accounting system. The report included findings related to security access to systems and not-public information and related to the management of the state's vendor files. We believe these findings are significant weaknesses in

[9] Office of the Legislative Auditor, Financial Audit Division, Report 10-34, *Department of Human Services: Healthcare Provider Payment Controls*, issued November 4, 2010.
[10] Office of the Legislative Auditor, Financial Audit Division, Report 10-24, *Department of Management of Budget: Banking and Vendor Controls*, issued July 1, 2010.

the state's internal controls over financial reporting because they existed in state's accounting and payroll systems that processed financial transactions that are material to the state's financial statements. We restate these findings and the department's responses in Appendix B to this report.

Recommendation

- *The agencies cited should ensure that they eliminate unnecessary or incompatible access to state business systems and incompatible duties in state business processes. If agency management determines that it is not possible to eliminate the incompatibilities, it should design, document, and implement mitigating controls and monitor the controls' performance and effectiveness in reducing the risk of error or fraud.*

Finding 3

Prior Finding Partially Resolved: The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

The Department of Management and Budget and the departments of Human Services, Employment and Economic Development, Education, Revenue, and Transportation did not have adequate controls, or the controls were not effective, to prevent and detect errors as they compiled the state's financial statements. We proposed, and the Department of Management and Budget made, adjustments to correct the financial statements and disclosures related to the significant portions of the following errors:

- The Department of Management and Budget did not accurately incorporate audited financial information from a component unit into the state's financial statements. The department did not properly eliminate about $27.7 million from both program revenues and total expenses for activity between the University of Minnesota and the university's component units or affiliated organizations. The university identified the activity as internal between university organizations, but did not properly eliminate it from a summary worksheet provided to the department; the department's review of the university worksheet was not sufficient to identify and correct the error. Financial activity occurring between internal departments of an entity should be eliminated from the financial statements so as to not overstate revenues and expenses.

- The Department of Management and Budget improperly included the operating activity of the Minneapolis Employees Retirement Fund in the preliminary financial statements of both the state's investment trust funds and its pension trust funds. The department did not identify this error. (Until recently, the State Board of Investment had invested the local retirement fund's assets, and the state had reported that activity in its investment trust funds. However, as of June 30, 2010, *Minnesota Statutes*[11] consolidated the local retirement fund into a pension trust fund administered by the Public Employees Retirement System.) In addition, the numbers provided in the preliminary investment trust financial statements - contributions of $267 million, investment income of $126 million, refunds of $399 million – materially misstated the actual operating activity of the fund.

- The Department of Human Services understated accounts payable and expenditures it reported to the Department of Management and Budget by $441.3 million. Due to formula errors in the department's healthcare accounts payable memo, the department's total of the federal fund payable did not include $401.4 million. (The Department of Management and Budget did not detect this error in its review of federal fund accounts payable.) In addition, the department did not accrue the fiscal year 2010 share of the healthcare expenditures for services that started in fiscal year 2010 but ended in fiscal year 2011. As a result, the department understated the federal and general funds payables by $20.3 and $9.4 million, respectively. Lastly, the department understated general fund payables to counties by $10.2 million. The department incorrectly reported half of the total grant amount for calendar year grants to counties rather than the actual amounts it paid to the counties for the fiscal year.

- The Department of Human Services understated accounts receivables and overstated healthcare expenditures by $10.2 million in the general fund, and understated revenues and overstated expenditures by $16.4 million in the federal fund. The department did not recognize the total amount of rebates receivable from drug companies; these rebates offset drug costs included in the healthcare expenditures. Because the drug rebate data from the Center of Medicaid and Medicare Services erroneously had $0 as unit costs for all drugs, the department reported $0 in drug rebate billings in its quarterly accounts receivable memo. Although the department was able to estimate the total of the quarterly billings, it failed to notify the Department of Management and Budget of the omission.

- The Department of Human Services overstated federal fund accounts receivable and grants payable by $7.6 million. The department incorrectly reported to the Department of Management and Budget that it had advanced $7.6 million in federal funds to counties prior to the end of the fiscal year. However, the department did not make the payments to the counties until August 2010. As a result, the Department of Management and Budget incorrectly recorded both a receivable and a payable for the August payment.

[11] *Minnesota Statutes* 2010, 353.50, subd. 5.

- The Department of Employment and Economic Development did not accurately calculate and report accounts receivable for the Unemployment Insurance Fund to the Department of Management and Budget. The department overstated receivables from other states by $2.0 million in its preliminary Unemployment Insurance Fund financial statements; it incorrectly included as receivables amounts it had received in fiscal year 2010. In addition, the department failed to accrue as receivables $2.9 million of fiscal year 2010 unemployment benefits the department paid on behalf of certain employers who reimburse the department for actual benefits paid, rather than paying a quarterly tax amount.

- The Department of Employment and Economic Development did not classify its liability to the federal government as long-term in its preliminary Unemployment Insurance Fund financial statements. As a result, the department did not prepare the additional note disclosures required for long-term liabilities. As of June 30, 2010, the department's loans from the U.S. Treasury to fund unemployment benefit payments totaled $599 million. The department reported this loan as a current liability on the financial statements, implying that it expected to repay the debt within the next fiscal year. The department will not have resources to repay the loan until taxes collected from employers exceeds benefits paid to unemployed workers. The department's Unemployment Insurance Fund projections showed this was unlikely to occur in fiscal year 2011.

- The Department of Education did not have adequate controls to identify and report certain accounts receivable amounts to the Department of Management and Budget for inclusion in the state's financial statements. School districts sometimes owed state funding back to the department, because their actual expenditures for a school year were less than originally expected, and the department recovered these amounts by reducing future aid disbursements to the schools. However, the department did not report $1.3 million of unrecovered overpayments of education grants in the general fund to the Department of Management and Budget as of June 30, 2010. A similar error of $.7 million occurred in the federal fund, but we did not propose a formal adjustment for this immaterial amount.

- The Department of Education did not include all amounts in a data analysis it performed as part of its calculation of the general and federal funds accounts payable amounts. The omitted amounts resulted in a $1.2 million overstatement of accounts payable. Also, the department did not perform a secondary review of the general and federal funds grants payable calculation, which could have identified and corrected these errors. We did not formally propose adjustments for these immaterial amounts.

