FINANCIAL RELATED AUDIT
OF THE

STATEWIDE COST ALLOCATION PLAN

DEPARTMENT OF MANAGEMENT AND BUDGET

October 1, 1994 through September 30, 1997

07-131-98

EXECUTIVE DIGEST

STATEWIDE COST ALLOCATION PLAN

INTRODUCTION	This report contains the results of our financial related audit* of the Statewide Cost Allocation Plan (SWCAP), Department of Management and Budget (DMB), for the period October 1, 1994 through September 30, 1997.
AUDIT PURPOSE	This financial related audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Financial related audits are conducted at various intervals to permit the Auditor General to express an opinion on the State's financial statements. Also, this audit complements our departmentwide financial audits, including the provisions of the Single Audit Act of 1984, which are conducted pursuant to Act 251, P.A. 1986.
BACKGROUND	A SWCAP is the mechanism by which a state identifies, summarizes, and allocates 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*. A SWCAP is required for the State to obtain reimbursement from the federal government for the costs of central support services provided to operating departments by the Department of Civil Rights, Department of Civil Service, DMB, Department of Treasury, and Office of the Auditor General.

* *See glossary on page 18 for definition*

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.

The State submits a proposed SWCAP based on estimated costs and a final SWCAP based on actual costs to the U.S. Department of Health and Human Services (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 1996-97, which included estimated costs for the fiscal year 1996-97 proposed SWCAP and carry-forward costs from the fiscal year 1994-95 final SWCAP.

DMB provides the approved indirect costs to the State's operating departments to obtain federal reimbursement of Statewide indirect costs. The amount of reimbursement for these Statewide indirect costs is determined by each operating department's method of billing indirect costs for different federal assistance programs. Statewide indirect costs allocated to operating departments and other funds for fiscal year 1996-97 were $77.7 million.

AUDIT OBJECTIVES AND CONCLUSIONS

Audit Objective: To assess the allowability of SWCAP costs in accordance with the Office of Management and Budget (OMB) Circular A-87.

Conclusion: We concluded that SWCAP costs were in accordance with OMB Circular A-87. However, we

* *See glossary on page 18 for definition.*

identified a reportable condition* involving allowable costs (Finding 1).

Audit Objective: To assess the reasonableness of the SWCAP methodology used to allocate central support service costs to user departments.

Conclusion: We concluded that the SWCAP allocation methodology was reasonable.

Audit Objective: To assess the timeliness of DMB's distribution of SWCAP costs to user departments.

Conclusion: We concluded that DMB distributed SWCAP costs to user departments in a timely manner.

Audit Objective: To assess whether the SWCAP complied with OMB Circular A-87 regarding the federal allowance for retained earnings of internal service funds and the related documentation requirements.

Conclusion: We concluded that the SWCAP generally complied with OMB Circular A-87 regarding the federal allowance for retained earnings; however, we identified a reportable condition involving excess working capital reserves (Finding 2). We also concluded that DMB complied with documentation requirements.

AUDIT SCOPE

Our audit scope was to examine the final Statewide Cost Allocation Plans that were completed in our audit period. Our audit scope was primarily to examine the final Statewide Cost Allocation Plan for fiscal year 1994-95, which was approved by HHS in the fiscal year 1996-97 Cost Allocation Agreement. We also examined the final

* *See glossary on page 18 for definition.*

Statewide Cost Allocation Plans for fiscal years 1995-96 and 1996-97 and the proposed Statewide Cost Allocation Plans for fiscal years 1997-98 and 1998-99 on a limited basis because these costs will be included in future Cost Allocation Agreements. 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.

AGENCY RESPONSES

Our audit report contains 2 findings and corresponding recommendations. DMB's preliminary response indicated that it agreed with both recommendations, has complied with one recommendation, and will comply with the other recommendation.

Ms. Janet E. Phipps, Director
Department of Management and Budget
Lewis Cass Building
Lansing, Michigan

Dear Ms. Phipps:

This is our report on the financial related audit of the Statewide Cost Allocation Plan (SWCAP), Department of Management and Budget, for the period October 1, 1994 through September 30, 1997.

