MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE

STATEWIDE COST ALLOCATION PLAN

DEPARTMENT OF MANAGEMENT AND BUDGET

March 2006

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

07-131-05

"...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof."

– Article IV, Section 53 of the Michigan Constitution

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REPORT SUMMARY

Performance Audit

Statewide Cost Allocation Plan

Department of Management and Budget

Report Number:
07-131-05

Released:
March 2006

The State of Michigan's Statewide Cost Allocation Plan (SWCAP) is the mechanism by which the State identifies, summarizes, and allocates unbilled indirect costs in a logical and systematic manner. The SWCAP also includes financial and billing rate information for billed central services directly charged to agencies or programs. The SWCAP is required for the State to obtain reimbursement from the federal government for Statewide indirect costs.

Audit Objective:
To assess the Department of Management and Budget's (DMB's) effectiveness in the implementation of the SWCAP.

Audit Conclusion:
We concluded that DMB effectively implemented the SWCAP. Our report does not include any reportable conditions related to this audit objective.

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Audit Objective:
To assess the effectiveness of DMB's process for assessment and recovery of central service costs.

Audit Conclusion:
We concluded that DMB was effective in assessing and recovering central service costs. However, our audit disclosed reportable conditions related to compliance with U.S. Office of Management and Budget (OMB) Circular A-87 (Finding 1) and establishment of billing rates (Finding 2).

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Agency Response:
Our audit report contains 2 findings and 3 corresponding recommendations. DMB's preliminary response indicated that it agreed with all of our recommendations.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

March 28, 2006

Ms. Lisa Webb Sharpe, Director
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Ms. Webb Sharpe:

This is our report on the performance audit of the Statewide Cost Allocation Plan, Department of Management and Budget.

This report contains our report summary; description of the Statewide Cost Allocation Plan; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; a summary of building occupancy cumulative costs, presented as supplemental information; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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DEPARTMENT OF MANAGEMENT AND BUDGET

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Description of the Statewide Cost Allocation Plan

The State of Michigan's Statewide Cost Allocation Plan (SWCAP) is the mechanism by which the State identifies, summarizes, and allocates unbilled indirect costs* in a logical and systematic manner. The SWCAP also includes financial and billing rate information for billed central services* directly charged to agencies or programs through internal service funds* and trust (retirement) funds and for building occupancy costs through the General Fund. The SWCAP is required by U.S. Office of Management and Budget Circular A-87 for the State to obtain reimbursement from the federal government for Statewide indirect costs.

Statewide indirect costs include the cost of central support services, such as accounting, purchasing, budgeting, payroll, and information systems, provided to operating departments. The Department of Civil Rights, Department of Civil Service, Department of Management and Budget (DMB), Department of Treasury, and Office of the Auditor General provide central support services.

The DMB Office of Financial Management is responsible for the State's SWCAP. Since 1986, DMB has contracted with a private consultant to prepare the SWCAP. DMB reviews and approves the SWCAP before it is submitted to the U.S. Department of Health and Human Services (HHS).

The State submits a proposed SWCAP based on estimated costs and a final SWCAP based on actual costs to HHS. HHS is the cognizant agency that annually approves the SWCAP and negotiates the Cost Allocation Agreement with DMB, establishing Statewide indirect costs for the State's operating departments. The Statewide indirect costs are established on a fixed with carry-forward basis*. The most recent Cost Allocation Agreement approved indirect costs for fiscal year 2002-03, which included actual costs for the fiscal year 2002-03 SWCAP and carry-forward costs from the fiscal year 2000-01 final SWCAP.

DMB provides the approved indirect costs to the State's operating departments for allocation to their federal assistance programs. Operating departments are required by Section 460, Act 431, P.A. 1984, to establish indirect cost rates and to charge indirect costs to awards, contracts, and grants. The amount of reimbursement for these

* *See glossary at end of report for definition.*

Statewide indirect costs is determined by each operating department's method of billing indirect costs for different federal assistance programs. Statewide indirect costs provided to operating departments and other funds for fiscal year 2003-04 were $76.8 million.

Audit Objectives

Our performance audit* of the Statewide Cost Allocation Plan (SWCAP), Department of Management and Budget (DMB), had the following objectives:

1. To assess DMB's effectiveness in the implementation of the SWCAP.

2. To assess the effectiveness of DMB's process for assessment and recovery of central service costs.

Audit Scope

Our audit scope was to examine the Statewide Cost Allocation Plans for fiscal years 2002-03 and 2003-04. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

A summary of building occupancy cumulative cost information was included in this report as supplemental information. However, our audit was not directed toward expressing an opinion on this information and, accordingly, we express no opinion on it.