- Prior Finding Not Resolved: The Department of Revenue did not accurately report accounts payable and receivable amounts to the Department of

Management and Budget for inclusion in the state's financial statements. The amounts reported by the department understated accounts payable by about $1.1 million and accounts receivable by about $5.2 million. Also, the amounts reported by the department misclassified about $36.3 million of accounts receivable as current instead of noncurrent assets. Finally, the department did not reconcile and verify that it accurately recorded various property tax remittances from counties on its internal tracking system, and we identified several errors in that system.

- The Department of Transportation has made significant progress in providing more accurate information for financial reporting; however, the department still had a couple of financial reporting errors for the fiscal year 2010 financial reporting period:

    - Prior Finding Partially Resolved: The Department of Transportation reported incorrect infrastructure and right of way capital asset balances to the Department of Management and Budget for inclusion in the state's financial statements. The department erroneously reduced infrastructure for $1.2 million of receipts related to right of way, which understated infrastructure and overstated right of way. This adjustment did not impact net assets. The department made other immaterial errors in the reporting of infrastructure by inappropriately reducing capital asset balances for expense transactions, reporting expense transactions as capital assets, and omitting accounts payable transactions. The department made similar errors in prior years. In addition, the department's control process did not include a secondary verification of the capital asset amounts submitted to the Department of Management and Budget; a secondary verification may have detected some of the errors.

    - The Department of Transportation made an erroneous $4.8 million payment to a vendor. The department's internal controls failed to prevent or timely detect this error. The department learned of the overpayment when the vendor notified the department. The vendor repaid the overpayment. Without adequate internal controls to prevent or detect and correct overpayments, the state's financial statements may include inaccurate amounts.

The Department of Management and Budget relies on agencies to provide accurate and complete information. The Department of Management and Budget and other agencies' internal reviews of the financial data were not effective to detect the errors noted above. Examples of effective internal review processes include analytical procedures to determine excessive variances between fiscal years, recalculations, and a final supervisory verification of financial data.

Although many of the errors this year were not significant enough to materially misstate the financial statements, the errors indicate that the agencies' processes and procedures for determining financial statement amounts may allow more significant errors to occur without detection.

Recommendations

- *The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements.*

- *The Department of Transportation should ensure that it designs effective invoice approval and payment controls to prevent or detect and correct inaccurate payments on a timely basis.*

Finding 4

Prior Finding Partially Resolved: The Department of Management and Budget did not always prepare accurate footnote disclosures to the financial statements.

Footnote disclosures are an integral part of the financial statements. The department improved its accuracy of reporting footnote disclosures this year. As shown below, however, two of the twenty draft footnote disclosures prepared and reviewed by the Department of Management and Budget contained material errors which required adjustments.

- *Note 2 – Cash, Investments, and Derivative Instruments*: The department overstated the fair value of TBA derivatives by $952 million.[12] Based on information provided by the state's master custodian and discussions its personnel had with representatives of the Governmental Accounting Standards Board, the fair value of TBA derivatives should be net of the related brokerage liability. The error occurred for a variety of reasons, including the state's implementation of a new accounting principle pertaining to derivatives,[13] and the complexity of derivative transactions. Despite some coordinated effort among the department, the State Board of Investment, and the master custodian the draft derivatives disclosure contained a material error.

- Prior Finding Not Resolved, *Note 11 - Operating Lease Agreements*: The department overstated the Minnesota State Colleges and Universities' operating lease agreements by $38.5 million. The colleges and universities did not communicate a late adjustment to the operating lease agreements disclosed in its audited financial statements, thus the draft Note 11

[12] TBA derivatives relate to mortgage-backed securities trades. The term TBA, which stands for "to be announced," is used because the actual mortgage-backed security that will be delivered to fulfill a TBA trade is not designated at the time the trade is made.
[13] Governmental Accounting Standards Board Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.*

disclosure did not agree with the colleges and universities' final financial statements.

The department's review processes did not detect these errors. The financial statements may be misleading if footnote disclosures are inaccurate, inconsistent with financial statement amounts, or missing required information.

Recommendation

- *The Department of Management and Budget should ensure the accuracy of footnote disclosures to the financial statements.*

Finding 5

Prior Finding Partially Resolved: The Department of Human Services did not reconcile child care assistance subsystem data to the state's accounting system and did not reconcile the healthcare accounts payable reports to the Medicaid Management Information System data warehouse.

The Department of Human Services did not consistently reconcile its child care assistance subsystem to the state's accounting system to ensure accurate financial information, as required by state policy.[14] Because the state's accounting system is the primary source of financial information for the state's financial statements, it is essential that the state's accounting system agrees with the underlying detail of financial transactions initiated and recorded in the department's subsystems. In fiscal year 2009, the department did not reconcile any months and, in fiscal year 2010, it sporadically reconciled five out of twelve months.[15] The department used the subsystem to provide approximately $195 million of child care assistance aid in fiscal year 2010.

In addition, the department did not reconcile the August 2010 healthcare accounts payable reports to its Medicaid Management Information System warehouse payment data. The department used these reports to accrue about $87 million of the August 2010 healthcare payments as fiscal year 2010 accounts payable. The department modified one of its three reports for August 2010 because that month had three payment cycles rather than two, as in prior years. Although the modification allowed the department to determine an accounts payable amount consistent with its process for prior years, it complicated the reconciliation to the warehouse data. However, the lack of reconciliation to the warehouse payment data increased the risk that a material misstatement could occur without detection.[16]

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[14] Department of Management and Budget Policy Number 0102-01.

[15] The Department of Human Services performed the reconciliation in October 2009, November 2009, January 2010, February 2010, and March 2010.

[16] Our audit procedures determined that the reported amount reconciled to the Medicaid Management Information System warehouse payment data.

Recommendation

- *The Department of Human Services should establish sufficient controls to ensure that staff complete timely reconciliations between the child care assistance subsystem data and the state's accounting system and reconciles the healthcare payable reports to its Medicaid Management Information System data warehouse.*

Appendix A

In Finding 2 on page 6, we identify weaknesses in security access controls over state business systems. As part of that finding, we refer to our audit of the Department of Human Services information technology controls over its payments to medical providers.[17] The report, issued in November 2010, included ten findings related to weaknesses in the department's internal controls or non compliance with federal or state legal requirements. Two of those findings, Finding 2 and Finding 5, were material weaknesses in the state's internal controls over financial reporting for fiscal year 2010 because the weaknesses existed in systems that processed financial transactions material to the state's general and federal funds. In this appendix, we present the findings and the department's response to the findings, as originally reported.

Finding 2 - The Department of Human Services did not adequately separate incompatible duties in its process for enrolling service providers.

