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OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Internal Controls Over Statewide Financial Reporting

Year Ended June 30, 2015

February 11, 2016 **Report 16-05**

FINANCIAL AUDIT DIVISION
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Financial Audit Division

The Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division has a staff of about 30 auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

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Conclusion on Internal Controls

The Financial Audit Division bases its conclusion about an organization's internal controls on the number and nature of the control weaknesses we found in the audit. The three possible conclusions are as follows:

Conclusion	Characteristics
Adequate	**The organization designed and implemented internal controls that effectively managed the risks related to its financial operations.**
Generally Adequate	**With some exceptions, the organization designed and implemented internal controls that effectively managed the risks related to its financial operations.**
Not Adequate	**The organization had significant weaknesses in the design and/or implementation of its internal controls and, as a result, the organization was unable to effectively manage the risks related to its financial operations.**

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

February 11, 2016

Members of the Minnesota State Legislature

The Honorable Mark Dayton, Governor

Mr. Myron Frans, Commissioner, Department of Management and Budget

Ms. Emily Johnson Piper, Commissioner, Department of Human Services

This report describes the scope of our testing of internal controls and compliance, and the results of that testing, performed as part of our audit of the *State of Minnesota's Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2015. The report is required by the auditing standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

We discussed the results of the audit with the Department of Management and Budget's staff at an exit conference on February 3, 2016.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

Table of Contents

Report Summary

Annually, the Department of Management and Budget prepares the State of Minnesota's *Comprehensive Annual Financial Report.* Included in that report are the state's basic financial statements for the past fiscal year. To prepare the statements, the Department of Management and Budget uses information from a variety of sources, including information provided by other agencies. Our audit resulted in an opinion on the basic financial statements, providing assurance that the statements are fairly stated, in all material respects, in accordance with generally accepted government accounting principles.

As part of our audit, we reviewed the state's internal controls over its financial reporting process and its compliance with legal requirements related to financial reporting. The state partially resolved the internal control findings related to its financial reporting process from our previous audit.[1] However, we identified some significant deficiencies in the state's internal controls over financial reporting during the current audit. We explain those deficiencies in the following findings.

Findings

- The Department of Management and Budget did not have adequate internal controls to ensure it informed us about a settlement with the Internal Revenue Service and discussed with us whether it warranted disclosure in the notes to the financial statements. (Finding 1, page 5)

- The Department of Human Services did not have adequate internal controls to prevent or detect an error in its calculation of a General Fund receivable. We reported a similar issue in our previous audit. (Finding 2, page 6)

Audit Scope

We audited the state's financial statements for the fiscal year ended June 30, 2015. Our audit scope included many large state agencies that had financial activities significant to the financial statements.

[1] Office of the Legislative Auditor's Financial Audit Division Report 15-02, *Internal Controls Over Statewide Financial Reporting*, issued February 19, 2015.

Independent Auditor's Report on Internal Controls Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Members of the Minnesota State Legislature

The Honorable Mark Dayton, Governor

Mr. Myron Frans, Commissioner, Minnesota Management and Budget

We have audited the basic financial statements of the State of Minnesota, as of and for the year ended June 30, 2015, and have issued our report thereon dated December 11, 2015.[1] The financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Minnesota, and the related notes to the financial statements, collectively comprise the state's basic financial statements. We conducted our audit in accordance with the 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.

Our report includes a reference to other auditors who audited the financial statements of the Minnesota State Colleges and Universities, Housing Finance Agency, Metropolitan Council, University of Minnesota, Office of Higher Education, Public Facilities Authority, and Workers' Compensation Assigned Risk Plan, as described in our report on the state's financial statements. The financial statements of the Housing Finance Agency and Workers' Compensation Assigned Risk Plan were not audited in accordance with *Government Auditing Standards*. This report does not include the results of the other auditors' testing of internal controls over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Controls Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the state's internal controls over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the state's internal controls. Accordingly, we do not express an opinion on the effectiveness of the state's internal controls.

Our consideration of internal controls was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal controls that might be

[1] Our audit report on the financial statements was included in the state's comprehensive annual financial report. Access to the report is available at the following website: http://www.mn.gov/mmb/accounting/reports/.