Audit Methodology

Our audit procedures, performed from March through July 2005, primarily covered the period October 1, 2002 through July 31, 2005. Our audit methodology included a preliminary review of the processes used in the development of the SWCAP. Our preliminary review included interviews and discussions with DMB staff regarding their functions and responsibilities and examination of applicable policies and procedures, laws, and federal regulations.

To assess DMB's effectiveness in the implementation of the SWCAP, we reviewed the most recent SWCAP that was based on actual costs. The review included an analytical review of balances and recent plan changes. We also reviewed the timeliness of the SWCAP, whether the SWCAP was based on actual accounting balances, whether

* *See glossary at end of report for definition.*

allocation methodologies were reasonable, and whether DMB properly provided SWCAP information to State departments for inclusion in their departmental indirect cost allocation plans.

To assess the effectiveness of DMB's process for assessment and recovery of central service costs, we reviewed the services provided and the processes used by DMB for billing State agencies for central service costs for services provided by various internal service funds, trust funds, and the General Fund. We also reviewed the retained earnings by program for various internal service fund and General Fund billed programs for compliance with federal and State requirements.

This review included U.S. Office of Management and Budget (OMB) Circular A-87 balance sheets submitted to the U.S. Department of Health and Human Services to demonstrate compliance with the OMB Circular A-87 limitation of working capital reserves to no more than 60 days of cash expenditures. In addition, this review determined if DMB complied with State requirements for billing rates to reflect the actual cost of providing services. We reviewed transfers to the General Fund and executive orders related to central services for compliance with OMB Circular A-87 requirements.

In addition, for consolidated printing, mailing, print and graphics, and vehicle services, we documented and tested the internal control over billings to help provide assurance that the billing system was working as designed. We reviewed a sample of billings. This testing was to determine that the billings for the internal service funds were based on correct rates and that agencies were properly billed based on the services provided. This also provided a basis for the Single Audits of the departments to rely on the billings from the internal service funds.

Agency Responses and Prior Audit Follow-Up

Our audit report contains 2 findings and 3 corresponding recommendations. DMB's preliminary response indicated that it agreed with all of our recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and DMB Administrative Guide procedure 1280.02 require DMB to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

We released our prior financial related audit of the Statewide Cost Allocation Plan, Department of Management and Budget (#0713198), in April 1999. DMB complied with both of our prior audit recommendations.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS IN IMPLEMENTATION OF THE SWCAP

COMMENT

Audit Objective: To assess the Department of Management and Budget's (DMB's) effectiveness in the implementation of the Statewide Cost Allocation Plan (SWCAP).

Conclusion: We concluded that DMB effectively implemented the SWCAP. Our report does not include any reportable conditions* related to this audit objective.

EFFECTIVENESS OF PROCESS FOR ASSESSMENT AND RECOVERY OF CENTRAL SERVICE COSTS

COMMENT

Audit Objective: To assess the effectiveness of DMB's process for assessment and recovery of central service costs.

Conclusion: We concluded that DMB was effective in assessing and recovering central service costs. However, our audit disclosed reportable conditions related to compliance with U.S. Office of Management and Budget (OMB) Circular A-87 (Finding 1) and establishment of billing rates (Finding 2).

FINDING

1. Compliance With OMB Circular A-87

   DMB did not comply with OMB Circular A-87 when it refunded the unrestricted portion of the Health Advance Funding Subaccount in the State Employees' Retirement Fund to the General Fund in fiscal year 2002-03. As a result, DMB may be required to refund $18.3 million to the federal government based on an estimate by DMB of the portion of the Subaccount that was from federal funds.

   Attachment B, subsection 8.e(5), OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, provides that the federal government shall

* *See glossary at end of report for glossary.*

receive an equitable share of any amounts of previously paid pension costs (including earnings thereon) which revert to the governmental unit in the form of a refund, withdrawal, or other credit.