The department did not adequately separate incompatible duties for 20 employees responsible for enrolling providers. Separation of incompatible duties is a fundamental internal control designed to ensure that no one employee or group of employees can perpetrate and conceal errors or fraud in the normal course of their duties. These employees could set up providers in the Medical Assistance system (MMIS), the state's accounting system, and the department's electronic claims submission interface. In addition, the same employees verified licensing information upon initial application. As a result, any one of these employees could set up an invalid provider and make fraudulent payments to that provider without detection. This weakness created an unacceptable risk of fraud.

Recommendation

- *The department should separate incompatible provider enrollment duties.*

Department of Human Services' Response to Finding 2

The department agrees with the recommendation. PE [Provider Enrollment] is currently organized so that each specialist develops an expertise with specific provider types. There are over 70 provider types. There are eighteen enrollment specialists. Nine of them are dedicated to enrolling the 50,000-plus Individual Personal Care Attendants (PCAs) who work for the 800-plus personal care agencies in Minnesota. The other nine specialists have mastered the variety of enrollment requirements attributable to the remaining 70,000-plus providers.

[17] Office of the Legislative Auditor, Financial Audit Division, Report 10-34, *Department of Human Services: Healthcare Provider Payment Controls*, issued November 4, 2010

While license verification is an important part of the enrollment process, there are a number of other elements, from the date of birth of an individual PCA to the names, addresses and Social Security Numbers of the owners and managers of a durable medical equipment provider, also required for enrollment. These elements vary from provider type to provider type. Some provider types' requirements, like Personal Care Provider Organizations (PCPOs), are more complex than others.

PE will meet the challenge presented by this finding by reorganizing the existing staff into two levels. The first level of staff will do the initial processing of documents submitted by new and currently enrolled providers, performing data entry and basic triage, and following up with providers who have missing or incorrect documents. The second level of staff will perform the necessary verification of requirements and activate, terminate or deny the provider's enrollment status. PE will work with Human Resources to determine if this change in structure will require changes to the job descriptions and job class.

Person Responsible: Adrian Alexander, Healthcare Operations Director
Estimated Completion Date: September 30, 2011

Finding 5 - Prior Finding Partially Resolved:[18] The Department of Human Services did not have sufficient controls to limit, monitor, or prevent incompatible or unnecessary access to the Medical Assistance system and the cash and food benefits system.

The department did not sufficiently limit access to the Medical Assistance system (MMIS) and the cash and food benefits system (MAXIS). The National Institute of Standards and Technology's access control standards include documenting the roles, responsibilities, and purpose of access controls, including identifying incompatible duties within and between roles.[19] Additionally, the department did not sufficiently monitor and manage system access to ensure it limited access to employees' job duties. The department had weaknesses in the following areas:

- The department had 25 employees with unnecessary access to create or modify data in the cash and food benefits system's warrant payment file. This file contained the data required for the department to print warrants for certain federal aid recipients.[20]

[18] Office of the Legislative Auditor, Financial Audit Division, Report 07-14, *Department of Human Services: Medicaid Management Information Systems Security Controls*, issued June 7, 2007, Finding 1.
[19] National Institute of Standards and Technology publication 800-53, AC-1, AC-5, AC-6.
[20] Although the department provided most federal food stamp and cash assistance benefits to recipients electronically through the cash and food benefits system, the department also provided some benefits by printing and mailing paper checks.

- The department had 13 staff with incompatible access to the Medical Assistance system. These employees could create or modify provider information, recipients, and claims for reimbursement. This combination would allow the employees to process fictitious transactions through the Medical Assistance system. The department had not detected this incompatible access because it did not have complete and accurate documentation for two of the Medical Assistance system's security groups. One security group had no documentation, and another had inaccurate information. Documentation of security groups is essential to ensure that the department limits employee access to the needs of assigned job duties and to prevent incompatible system access.

By not adequately limiting access to the systems, the department significantly increased its risk of fraud.

Recommendations

- *The department should eliminate unnecessary employee access to the cash and food benefits system's warrant payment file.*
- *The department should eliminate incompatible access to systems when possible or design effective mitigating controls.*
- *The department should ensure its security documentation is complete and accurate.*

Department of Human Services' Response to Finding 5

The department agrees with [the first bullet of] this recommendation. Access for the 25 employees to the warrant payment file was removed July 2010.

Person Responsible: Kate Wulf, TSS Director
Estimated Completion Date: Completed

The department agrees with [the second bullet of] this recommendation. For those staff whose job responsibilities require access which is potentially incompatible, e.g., the ability to pay claims and enroll providers, reports need to be designed, created and reviewed to audit their activities.

Person Responsible: Adrian Alexander, Healthcare Operations Director
Estimated Completion Date: December 31, 2010

The department agrees with [the third bullet of] this recommendation. The Health Care Operations security group documentation is complete and accurate.

Person Responsible: Adrian Alexander, Healthcare Operations Director
Estimated Completion Date: Completed

Appendix B

In Finding 2 on page 6, we identify weaknesses in security access controls over state business systems. As part of that finding, we refer to our audit of the Department of Management and Budgets' information technology controls over its banking and vendor relationships.[21] The report, issued in July 2010, included five findings related to weaknesses in the department's internal controls or non compliance with state policy. Three of those findings (findings 2, 3, and 4) were material weaknesses in the state's internal controls over financial reporting for fiscal year 2010 because the weaknesses existed in systems that processed financial transactions material to the state's general and federal funds. In this appendix, we present the findings and the department's response to the findings, as originally reported.

Finding 2 - Department of Management and Budget did not adequately manage vendor files within the state's accounting system.

The department did not verify the legitimacy of new vendors added to the state's accounting system or changes made to current vendor information, including addresses, phone numbers, and contact names. In addition, the department did not guard against keying errors when entering vendor bank routing and account numbers and did not promptly purge obsolete vendors.

While the department performed some limited procedures, it generally authorized state agencies' requests to establish new vendors or make changes to vendor information without validating important vendor data, such as its tax identification number, address, contact person, or phone number. Department staff asserted that they did not have sufficient resources to validate the hundreds of vendor changes requested each day. However, the department had not fully assessed how it could automate, monitor, or verify, on a sample basis, the validity of this important data. We discussed several additional tests and validation processes the department could consider to enhance its review of vendor information.