This report contains our executive digest; description of the SWCAP; audit objectives, audit scope, and agency responses; comments, findings, recommendations, and agency preliminary responses; schedule of questioned 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

This page left intentionally blank.

TABLE OF CONTENTS

STATEWIDE COST ALLOCATION PLAN
DEPARTMENT OF MANAGEMENT AND BUDGET

INTRODUCTION

	Page
Executive Digest	1
Report Letter	5
Description of the Statewide Cost Allocation Plan	8
Audit Objectives, Audit Scope, and Agency Responses	9

COMMENTS, FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

Allowability of Costs	11
1. Allowable Costs	11
Cost Allocation Methodology	12
Distribution of Costs to Departments	12
Internal Service Funds	12
2. Excess Working Capital Reserves	13

SUPPLEMENTAL INFORMATION

Schedule of Questioned Costs	16

GLOSSARY

Glossary of Acronyms and Terms

Description of the Statewide Cost Allocation Plan

A Statewide Cost Allocation Plan (SWCAP) is the mechanism by which a state identifies, summarizes, and allocates 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. A SWCAP is required by 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 1996-97, which included estimated costs for the fiscal year 1996-97 proposed SWCAP and carry-forward costs from the fiscal year 1994-95 final SWCAP.

DMB provides the approved indirect costs to the State's operating departments for allocation to their federal assistance programs. Operating departments bill for federal reimbursement of Statewide indirect costs from federal assistance programs. The amount of reimbursement for these Statewide indirect costs is determined by each operating department's method of billing indirect costs for different federal assistance programs. Statewide indirect costs allocated to operating departments and other funds for fiscal year 1996-97 were $77.7 million.

Audit Objectives, Audit Scope, and Agency Responses

Audit Objectives

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

1. To assess the allowability of SWCAP costs in accordance with the Office of Management and Budget (OMB) Circular A-87.

2. To assess the reasonableness of the SWCAP methodology used to allocate central support service costs to user departments.

3. To assess the timeliness of DMB's distribution of SWCAP costs to user departments.

4. To assess whether the SWCAP complied with OMB Circular A-87 regarding the federal allowance for retained earnings of internal service funds and the related documentation requirements.

Our audit, relative to the objectives for the assessment of allowability of costs, reasonableness of methodology, and compliance with OMB Circular A-87 for the SWCAP, complements our departmentwide financial audits, including the provisions of the Single Audit Act of 1984, which are conducted pursuant to Act 251, P.A. 1986.

Audit Scope

Our audit scope was to examine the final Statewide Cost Allocation Plans that were completed in our audit period. Our audit scope was primarily to examine the final Statewide Cost Allocation Plan for fiscal year 1994-95, which was approved by the U.S. Department of Health and Human Services in the fiscal year 1996-97 Cost Allocation Agreement. We also examined the final Statewide Cost Allocation Plans for fiscal years 1995-96 and 1996-97 and the proposed Statewide Cost Allocation Plans for fiscal years 1997-98 and 1998-99 on a limited basis because these costs will be included in future Cost Allocation Agreements. 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.

Agency Responses

Our audit report contains 2 findings and corresponding recommendations. DMB's preliminary response indicated that it agreed with both recommendations, has complied with one recommendation, and will comply with the other recommendation.

The agency preliminary response which 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.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

ALLOWABILITY OF COSTS

COMMENT

Audit Objective: To assess the allowability of the Statewide Cost Allocation Plan (SWCAP) costs in accordance with the Office of Management and Budget (OMB) Circular A-87.

Conclusion: We concluded that the SWCAP costs were in accordance with OMB Circular A-87. However, we identified a reportable condition involving allowable costs.

FINDING

1. Allowable Costs

Department of Management and Budget (DMB) had not established sufficient procedures to ensure that it included all allowable indirect costs in the SWCAP.