DMB created the Health Advance Funding Subaccount within the State Employees' Retirement Fund in fiscal year 2001-02 to help fund future health benefits of State employees after they retire. The Subaccount was funded with pension contributions of $87.5 million from all departments and funds whose employees participate in the State Employees' Retirement System and subsequent interest earnings. Along with the General Fund, numerous federal grants and other restricted funds financed these pension contributions. In fiscal year 2002-03, DMB transferred $57.0 million, which represented DMB's estimate of the portion of the Subaccount that was funded in the previous year by General Fund/general purpose funding to help balance the General Fund budget as provided by Act 743, P.A. 2002.

DMB should pursue remedies with the federal cognizant agency that oversees the Statewide Cost Allocation Plan to ensure that the federal government receives its equitable share of the refunded pension costs in accordance with OMB Circular A-87.

RECOMMENDATION

We recommend that DMB comply with OMB Circular A-87 when refunding amounts from the Health Advance Funding Subaccount in the State Employees' Retirement Fund.

AGENCY PRELIMINARY RESPONSE

DMB agreed and informed us that, as noted by the auditors, the fiscal year 2002-03 transfer from the Health Advance Funding Subaccount to the General Fund was made in accordance with Act 743, P.A. 2002. At the time the transfer was made, DMB believed that additional transfers or refunds of amounts accumulated in the Subaccount were unnecessary. Based on the research done by the auditors, DMB will explore whether additional remedies are needed to return a portion of the amount remaining in the Subaccount to the federal government.

FINDING

2. Establishment of Billing Rates

DMB did not establish billing rates to ensure that it recovered the full cost of providing print and graphics services to other State agencies. In addition, DMB should evaluate whether increasing its billing rates for building occupancy costs would result in a sufficient amount of additional federal and other State restricted funds to justify increasing the rates.

Our review of DMB's print and graphics services and building occupancy billing rates disclosed:

a. DMB had not established a billing rate for print and graphics services sufficient to avoid losses averaging $0.8 million during fiscal years 1995-96 through 2003-04 or recovered these losses through subsequent years' billing rates. Sections 221 and 269, Act 431, P.A. 1984, require that DMB's billing rates for print and graphics services reflect the actual cost of the services provided. DMB financed these losses through borrowings from the State's Common Cash pool, which resulted in federal and other restricted funding sources not sharing in the cost of the services provided.

   In an attempt to recover losses incurred in fiscal year 2003-04, DMB increased its print and graphics services billing rates for fiscal year 2004-05. Also, to increase revenue, DMB reduced to $500 the delegated authority for State agencies to purchase printing services from other sources. Further, DMB's fiscal year 2005-06 business plan provides for several print and graphics services changes to substantially decrease expenses and increase revenues. Our analysis of DMB's operating schedules for the first six months of fiscal year 2004-05 indicated that DMB may be able to avoid losses for print and graphics services in fiscal year 2004-05; however, without the changes planned for fiscal year 2005-06, it appears unlikely that DMB will significantly reduce the $5.9 million of accumulated losses from prior fiscal years.

   DMB informed us that it keeps the billing rates for print and graphics services low to lessen the impact at the program and agency level. However, maintaining lower billing rates results in underbilling federal and other restricted funding sources.

b. DMB should perform an analysis to determine if increasing building occupancy billing rates for State programs would result in a net benefit to the State through the recovery of additional federal and State restricted funds. DMB did not charge State agencies at a rate that covered all allowable building occupancy costs, such as building use charges and bond interest. As a result, DMB had not billed additional allowable costs of $20.4 million in fiscal year 2003-04 and an annual average loss of $7.2 million for fiscal years 1994-95 through 2003-04.

Federal regulations allow DMB to increase rates to recover a 2% building use charge and interest on bonds used to finance construction as part of the cost of building occupancy. The 2% building use charge is intended to reimburse the State for the cost of constructing the buildings in prior years. Federal regulations require that if federal programs were billed the 2% building use charge, State funding sources would also have to be billed the 2% building use charge.

DMB informed us that it tries to keep building occupancy rates low to limit the negative impact on State programs. In addition, not all programs would be able to recover additional building occupancy costs from federal or other State restricted funding sources because the programs are not allowed to recover administrative costs or have already recovered the full amount of the federal award. However, DMB had not determined the amount of additional building occupancy costs that could be recovered from federal and other restricted funding sources to determine if the additional funds were sufficient to pursue. For example, if 20% of the average annual loss of $7.2 million had been recovered from federal and other restricted funding sources, the annual savings to the General Fund could total $1.4 million annually.