The lack of verification of vendor data and data changes increases the risk that the state could process a payment to the wrong vendor or a fictitious vendor. Through the course of our audit, we identified nine questionable vendors receiving state payments, which we referred to the department for further investigation. The department provided plausible explanations for six of these vendors, and as of June 2010, continued to research and investigate the remaining three vendors. Vendor payments to those three accounts from July 1, 2007, through March 23, 2010, totaled $188,058.

[21] Office of the Legislative Auditor, Financial Audit Division, Report 10-24, *Department of Management and Budget: Banking and Vendor Controls*, issued July 1, 2010

Although the department required vendors to submit written EFT request forms when establishing payments via EFT or making changes to certain information, it did not require vendors to document their authorizations for all changes. In addition to changes submitted by state agencies, vendors also contacted the department directly to request changes to their vendor data. The department did not have adequate controls to ensure that all changes were authorized and validated. Changes in vendor information present risks for the state in making accurate and valid payments.

In addition, the department did not have controls to prevent or detect keying errors when entering vendor's banking information into the state's accounting system. The department relied on the bank's validation of the account as its primary control to identify inaccurately input accounts. For example, the department had incorrectly input one of the 29 EFT request forms we tested, but the bank rejected the change because the bank account number was not valid. However, in September 2009, the department incorrectly input another bank account number that was not the vendor's account but was a valid account at the bank; the state subsequently processed payments totaling nearly $30,000 to the wrong account. The error was not discovered until the intended vendor notified the department that it had not received payment.

Finally, the department did not purge obsolete vendors in accordance with its internal procedures.[22] Those procedures require the department to purge vendors that do not have any activity within two years or are designated as one-time-payment vendors, more than 30 days old. As of April 2010, the state's accounting system had over 133,000 active vendors (17 percent of total vendors) that met the criteria to be purged. The department explained that it had not purged vendors because, after the collapse of I-35W bridge in August 2007, the Attorney General's Office had prohibited the department from deleting, overwriting, or otherwise destroying or altering electronic information "relating to the I-35W bridge or any other bridge." We think the department's decision to suspend its automatic purging of inactive vendors was too broad of an interpretation of this directive. Purging inactive vendors is an effective internal control to reduce the risk of inappropriate or fraudulent transactions.

By not maintaining accurate vendor files, the department increased the risk that a state employee with incompatible access to the state's accounting system could process fraudulent payments without detection. As of March 2010, more than 200 employees had incompatible access to the state's accounting system.[23]

[22] Department of Management and Budget internal procedure "Vendor Purge."
[23] Employees could request vendor information, encumber funds, and make disbursements.

Recommendation

- *The department should develop control and monitoring procedures to ensure that vendor information and subsequent changes to that information are valid, accurate, authorized, and current.*

Department of Management and Budget's Response to Finding 2

With the size and complexity of the state's operations, and with approximately 150 new vendors added daily to the accounting system, we have historically relied on agency requests for vendor additions. For changes to existing vendors, we have already strengthened our controls for certain high risk changes. Further controls will be implemented with the new accounting system (SWIFT). When SWIFT is implemented July 2011, vendor information will be entered through a secure self service portal. On-line completion of W-9 information will be required before approval for most vendors. A weekly process has been implemented to verify banking account and routing number changes. A similar duplicate entry system has been designed for the new accounting system. When we have completed research on the remaining vendors identified, we will evaluate the risk and design ongoing controls.

Our regularly scheduled process to purge obsolete vendors was interrupted due to a litigation hold related to the I-35W bridge collapse in August 2007. The instructions for data retention received from the Attorney General's Office were comprehensive; we believe delaying the purge process was the proper response. MMB has recently obtained approval from the Attorney General's Office to purge old data after a backup file has been made and plans to do so are underway.

Person Responsible: Deloris Staffanson, Agency Support Director
Estimated Completion Date: July 2011

Finding 3 - The Department of Management and Budget did not sufficiently restrict access to some data files containing not public vendor information.

The department did not have adequate controls to limit access to data files containing not public vendor and banking information. The department had not monitored or reviewed who had access to these sensitive files. Nearly 200 people and administrative software program accounts from the departments of Management and Budget, Transportation, and Office of Enterprise Technology had unnecessary access to read data files containing not public bank account information used for ACH and warrant payments. In addition, 70 Office of Enterprise Technology staff and administrative software program accounts had unnecessary access to modify these files. While the sensitive ACH files from the state's accounting system were temporarily stored on the Department of Management and Budget's computers and internal network, 13 people had unnecessary modify access.

The ability to read and modify sensitive files used in banking and other processes should be limited to only those people and administrative software program accounts needing that access.[24] By allowing excessive access, the department increased the risk that someone could inappropriately see, use, sell, or change the not public information.

Finally, the department had not assessed its need to monitor unauthorized access to files containing not public data. It had not customized its computers to log key security events. Monitoring is important in detecting and promptly responding to security events to ensure unauthorized individuals have not read or modified the files or data.[25]

Recommendations

- *The department should further restrict employee access to files containing not public data and periodically review the access to ensure it is still needed.*
- *The department should develop a monitoring process to assess unauthorized access to files containing not public data.*

Department of Management and Budget's Response to Finding 3

These recommendations have been and continue to be in place for our agency users. Your recommendations are to apply similar processes for internal, central support staff. We agree this should be done. We have begun to implement internal annual re-certification for MMB staff. We will continue to work with OET to reduce the number of OET individuals required to have clearance to our systems and data to only those determined to be essential to the process. We will certify at least annually the access of our support staff and will place risk mitigation controls around the more sensitive files, including monitoring actions, as recommended. We have already begun to institute a process for the first recommendation above and the other recommendations will follow soon.

Persons Responsible: Deloris Staffanson, Agency Support Director and John Vanderwerf, Chief Technology Officer, working with OET management

Estimated Completion Date: October 2010

[24] National Institute of Standards and Technology 800-53, AC-6 *Least Privilege.*

[25] National Institute of Standards and Technology 800-53, AU-2 *Auditable Events,* AU-3 *Content of Audit Records,* and AU-6 *Audit Review, Analysis and Reporting.*

Finding 4 - The Department of Management and Budget allowed incompatible access to the state's accounting system and unnecessary access to the bank's web-based application.

The department gave five department employees incompatible access to the state's accounting system. These five employees had the ability to cancel electronic payments, reissue those payments via warrants, and update the vendor files. These functions represent unique responsibilities required to be performed only at the department, but not by the same person. The department defined incompatible access for receipt and disbursement functions performed by other state agencies but did not define or monitor incompatible access for its own employees and processes with these unique responsibilities.

