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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, 2014

February 19, 2015 **Report 15-02**

FINANCIAL AUDIT DIVISION
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Financial Audit Division

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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

Senator Roger J. Reinert, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Myron Frans, Commissioner
Department of Management and Budget

In auditing the State of Minnesota's basic financial statements for the year ended June 30, 2014, we considered the state's internal controls over financial reporting. We also tested the state's compliance with significant legal provisions impacting the basic financial statements.[1] This report contains a finding and recommendation related to compliance and internal controls 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 the deficiencies identified in Finding 1, which relates to the preparation of the basic financial statements, to be significant deficiencies. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by management to ensure that the possibility of a material misstatement of the entity's financial statements will be prevented or detected and corrected on a timely basis.

Individual agency responses to our finding and recommendation 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.

The purpose of this report is solely to describe the scope and results of our testing of the state's internal controls over financial reporting. Accordingly, this report is not suitable for any other purpose.

James R. Nobles	Cecile M. Ferkul, CPA, CISA
Legislative Auditor	Deputy Legislative Auditor

End of Fieldwork: December 12, 2014

Report Signed On: February 18, 2015

[1] We separately report the results of our tests of compliance with federal programs.

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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 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 finding.

Finding

- The departments of Management and Budget and Human Services did not have adequate internal controls to prevent or detect some errors in the financial information used to compile the financial statements, including footnote disclosures.

Audit Scope

We audited the state's financial statements for the fiscal year ended June 30, 2014. 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 14-04, *Report on Internal Control Over Statewide Financial Reporting*, issued February 14, 2014.

Finding and Recommendation

Finding 1

The departments of Management and Budget and Human Services did not have adequate internal controls to prevent or detect some errors in the financial information used to compile the financial statements, including footnote disclosures.

The departments of Management and Budget and Human Services had some significant deficiencies in their internal controls over the financial reporting process.[2] Because of those deficiencies, some errors existed in the preliminary financial statements. After our audit work detected the errors, Department of Management and Budget staff made adjustments to its preliminary financial statements to correct the following errors:

- The Department of Human Services incorrectly reported to the Department of Management and Budget the amount of provider surcharge receivable. The provider surcharge is paid to the state by managed care organizations and other medical providers;[3] the receivable is the amount owed but not paid by the end of the state's fiscal year. Before fiscal year 2014, the department had estimated the provider surcharge receivable amount based on a delayed monthly billing schedule set in state statute. Under this delayed billing schedule, the department billed monthly for a calendar year's surcharge starting in October of the following year (after the state had received and reviewed the final reports from the medical providers.) Because of the delayed billing schedule, the department had estimated the provider surcharge receivable based on 21 months of owed but not paid surcharges.

  A statutory change in 2013 required the medical providers to pay the surcharge earlier.[4] It required the medical providers to pay the surcharge amounts for calendar years 2012 and 2013 on June 15, 2014, and then to pay the annual surcharge amount for each calendar year in a lump sum payment on June 15 of the following year.[5] The department, however, did not adjust its accounts receivable estimate calculation. It included in the

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[2] *AICPA Statement on Auditing Standards* AU-C 265.07: 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 management to ensure that the possibility of a material misstatement of the entity's financial statements will be prevented or detected and corrected on a timely basis.

[3] Four types of medical providers pay this surcharge to the Department of Human Services: 1) managed care organizations; 2) hospitals; 3) nursing homes; and 4) independent care facilities (group homes) for people with developmental disabilities.

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

[5] *Minnesota Statutes* 2013, section 256.9657.

calculation the amounts paid by the medical providers in June 2014 for calendar years 2012 and 2013, overstating by about $36 million the provider surcharge receivable amount it provided to the Department of Management and Budget. The Department of Management and Budget used this incorrect amount in the draft financial statements for the General Fund. After adjusting for the overstatement, the fiscal year 2014 provider surcharge receivable totaled about $281 million.

- The Department of Management and Budget understated by about $33.3 million both assets and liabilities associated with loaned securities in the draft Supplemental Retirement Fund financial statements submitted for audit.[6] The Supplemental Retirement Fund accounts primarily for retirement money invested through the State Board of Investment for local volunteer police officers and fire fighters that invest funds through the State Board of Investment. The State Board of Investment provided the department with the correct financial information; however, Department of Management and Budget staff did not properly incorporate into the state's financial statements all of the securities lending information for an organization that began investing in the Supplemental Retirement Fund in fiscal year 2014.