RECOMMENDATIONS

We recommend that DMB establish billing rates to ensure that it recovers the full cost of providing print and graphics services to other State agencies.

We also recommend that DMB evaluate whether increasing its billing rates for building occupancy costs would result in a sufficient amount of additional federal and other State restricted funds to justify increasing the rates.

AGENCY PRELIMINARY RESPONSE

DMB agreed with our first recommendation and informed us that it had complied. DMB indicated that print and graphics service rates are developed to cover the full costs. DMB believes that most of the losses occurred in fiscal year 2001-02 and fiscal year 2002-03 primarily because of an economic downturn. DMB informed us that to curtail losses, it has moved aggressively to cut costs, change operating procedures and products, and close Rapid Copy Centers to respond to these abrupt changes in the business environment. DMB also informed us that it has adjusted prices and will continue to price products to recover current costs and past losses. In addition, DMB informed us that raising prices precipitously to cover the immediate losses would have resulted in even less revenue and more losses from a further decline in demand.

DMB also agreed with our second recommendation and informed us that it will complete an analysis by June 30, 2006. DMB believes the analysis will justify the budget policy of not including in the building occupancy rate the building use and interest expenses.

SUPPLEMENTAL INFORMATION

UNAUDITED

STATE OF MICHIGAN
Department of Management and Budget
Building Occupancy Cumulative Costs
Fiscal Years 1991-92 Through 2003-04

Building	Cumulative Profit (Loss) 1991-92 through 2002-03	Refunded in 2003-04	Cumulative Adjusted Profit (Loss) 1991-92 through 2002-03	Fiscal Year 2003-04 Allowable Costs	Fiscal Year 2003-04 Revenues	Fiscal Year 2003-04 Profit (Loss)
Williams	$ (530,693)	$	$ (530,693)	$ 2,123,151	$ 920,427	$ (1,202,724)
Mason/Treasury	(1,466,670)		(1,466,670)	4,969,635	4,253,490	(716,145)
Cass	(2,231,059)		(2,231,059)	2,472,258	2,168,872	(303,386)
Ottawa/Hannah	2,434,653		2,434,653	4,038,062	4,569,091	531,029
Total Central Offices	$ (1,793,769)	$ 0	$ (1,793,769)	$ 13,603,106	$ 11,911,880	$ (1,691,226)
Grand Tower	1,410,681	777,550	633,131	2,483,734	3,570,980	1,087,246
Van Wagoner	(803,493)		(803,493)	2,698,585	2,424,181	(274,404)
Ellis	(52,920)		(52,920)	508,557	491,802	(16,755)
Romney	(14,182,029)		(14,182,029)	3,647,171	2,668,270	(978,901)
Constitution Hall	(8,977,145)		(8,977,145)	11,032,914	6,004,334	(5,028,580)
Hall of Justice	(2,558,299)		(2,558,299)	9,317,881	3,504,368	(5,813,513)
Capitol Tower	(580,723)		(580,723)	523,922	364,146	(159,776)
Library and Historical Center	(3,422,789)		(3,422,789)	3,493,820	1,998,694	(1,495,126)
Governor residence	(39,152)		(39,152)			
Hosmer Warehouse	(19,482)		(19,482)			
General Office	(642,924)		(642,924)	2,444,479	2,383,313	(61,166)
Secretary of State	(1,917,512)		(1,917,512)	1,509,753	1,654,190	144,437
General Services	(1,422,038)		(1,422,038)	1,092,322	1,162,511	70,189
State Police Training Academy	(1,866,740)		(1,866,740)	1,117,917	1,742,064	624,147
State Police Laboratory	(2,631,669)		(2,631,669)	2,811,044	1,325,080	(1,485,964)
Materials Management	(358,320)		(358,320)			0
Secondary Operations Center	(382,516)		(382,516)	5,761,506	3,406,246	(2,355,260)
First District Headquarters	42,033		42,033	104,588	109,138	4,550
Vehicle and Travel Services	(143,765)		(143,765)	505,306	412,640	(92,666)
Construction and Technology	(666,930)		(666,930)	691,446	734,263	42,817
Transportation Photography Laboratory	(176,750)		(176,750)	253,825	218,371	(35,454)
Transportation Warehouse	(199,282)		(199,282)	388,241	519,637	131,396
Rickle Road Laboratory	(763,899)		(763,899)	330,990	260,137	(70,853)
Baker-Olin	270,613		270,613	1,744,747	1,920,058	175,311
State Laboratory	(1,400,051)		(1,400,051)	2,010,001	1,958,750	(51,251)
Records Center	(187,462)		(187,462)	313,299	335,496	22,197
Terminal Street Laboratory	(672,877)		(672,877)	278,064	270,033	(8,031)
Executive Plaza	(4,636,214)		(4,636,214)	1,469,542	228,785	(1,240,757)
Labor	(1,113,913)		(1,113,913)	157,956		(157,956)
Cadillac Place	3,005,226		3,005,226	20,259,244	19,041,610	(1,217,634)
Flint Office Building	(6,279,593)		(6,279,593)	1,043,253	1,075,033	31,780
Grand Rapids Office Building	(787,307)		(787,307)	995,013	598,530	(396,483)
Grand Rapids Office Building - Monroe Street	(17,310)		(17,310)	2,284,666	1,861,044	(423,622)
Saginaw Office Building	(7,938,850)		(7,938,850)	937,124	1,269,153	332,029
Jackson Office Building	870		870	757,112	891,054	133,942
Escanaba Office Building	(334,787)		(334,787)	292,149	331,830	39,681
Traverse City Office Building	(1,973,040)		(1,973,040)	813,471	630,816	(182,655)
Total All Buildings	$ (64,214,127)	$ 777,550	$ (64,991,677)	$ 97,676,748	$ 77,278,437	$ (20,398,311)