The department did not detect or correct inappropriate access the bank provided to five employees of other state agencies. The accesses allowed the employees to perform disbursement transactions from three different state bank accounts. The bank inadvertently established the access when it migrated to a new application. The department did not, however, sufficiently monitor or question this access. We verified that no inappropriate disbursements were made from the three accounts.

State policy requires agencies to limit access to only those functions an employee needs to perform job duties and to avoid allowing incompatible access to accounting systems.[26] The risk of errors and fraud increases when employees have incompatible or excessive access to the state's accounting system and banking applications. Had the department reviewed employees' access, it could have identified and corrected the incompatible and excessive access.

Recommendations

- *The department should eliminate incompatible and unnecessary access to the state's accounting system and banking applications.*

- *The department should identify incompatible security groups that its employees have to perform the department's unique responsibilities.*

- *The department should periodically review employee access to ensure the roles granted are necessary and compatible with their current job functions.*

[26] Department of Management and Budget Policy 1101-07 *Security and Access.*

Department of Management and Budget's Response to Finding 4

The security access for the five MMB employees has been reviewed and access for two of them will be reduced to remove the incompatible functions. For the remaining three employees, access to vendor files will be reviewed to determine whether additional mitigating controls are needed. Access to perform disbursement transactions has been removed for the five state agency employees who were granted access by the bank.

In the future, anytime a migration occurs from one system to another at the bank, treasury staff will ensure all proper changes are made and only appropriate access is granted.

Persons Responsible: Deloris Staffanson, Agency Support Director and Joe Howe, Director of Treasury Operations
Estimated Completion Date: September 2010

February 10, 2011

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

Dear Mr. Nobles:

Thank you for the opportunity to discuss with your staff the audit findings in the Report on Internal Control over Statewide Financial Reporting. Since this report includes all findings statewide, our response will specifically address only those findings related to the Department of Management and Budget. The remainder of the findings will be addressed by the specific agency involved. However, we will continue to work with agencies to ensure all findings in this report are implemented.

We place a high priority on continuing our long history of issuing high quality, accurate financial statements in compliance with Generally Accepted Accounting Principles (GAAP). Our 25-year history of receiving unqualified audit opinions and the "Certificate of Achievement for Excellence in Financial Reporting" from the Government Finance Officers Association is important to us. We value suggestions which will make our existing process even stronger.

Recommendation

Finding 1. Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements.

Response

We appreciate your acknowledgment that we have fully assessed and documented our financial reporting risks as well as performed and documented detailed assessments of procedures and risks related to reporting accounts receivable and accounts payable and implementation of the fund balance reporting requirements of a new accounting pronouncement. We will continue to provide training and oversight to state agencies related to the state's overall financial reporting process and work with the state agencies cited as they continue to develop comprehensive internal control structures for their financial reporting processes and responsibilities.

Person Responsible: Lori Mo, Accounting Services Assistant Commissioner

Implementation Date: December 31, 2011

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Recommendation

Finding 3. The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

Response

We continue to place a high emphasis on our review process. Extensive analysis and supervisory reviews are conducted of work performed by our financial reporting team. These reviews are designed to prevent material misstatements to the financial statements.

We will add additional instructions in our memo to the University of Minnesota (U of M) requesting activity between the University and its component units be properly eliminated against the accounts the activity is reported.

As the state is a very complex reporting entity, significant changes occur each year that require extensive analysis to ensure financial information is properly classified and reported in compliance with GAAP. During the current year, Minneapolis Employees Retirement Fund changed from an investment trust fund to a pension trust fund as a result of new legislation changing the state's fiduciary role. We had numerous meetings/communication with the State Board of Investment and Public Employees Retirement Association to discuss the interpretation of the legislation and the applicable GAAP. Timing of the completion of all of our reviews continues to be a challenge. While we have a process in place to reconcile all of our changes in fund structure after all funds are completed, the investment trust fund was due much earlier in the process and this reconciliation was not yet complete.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: December 31, 2011

Finding 4. The Department of Management and Budget did not always prepare accurate footnote disclosures to the financial statements.

Response

We continue to go through very extensive review processes to ensure all footnote disclosures agree with the financial statements and comply with applicable GAAP.

During the year, we implemented new GAAP relating to derivatives that was very complex and required significant communications with other states, the Government Accounting Standards Board (GASB sets GAAP), the State Board of Investments and the master custodian. Many judgments were necessary to interpret this new GAAP. Guidance was unclear whether the fair value of TBA derivatives should be reported net of related brokerage liabilities or gross until very late in the financial statement preparation process. We will continue to work with other states and GASB to ensure new GAAP is implemented accurately.

We will also stress to the Minnesota State Colleges and Universities that revised notes are sent timely and that the financial statements including the notes to the financial statements are sent to us prior to sending to the Office of the Legislative Auditors.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: December 31, 2011

Again, thank you for the opportunity to discuss and respond to the audit findings of the department. We value your work to improve Minnesota's internal control structure.

Sincerely,

James Schowalter
Commissioner

Minnesota Department of Education

February 14, 2011

James Nobles
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1063

Dear Mr. Nobles:

Thank you for the opportunity to respond to the findings for the Minnesota Department of Education which were included in the audit of the State of Minnesota's financial statements for the year ended June 30, 2010. Specific findings for the Department include findings 1, 2, and 3. The response to each finding, person responsible for implementation and timeframe is included with each finding.

Finding 1: "Prior Finding Partially Resolved: Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements."

OLA Recommendation "The Department of Education should assess risks and develop a comprehensive internal control structure for their financial reporting processes and responsibilities."

The Department agrees with this recommendation and will strengthen the risk assessment and internal control structure. The Department has, and will be working through the guidance being provided by the Internal Controls group at Minnesota Management and Budget. With their direction, along with dedicating staff to accomplishing this task, the Department plans to complete its risk assessment and analysis (and have developed a comprehensive internal control structure) by Dec. 31, 2011. The responsibility for implementation of this finding is with Al Louismet, Agency Accounting Operations Manager.

Finding 2: "Prior Finding Partially Resolved: Several agencies allowed employees to have inappropriate access to state business systems or perform incompatible duties without establishing mitigating controls."

OLA Recommendation: "The agencies citied should ensure that they eliminate unnecessary or incompatible access to state business systems and incompatible duties in state business processes. If

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agency management determines that it is not possible to eliminate the incompatibilities, it should design, document, and implement mitigating controls and monitor the controls' performance and effectiveness in reducing the risk of error or fraud."