The Department of Management and Budget also had errors in one of the financial statement footnotes. Because footnote disclosures are an integral part of the financial statements, disclosures that are inaccurate, inconsistent with financial statement amounts, or missing required information may be misleading. The department did not detect the following errors in its draft footnote disclosure for cash, investments, and derivatives:

- For the governmental, proprietary, and agency funds, the department overstated corporate stock by $3.6 million in the interest rate risk schedule. The interest rate risk schedule presented investments that totaled $10.9 billion.

- For the pension and investment trust funds, the department overstated certain investments by $19.7 million in the credit risk exposure and interest rate risk schedules. It overstated the amount of triple-A rated investments in the credit risk exposure schedule and overstated the amount of short term notes in the interest rate risk schedule. In total, the credit risk exposure and interest rate risk schedules had $17.4 billion and $69.6 billion of investments, respectively.

- For the pension and investment trust funds, the department had errors in the $69.6 billion of investments reported in the interest rate risk schedule.

[6] Lending securities to other inventors is a common practice and is allowed by *Minnesota Statutes* 2014, 11A.11. To secure the loan, the borrower must provide the state with cash or other securities as collateral.

Because the errors offset, department staff did not identify the following errors:

- Department staff understated mutual funds by $1.5 billion when they used a truncated amount in their supporting work.
- Department staff overstated corporate stock by $1.5 billion when they duplicated some data in their supporting work.

These errors occurred because the department did not adequately verify the accuracy of the accounts or the amounts to the relevant reports. The department subsequently corrected these errors in the footnotes included with the published financial statements.

The Department of Management and Budget conducted the final overall financial statement reviews and relied on agencies to provide accurate and complete information for use in developing the financial statements. However, the departments' internal reviews of the financial data were not effective to prevent or detect the errors noted above.

Recommendation

- *The Department of Management and Budget and the Department of Human Services should strengthen internal controls by conducting effective reviews of financial data to ensure the state prepares accurate financial statements and footnote disclosures.*

MINNESOTA
Management
& Budget

February 13, 2015

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 finding in the Report on Internal Control over Statewide Financial Reporting.

We continue to 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 29-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 appreciate that the prior findings have been completely resolved and value suggestions which will make our existing process even stronger.

Finding

The departments of Management and Budget and Human Services did not have adequate internal controls to prevent or detect some errors in the financial information used to compile the financial statements, including footnote disclosures.

Response

We continue to place a high emphasis on our review process. Extensive analysis and supervisory reviews are conducted to review and verify the material financial statement and footnote information. These reviews are designed to prevent material misstatements to the financial statements and note disclosures.

We will also continue to work with the State Board of Investment to understand fund structure changes related to the state's complex investment structure and ensure all financial activity and balances are properly reported, including security lending activity.

Person Responsible: Barb Ruckheim, Financial Reporting Director
Implementation Date: December 31, 2015

Sincerely,

Myron Frans
Commissioner

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Minnesota Department of **Human Services**

February 17, 2015

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, 2014*." The audit results remind us that while we have succeeded in building a strong internal control environment over financial reporting, we still need to be vigilante in evaluating, testing and maintaining that environment. We appreciate your efforts to help us maintain and improve these controls. Below is our response to the Department of Human Services' finding.

Audit Finding #1

The departments of Management and Budget and Human Services did not have adequate internal controls to prevent or detect some errors in the financial information used to compile the financial statements, including footnote disclosures.

Audit Recommendation #1

Recommendations

- *The Department of Management and Budget and the Department of Human Services should strengthen internal controls by conducting effective reviews of financial data to ensure the state prepares accurate financial statements and footnote disclosures.*

Agency Response to Audit Recommendation #1

The department agrees with this finding and recommendation. This error occurred as a result of change in legislation that impacted the timing of provider surcharge payments. While this specific issue has been addressed we will continue to refine our process of compilation and review of financial data submitted to Minnesota Management and Budget for the preparation of financial statements.

Person Responsible: Terri Engel, Accounting Operations Manager
Estimated Completion Date: June 30, 2015

Department of Human Services'
Response to the Legislative Draft Audit Report titled
Report on Internal Control Over Statewide Financial Reporting
for the Year Ended June 30, 2014

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,

Lucinda E. Jesson
Commissioner

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