Source: Department of Management and Budget Building Occupancy Building Rental Rate Cost Allocation Plan.

Cumulative Profit (Loss)	60 Days of Allowable Costs (Expenditures)	Balance More (Less) Than Federal Limits
$ (1,733,417)	$ 353,859	$ (2,087,276)
(2,182,815)	828,273	(3,011,088)
(2,534,445)	412,043	(2,946,488)
2,965,682	673,010	2,292,672
$ (3,484,995)	$ 2,267,184	$ (5,752,179)
1,720,377	413,956	1,306,421
(1,077,897)	449,764	(1,527,661)
(69,675)	84,760	(154,435)
(15,160,930)	607,862	(15,768,792)
(14,005,725)	1,838,819	(15,844,544)
(8,371,812)	1,552,980	(9,924,792)
(740,499)	87,320	(827,819)
(4,917,915)	582,303	(5,500,218)
(39,152)		(39,152)
(19,482)		(19,482)
(704,090)	407,413	(1,111,503)
(1,773,075)	251,626	(2,024,701)
(1,351,849)	182,054	(1,533,903)
(1,242,593)	186,320	(1,428,913)
(4,117,633)	468,507	(4,586,140)
(358,320)		(358,320)
(2,737,776)	960,251	(3,698,027)
46,583	17,431	29,152
(236,431)	84,218	(320,649)
(624,113)	115,241	(739,354)
(212,204)	42,304	(254,508)
(67,886)	64,707	(132,593)
(834,752)	55,165	(889,917)
445,924	290,791	155,133
(1,451,302)	335,000	(1,786,302)
(165,265)	52,217	(217,482)
(680,908)	46,344	(727,252)
(5,876,971)	244,924	(6,121,895)
(1,271,869)	26,326	(1,298,195)
1,787,592	3,376,541	(1,588,949)
(6,247,813)	173,876	(6,421,689)
(1,183,790)	165,836	(1,349,626)
(440,932)	380,778	(821,710)
(7,606,821)	156,187	(7,763,008)
134,812	126,185	8,627
(295,106)	48,692	(343,798)
(2,155,695)	135,579	(2,291,274)
$ (85,389,988)	$ 16,279,458	$ (101,669,446)

GLOSSARY

Glossary of Acronyms and Terms

billed central services	Central services billed to benefiting agencies on an individual fee-for-service basis.
DMB	Department of Management and Budget.
fixed with carry-forward basis	A basis for establishing statewide indirect costs whereby the costs are estimated in the Cost Allocation Agreement and are adjusted for actual costs in a later year.
HHS	U.S. Department of Health and Human Services.
indirect costs	Costs incurred for a common or joint purpose that benefit more than one program or function.
internal service fund	A fund established to account for financial transactions for services provided by a State agency to other State agencies.
OMB	U.S. Office of Management and Budget.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.
reportable condition	A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.
SWCAP	Statewide Cost Allocation Plan.

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