MDE IT Division is taking several steps to resolve the audit finding. They are appointing a senior network engineer to the position of CISO (Chief Information Security Officer) and supporting him with additional training for specialty certification needed for full credentialing. They are adding two additional positions to their network staff. They have recently hired an ITS 3 to assume additional duties needed to bring the agency into compliance with security measures. They will be shifting responsibilities of an existing ITS3 staff member and hiring one additional ITS1 position to assume help desk duties so that more experienced personnel can devote their time to establishing and maintaining security protocols for application access. We expect the final staff member to be in place within six months. At that time we will be able to devote full efforts to resolving the remaining security mapping in the audit finding. We expect this audit finding to be fully resolved by the end of the 2011 calendar year. The responsibility for implementation of this finding is with Cathy Wagner, IT Director.

Finding 3: "Prior Finding Partially Resolved: "The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements."

OLA Recommendation: "The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements."

The Department agrees with this finding. Our response to this finding is the same as in finding 1 and we will be assessing our risk as it relates to financial reporting in order to implement strong review and oversight in our preparation of data for the financial statements. We expect this finding to be resolved by December 31, 2011. The responsibility for implementing this finding is with Al Louismet, Agency Accounting Operations Manager.

I appreciate the opportunity to respond to these findings for the Department of Education. Please contact Al Louismet at 651-582-8683 if you have any questions.

Sincerely,

Brenda Cassellius

Dr. Brenda Cassellius
Commissioner

C: Jessie Montano
Al Louismet
Cathy Wagner

February 8, 2011

Mr. James R. Nobles
Legislative Auditor
Centennial Office Building, First Floor
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to the findings and recommendations as a result of the audit of the State of Minnesota financial statements for the year ended June 30, 2010. The Department of Employment and Economic Development (DEED) was referenced in one of the findings.

Audit Finding 3: Prior Finding Partially Resolved: The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

Recommendation:

- *The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements.*

Response: The department agrees with the finding and the recommendation.

1. DEED agrees that errors were made in the calculation of accounts receivable for the Unemployment Insurance Fund. Additional reviews will be performed in this area during the preparation of future financial statements.

2. DEED had authorized the federal government to apply all available revenue deposited each day to the outstanding loan balance. DEED assumed that these loan payments would be applied to the debt on a First-In, First-Out (FIFO) basis. This would have resulted in all amounts borrowed during FY 2010 being paid off during FY 2011. DEED subsequently learned that the federal government manages payments against these loans on a Last-In, First-Out (LIFO) basis. Therefore, DEED agrees that the loan amount should have been classified as a long-term liability.

Cindy Farrell, Chief Financial Officer, will oversee implementation of this recommendation for the FY 2011 financial statements to be prepared by October 15, 2011.

If you have any questions or need additional information please contact Cindy Farrell at 651-259-7085 or Cindy.Farrell@state.mn.us.

Sincerely,

Mark Phillips
Commissioner

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Minnesota Department of **Human Services**

February 14, 2011

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

Dear Mr. Nobles:

The enclosed material is the Department of Human Services' response to the findings and recommendations included in the draft audit report titled, "Report on Internal Control Over Statewide Financial Reporting" for the fiscal year ended June 30, 2010. It is our understanding that our response will be published in the Office of the Legislative Auditor's final audit report.

The Department of Human Services policy is to follow up on all audit findings to evaluate the progress being made to resolve them. Progress is monitored until full resolution has occurred. If you have any further questions, please contact Gary L. Johnson, Internal Audit Director, at (651) 431-3623.

Sincerely,

Lucinda E. Jesson
Commissioner

Enclosure

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Department of Human Services
Response to the Legislative Audit Report on
Internal Control Over Statewide Financial Reporting
For the Period July 1, 2009, through June 30, 2010

Audit Finding #2

Prior Finding Partially Resolved: As of June 30, 2010, the Department of Human Services had fourteen employees who had incompatible security access to the state's accounting system without establishing mitigating controls.

Audit Recommendation #2

- *The agencies cited should ensure that they eliminate unnecessary or incompatible access to state business systems and incompatible duties in state business processes. If agency management determines that it is not possible to eliminate the incompatibilities, it should design, document, and implement mitigating controls and monitor the controls' performance and effectiveness in reducing the risk of error or fraud.*

Agency Response to Audit Finding #2

The department agrees with this recommendation. The department is continuing to monitor and modify employee's access to the State's Accounting System to address incompatible access. With the conversion to SWIFT on July 1, 2011, staff assigned access to the new system will be reviewed to ensure that the access they are granted does not result in incompatible or unnecessary access. In cases where it is not possible to eliminate incompatible access in SWFIT, compensating controls will be put in place to address employees with incompatible access.

Person Responsible: Martin Cammack, Financial Operations Director
Estimated Completion Date: December 31, 2011

Audit Finding #3

Prior Finding Partially Resolved: The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

Audit Recommendation #3

- *The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements.*

Agency Response to Audit Finding #3 (applicable to the three DHS bulleted items)

The department agrees with this recommendation. The department will evaluate our process for preparing and reviewing schedules of financial data submitted for preparation of the state's financial statements to identify areas where additional reviews will improve internal controls over reporting.

Person Responsible: Martin Cammack, Financial Operations Director
Estimated Completion Date: December 31, 2011

Audit Finding #5

Prior Finding Partially Resolved: The Department of Human Services did not reconcile child care assistance subsystem data to the state's accounting system and did not reconcile the healthcare accounts payable reports to the Medicaid Management Information System data warehouse.

Audit Recommendation #5

- *The Department of Human Services should establish sufficient controls to ensure that staff complete timely reconciliations between the child care assistance subsystem data and the state's accounting system and reconciles the healthcare payable reports to its Medicaid Management Information System data warehouse.*

Agency Response to Audit Finding #5

The department agrees with this recommendation. The department will complete the child care subsystem reconciliation process approved by the OLA monthly effective July 1, 2010, and will perform a reconciliation process between the healthcare payable reports and the Medicaid Management Information System.

Person Responsible: Martin Cammack, Financial Operations Director
Estimated Completion Date: December 31, 2011

February 11, 2011

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:

Thank you for the opportunity to review and respond to the findings and recommendations in your report on internal controls over statewide financial reporting for the fiscal year ended June 30, 2010. As always, we take any audit finding very seriously and have already initiated corrective actions to address your findings and recommendations.