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material weaknesses or significant deficiencies.[2] Therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, we did not identify any deficiencies in internal controls that we consider to be material weaknesses. We did identify certain deficiencies in internal controls, described in the accompanying *Findings and Recommendations* section as Findings 1 and 2, which we consider to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the state's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

State of Minnesota's Response to Findings

The state's responses to the findings identified in our audit are provided in the accompanying *Agency Responses* section. The state's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal controls and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the state's internal controls or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the state's internal controls over financial reporting and compliance as part of our financial statement audit. Accordingly, this communication is not suitable for any other purpose.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

December 11, 2015

[2] A deficiency in internal controls exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the state's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Findings and Recommendations

Finding 1

The Department of Management and Budget did not have adequate internal controls to ensure it informed us about a settlement with the Internal Revenue Service and discussed with us whether it warranted disclosure in the notes to the financial statements.

The department did not initially disclose in the notes to the financial statements a $537,025 settlement paid to the Internal Revenue Service for a violation of federal regulations. Department staff had decided not to disclose the settlement in the notes because the amount was immaterial, but did not tell us about the settlement or discuss with us its decision not to disclose. Instead, we learned about the settlement through other contacts in mid-December 2015.

On five occasions between 2010 and 2011, the State Board of Investment violated federal regulations by purchasing some of the state's general obligation bonds as investments. According to federal regulations, a bond is considered retired when "the bond is purchased or otherwise acquired by or on behalf of the issuer…."[1] Although it was not the state's intent to retire the bonds, the state put at risk the bonds' tax-exempt status and interest earned by bondholders could have become taxable. Upon identifying the violations, the department notified the Internal Revenue Service to discuss a resolution. In September 2014, the department agreed to and paid the settlement to the Internal Revenue Service so that the bonds would continue to be treated as outstanding and retain their tax-exempt status.

When we reviewed the settlement, we concluded the violations and resulting settlement were significant enough, based on qualitative considerations, to warrant disclosure in the notes, since the municipal bond community (bond rating agencies, underwriters, and bondholders) are primary users of the state's financial statements. We withheld our opinion until the department added an adequate disclosure of the settlement to the notes or otherwise showed us that a note disclosure was not necessary. The department chose to disclose the settlement in the notes to ensure it published the financial statements by the statutory deadline.[2]

Recommendation

- *The Department of Management and Budget should strengthen internal controls to ensure it informs us about uncommon transactions and discusses potential disclosures for those transactions in the notes to the financial statements.*

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[1] Internal Revenue Service Notice 88-130, 1988-52 I.R.B 12 (December 14, 1988).

[2] *Minnesota Statutes* 2015, 16A.50 requires the department to issue the state's financial statements by December 31 of each year.

Finding 2

The Department of Human Services did not have adequate internal controls to prevent or detect an error in its calculation of a General Fund receivable.

The department incorrectly calculated and reported to the Department of Management and Budget the amount of the provider surcharge receivable from Minnesota hospitals. State statutes require hospitals to pay a surcharge equal to 1.56 percent of net patient revenues, excluding net Medicare revenues.[3] The receivable is the surcharge amount owed but not paid by the end of the state's fiscal year. The department estimated the receivable amount based on the payment schedule set in state statute. Before fiscal year 2015, that payment schedule required hospitals to pay the surcharge for a calendar year in 12 monthly payments, beginning in October of the following year. Because of that payment schedule, the estimated receivable was based on 21 months of owed but not paid surcharges.

A statutory change effective October 2014 accelerated that payment schedule, requiring hospitals to pay the surcharge for a calendar year in nine monthly payments, beginning in October of the following year.[4] Under that accelerated payment schedule, the estimated receivable should be based on 18 months of owed but not paid surcharges. However, the department did not adjust its receivable calculation for the statutory change, overstating the receivable by $23,465,000. After adjusting for the overstatement, the General Fund receivable for provider surcharges from hospitals totaled $232,127,000.

We reported a similar issue last year related to the provider surcharge receivable from Minnesota health maintenance organizations.[5]

Recommendation

- *The Department of Human Services should strengthen internal controls by conducting effective reviews of receivable calculations to ensure the state prepares accurate financial statements.*

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[3] *Minnesota Statutes* 2015, 256.9657, subd. 2.

[4] *Laws of Minnesota* 2013, chapter 108, article 6, section 3.

[5] Office of the Legislative Auditor's Financial Audit Division Report 15-02, Internal Controls Over Statewide Financial Reporting, issued February 19, 2015.

MINNESOTA
Management
& Budget

February 8, 2016

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. Because this report includes all findings statewide, our response will specifically address only the finding related to Minnesota Management and Budget. The remaining finding will be addressed by the specific agency involved.

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 30-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.

Finding 1: The Department of Management and Budget did not have adequate internal controls to ensure it informed us about a settlement with the Internal Revenue Service and discussed with us whether it warranted disclosure in the notes to the financial statements.

Recommendation:

The Department of Management and Budget should strengthen internal controls to ensure it informs us about uncommon transactions and discusses potential disclosures for those transactions in the notes to the financial statements.

Response

We appreciate your acknowledgment that we identified that the State Board of Investment violated federal regulations by purchasing some of the state's general obligation bonds as investments and that we self-reported this to the IRS. As a result, the State Board of Investment purchases did not impact the tax-exempt status of those bonds.

We worked with bond counsel on the IRS settlement and discussed disclosure requirements with them. Based on input from bond counsel, financial advisors, and industry best practices, we concluded the settlement with the IRS was not a required disclosure in the notes to the financial statements. Experience of both bond counsel and

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financial advisors led them to advise that these types of settlements are typically not disclosed in financial statements unless the terms of the settlement agreement require it. In addition, the Government Finance Officers Association (GFOA) has issued best practices related to debt management and debt issuance and these best practices do not recommend posting of information related to regulatory actions (including documents related to the SEC Municipalities Continuing Disclosure Cooperation Initiative or the IRS Voluntary Closing Agreement Program) unless specifically required as part of a Continuing Disclosure Agreement or other legal obligation.

In the interest of preventing further purchases of state bond obligations by agencies, MMB has adopted a new policy requiring agencies to certify their compliance with IRS requirements annually. In addition, MMB adopted a new policy to strengthen the communication and transparency of payments that occur under Minnesota Statute 16A.641.

We continue to place a high emphasis on ensuring that our notes to the financial statements present all required disclosures. The Financial Reporting team works extensively with senior staff, the budget team leads, and executive budget officers throughout the year to identify material items that may impact financial reporting, including changes in legislation and unusual items. These communications are designed to prevent material misstatements to our financial statements and note disclosures. We will discuss with the OLA the nature and significance of uncommon transactions for which we make professional judgments regarding disclosures.

Person Responsible: Kristin Hanson, Assistant Commissioner
Estimated completion date: February 29, 2016

Again, thank you for the opportunity to discuss and respond to the audit finding of the department. We value your work to improve internal controls in the state of Minnesota.

Sincerely,

Myron Frans

Myron Frans
Commissioner

Minnesota Department of **Human Services**

February 8, 2016

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

Dear Mr. Nobles:

Thank you for the opportunity to review and comment on the draft report titled "*Internal Controls Over Statewide Financial Reporting Year Ended June 30, 2015*." It is our understanding that our response will be published in the Office of the Legislative Auditor's final audit report.

While we have built and continue to maintain a strong control environment, this audit points out that we need to do a better job of recognizing the impact that new legislation might have on existing processes and internal controls. We appreciate and value the work your office does to help us test and improve our control environment around financial reporting. Below is our response to the Department of Human Services' finding.

Audit Finding #2

The Department of Human Services did not have adequate internal controls to prevent or detect an error in its calculation of a General Fund receivable.

Audit Recommendation #2

Recommendations

- *The Department of Human Services should strengthen internal controls by conducting effective reviews of receivable calculations to ensure the state prepares accurate financial statements..*

Agency Response to Audit Recommendation #2

The department agrees with this finding and recommendation. This error occurred as a result of a change in legislation that impacted the timing of hospital surcharge payments. In addition to addressing this specific issue the Department has also developed a document summarizing the different surcharge programs, including invoicing and payment timeframes. This document will allow the Department to consistently address the reporting of surcharge amounts from year to year. In addition, this document will provide a tool to allow us to more easily identify when legislative or program changes need to be reflected in calculation of amounts to be reported on financial statements.

Person Responsible: Terri Engel, Accounting Operations Manager
Estimated Completion date: changes have been completed.

Thank you again for the professional and dedicated efforts of your staff during this audit. 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,

Emily Johnson Piper

Emily Johnson Piper
Commissioner