Finding 1 - Prior Finding Partially Resolved: Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements of financial statements.

We concur with your report comment that we have not fully assessed and documented our financial reporting risks. While we continue to believe that we have strong, effective financial controls in place, we recognize that we need to do more to improve documentation of our internal controls over financial reporting processes and to perform formal risk assessments periodically. We plan to hire an individual prior to fiscal year end whose position responsibilities will include these duties. It is our goal to implement a comprehensive internal control structure for financial reporting by the end of fiscal year 2012. Accounting Director Dennis E. Jensen and Assistant Executive Director Judy Hunt are the persons responsible for resolution of this finding.

Finding 2. Prior Finding Partially Resolved: Several agencies allowed employees to have inappropriate access to state business systems or perform incompatible duties without establishing mitigating controls.

We appreciate your acknowledgement of our recent progress to resolve this audit issue. We are continuing efforts to eliminate incompatible duties or establish mitigating controls to reduce the risk of error or fraud. In January 2011, managers reviewed employees' access privileges and authorized modifications, where necessary, to limit employees' access to only those functions that are necessary for their assigned job duties. We are still developing a formal process to periodically review and recertify computer

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users' access to our systems. This involves the development of a procedural manual that will guide managers and supervisors to select the appropriate user profile for each of their employees who need access to our systems to perform their assigned job duties. Persons responsible for finalizing the review and recertification process and completing the user profile guide for management and supervisors use are Information Systems Manager Al Cooley and Assistant Database Administrator Lloyd Johnson.

We will continue to explore options to eliminate incompatible access among our employees who have the ability to update member account information or to mitigate the risks of error or fraud associated with their access profiles. Resolution of this audit issue may require computer programming changes, independent reviews, implementation of a quality control function for our defined benefit plans, or other mitigating controls. Persons responsible for resolution of this audit issue include Information Systems Manager Al Cooley and Assistant Executive Directors Judy Hunt and Erin Leonard.

We hope to resolve all aspects of this finding by the end of December, 2011.

We appreciate the work of your agency to identify areas within MSRS that need improvement. We are committed to taking appropriate actions to further strengthen our internal control structure.

Sincerely,

David Bergstrom

Dave Bergstrom
Executive Director

cc: Judy Hunt
Dennis E. Jensen
Lloyd Johnson
Erin Leonard
Al Cooley

MINNESOTA · REVENUE

February 10, 2011

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

Dear Mr. Nobles:

This letter contains our responses to the Office of Legislative Auditor's findings and recommendations contained in a draft report we received on January 28, 2011. The audit covers basic financial statements for the year ended June 30, 2010.

As it pertains to the Minnesota Department of Revenue, the audit report focuses on three findings, each of which we address below under "agency response."

Finding (1): Prior Finding Partially Resolved: "Several agencies (including the Department of Revenue) lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements."

Recommendation: *The Departments of Education, Revenue, and Transportation, the State Board of Investment and the Minnesota State Retirement System should assess risks and develop a comprehensive internal control structure for their financial reporting processes and responsibilities.*

Agency Response:

In FY 2010, the Department of Revenue completed the Control Environment Tool designed by the Internal Control and Accountability Unit at MMB. This tool was designed to assess the department's control environment, the foundation of an effective internal control system. The department did not take the next step, completing a risk assessment, because we were still in transition from our old tax systems to our new Integrated Tax System, GenTax. Now that all of our major tax types have been converted to GenTax we are ready to begin that next step. We will request assistance from the Internal Control and Accountability Unit in developing a risk assessment process.

Person(s) responsible for resolving the finding: Jean Jochim and Dan Ostdiek

Expected resolution date: December, 2011

Finding (2): Prior Finding Partially Resolved: "Several agencies (including the Department of Revenue) allowed employees to have inappropriate access to state business systems or perform incompatible duties without establishing mitigating controls.

Recommendation: *The agencies cited should ensure that they eliminate unnecessary or incompatible access to state business systems and incompatible duties in state business processes. If agency management determines that it is not possible to eliminate the incompatibilities, it should design, document, and implement mitigating controls and monitor the controls' performance and effectiveness in reducing the risks of error or fraud.*

Agency Response Part a:

As long as human weakness and criminal intent exist there is the possibility of fraud and collusion. In light of recent tax refund fraud the Department of Revenue has taken five key steps to minimize the risk of future fraud. The steps include:

1. Policy and procedural enhancements
2. New policies on reviewing employee activities
3. Systems reporting enhancements
4. Systems security limitations and restrictions
5. Management training, education, and employee communication

The specifics of these changes are described below.

Policy and procedural enhancements

Policy enhancements will include, but not be limited to:

a. Prohibiting employees from approving refunds they manually create
b. Requiring employees approving refunds to be at a higher level organizationally, than employees requesting refunds
c. Prohibiting employees from requesting or approving refunds for a tax type outside of their assigned tax type
d. Employees requesting a manual refund must provide a detailed reason for the refund
e. Each division will retain a checklist for employees who approve work to make sure appropriate approval reviews occur

New policies on reviewing employee activities

a. Revenue's new integrated tax system (GenTax) provides the capability to generate employee activity reports. Management will be held accountable for reviewing such reports and flagging and investigating unusual or suspicious employee activity.

b. The agency's internal audit presence will be increased. Internal Audit will be responsible for reviewing reports and following up on indicators flagged in reports.

Systems reporting enhancements

Revenue's 20-year-old legacy tax systems were incapable of generating employee activity reports from which management could have readily reviewed the work of selected employees.

a. The Department is developing several reports that will include data to aid in identifying potential employee issues.
b. Written policies will include a requirement for direct supervisors and Internal Audit to review reports and report identified issues.
c. System enhancements have been made to automatically restrict security access and make it easier for supervisors to track security.

Systems security limitations and restrictions

a. Upon discovery of refund fraud existing refund safeguards within the new GenTax system were reviewed.
b. We are reviewing current access authorities of every employee and tracking historical accesses of all employees. Where appropriate, we are restricting or removing accesses.

Management training, education, and employee communication

a. The Department of Revenue has begun developing a more targeted training program for employees in several areas, including their responsibilities for the proper handling and use of taxpayer records.
b. A new statement will be added to the agency's Code of Conduct which strongly warns employees that inappropriate use of DOR systems and participating in fraudulent activities could result in severe discipline, including dismissal. These important messages to employees will be repeated at employee forums and through the use of the agency's intranet, which is the first screen employees see when they boot-up their computers.
c. The Department of Revenue is working towards developing management training to help managers learn how to review new reports, look for "red flags", and identify and address inappropriate behavior that is often associated with inappropriate activities.

Person responsible for resolving the finding: Terri Steenblock

Expected resolution date: On-going

Agency Response Part b:

The Special Taxes Division has undertaken steps to address the possible risks of fraud or error related to access to the stamp room and to systems which control stamp inventory and accounting. They include:

1. Installation of a motion activated video camera in the stamp room. All activities in the room are recorded and maintained by HR staff.
2. Monthly Stamp Room door access reports from HRM
3. Regular review of cigarette tax system rights
4. Separation of duties so stamp fillers do not take inventory

The Special Taxes Division intends to further reduce the risk of fraud or error by working on the following in the immediate term:

1. Separate the stamp order invoicing duties and the stamp order filling duties.
2. Reduce the number of cardholders with access to the stamp room.
3. Create rules around who may print inventory reports in cigarette tax system, and who conducts monthly inventory counts.
4. Reinforce system rights for who may make cigarette tax system accounting adjustments.
5. Explore steps that can be taken to reduce the risk of stamp loss, including modifications to the stamp room configuration by possibly enabling separation of inventory.
6. Replacement of the 20 year old cigarette tax system with a modern integrated tax system which will have many checks and balances not currently available.

Person responsible for resolving the finding: Wayne Lang

Expected resolution date: February, 2012

Finding (3): Prior Finding Partially Resolved: "The Department of Management and Budget and other agencies (including the Department of Revenue) did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

Recommendation: *The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements.*

Agency Response:

The Financial Management Division is updating the process of collecting data for inclusion in the state's financial statements. The current process is very manual and, in recent years, complicated by data from both our Legacy Systems and new Integrated Tax System. Now that all of our major tax types have been converted to GenTax, we are planning to use the systems reporting capabilities to minimize manual intervention and the associated increased probability of errors. The Financial Management Division will also continue to partner with the Property Tax Division to improve the accuracy of the property tax remittance data. However, the statewide property tax will be converted to GenTax in March 2012, which will automate the collection and reconciliation processes.

Person(s) responsible for resolving the finding: Jean Jochim and Dan Ostdiek

Expected resolution date: December, 2011

Sincerely,

Daniel A. Salomone
Commissioner

MINNESOTA STATE BOARD OF INVESTMENT

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February 14, 2011

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

Dear Mr. Nobles:

Thank you for the opportunity to respond to your report on internal control over the State Board of Investment financial reporting process.

Prior Finding Partially Resolved: The State Board of Investment made only limited progress toward developing its comprehensive internal control structure and had not fully assessed and documented its financial reporting risks.

Recommendation: The State Board of Investment should assess risks and develop a comprehensive internal control structure for financial reporting processes and responsibilities.

Response: While the past year included the implementation of several initiatives and new GASB requirements which resulted in substantial changes to financial reporting for the State Board of Investment, we recognize the need to fully assess and document financial reporting risks in light of all the changes. The State Board of Investment will continue working to develop and maintain an effective internal control structure in accordance with Department of Management and Budget policy.

Person Responsible: Administrative Director

Implementation Date: June 30, 2011

Thank you for the opportunity to respond to your findings and recommendations.

Sincerely,

Howard Bicker
Executive Director.

Minnesota Department of Transportation

Transportation Building
395 John Ireland Boulevard
Saint Paul, Minnesota 55155-1899

February 8, 2010

James R. Nobles
Legislative Auditor
100 Centennial Office Building
658 Cedar Street
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to the audit of the State of Minnesota's financial statements for the year ended June 30, 2010. This letter is the Minnesota Department of Transportation (Mn/DOT) response to the draft report issued by the Office of the Legislative Auditor.

Finding 1 – Prior finding partially resolved: Several agencies lacked a comprehensive internal control structure over financial reporting to sufficiently mitigate the risk of potential misstatements in the financial statements.

Recommendation: The Department of Management and Budget should continue to provide training and oversight to state agencies related to the state's overall financial reporting process and work with those state agencies cited as they continue to develop comprehensive internal control structures for their financial reporting processes and responsibilities.

Response: Mn/DOT believes strongly in financial integrity and concurs with this finding. Mn/DOT is addressing this issue in the following manner:

1. Mn/DOT is using the Agency-wide Minnesota Management and Budget (MMB) Control Environment Self-Assessment Tool to determine if adequate controls are in place throughout the agency. Seven teams were set up to identify areas to work through to strengthen internal control and improve business processes and roles.
2. Mn/DOT is using the LEAN process to ensure financial management information is complete and accurate. LEAN is a coordinated state government initiative for improving the organizational performance and results in Minnesota's state government agencies.

Responsible Staff: Pamela Tschida, Acting Chief Financial Officer
Implementation Date: February, 2011 and ongoing.

Finding 3 – Prior Finding Partially Resolved: The Department of Management and Budget and other state agencies did not have adequate controls to prevent and detect errors in the financial information used to compile the financial statements.

Recommendations:

- *The Department of Management and Budget and other state agencies should conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements.*
- *The Department of Transportation should ensure that it designs effective invoice approval and payment controls to prevent or detect and correct inaccurate payments on a timely basis.*

Response to the first recommendation: Mn/DOT concurs with the recommendation to conduct sufficient reviews of financial data to ensure the state prepares accurate financial statements. Since accounting for all capital assets has been identified as a critical control issue, Mn/DOT is realigning resources to incorporate a supervisory control to mitigate this weakness. Mn/DOT will continue to work with MMB staff to ensure the integrity of its financial reporting for all capital assets.

Response to the second recommendation: Mn/DOT concurs with the recommendation that it should design effective invoice approval and payment controls to prevent or detect and correct inaccurate payments on a timely basis. Mn/DOT will review and update its current processes and procedures. Mn/DOT staff will continue to educate staff on internal controls to ensure an accurate invoice approval and payment process. In addition, within the coming year, an updated payment voucher system will be installed that will eliminate the opportunity for this type of error.

Responsible Staff: Pamela Tschida, Acting Chief Financial Officer and Gerald Wood, Accounting Director
Implementation Date: February, 2011

Thank you for the opportunity to respond to your findings and recommendations. Mn/DOT will monitor the implementation to the successful resolution of these findings. Please contact Gerald Wood, Accounting Director, at 651-366-4904 with any follow-up questions or information.

Sincerely,

Thomas K. Sorel
Commissioner of Transportation