DMB selected the DAFR 9220 report to accumulate indirect costs for the development of the SWCAP. The DAFR 9220 report was selected because it provided an appropriate level of detail of agency revenue and expenditures to identify allowable indirect costs. However, the program logic of the DAFR 9220 report inadvertently excluded some expenditures. This resulted in DMB understating indirect costs by $38,332 in the fiscal year 1994-95 SWCAP. DMB also used the DAFR 9220 report to develop subsequent years' SWCAP reports, which could potentially misstate indirect costs for fiscal years 1995-96 and 1996-97.

Because DMB provides SWCAP costs to State agencies to obtain federal reimbursement, understated costs in the SWCAP result in State agencies claiming less costs for reimbursement.

RECOMMENDATION

We recommend that DMB establish sufficient procedures to ensure that it includes all allowable indirect costs in the SWCAP.

AGENCY PRELIMINARY RESPONSE

DMB agreed with the recommendation and informed us that it has complied. DMB reconciled SWCAP costs with the official State books for fiscal year 1997-98 and will reconcile each subsequent year.

COST ALLOCATION METHODOLOGY

COMMENT

Audit Objective: To assess the reasonableness of the SWCAP methodology used to allocate central support service costs to user departments.

Conclusion: We concluded that the SWCAP allocation methodology was reasonable.

DISTRIBUTION OF COSTS TO DEPARTMENTS

COMMENT

Audit Objective: To assess the timeliness of DMB's distribution of SWCAP costs to user departments.

Conclusion: We concluded that DMB distributed SWCAP costs to user departments in a timely manner.

INTERNAL SERVICE FUNDS

COMMENT

Audit Objective: To assess whether the SWCAP complied with OMB Circular A-87 regarding the federal allowance for retained earnings of internal service funds and the related documentation requirements.

Conclusion: We concluded that the SWCAP generally complied with OMB Circular A-87 regarding the federal allowance for retained earnings; however, we identified a reportable condition involving excess working capital reserves. We also concluded that DMB complied with documentation requirements.

FINDING

2. Excess Working Capital Reserves

DMB did not adjust billed central services that exceeded allowable reserves in internal service funds. Microfilm operations had excess working capital of $443,223 and purchased services had excess working capital of $637,280 as of September 30, 1997.

Billed central services are accounted for in internal service funds and are billed to State agencies on an individual fee-for-service basis. These billed costs may be eligible for federal reimbursement at the State agencies. OMB Circular A-87 establishes a reasonable level of working capital of up to 60 days' cash expenses to operate from one billing cycle to the next. This requirement is intended to prevent internal service funds from overbilling State agencies and federal programs for costs. OMB Circular A-87 requires an annual reconciliation comparing revenue generated and allowable costs, including the working capital reserve, and an adjustment for any excess working capital reserves.

DMB completed annual reconciliations for each of the 27 billed central services accounted for in four internal service funds to determine if the rates charged to users should be adjusted. These reconciliations disclosed excess working capital reserves for microfilm operations in fiscal years 1994-95, 1995-96, and 1996-97 and for purchased services in fiscal years 1995-96 and 1996-97. In addition, DMB's projected financial reports for fiscal years 1997-98 and 1998-99 forecast continual increases of excess working capital reserves for both microfilm operations and purchased services.

The Implementation Guide for OMB Circular A-87 states that interest may be assessed on excess working capital reserves.

RECOMMENDATION

We recommend that DMB adjust billed central services that exceed allowable reserves in internal service funds.

AGENCY PRELIMINARY RESPONSE

DMB agreed with the recommendation and is currently negotiating with the U.S. Department of Health and Human Services for a resolution of excess working capital reserves.

SUPPLEMENTAL INFORMATION

STATEWIDE COST ALLOCATION PLAN
Department of Management and Budget
Schedule of Questioned Costs
Fiscal Years Ended September 30, 1997, 1996, and 1995

Program	Finding	Questioned Costs (A)(B)
SWCAP - Allocated Costs	Expenditures were underreported for fiscal year 1994-95 because of incorrect report logic in the reports used to compile the SWCAP.	$ (38,332)
SWCAP - Allocated Costs	A negative expenditure transaction was processed in the accounting records for fiscal year 1994-95 after the reports were compiled for SWCAP expenditures.	773
SWCAP - Allocated Costs	Expenditures for penalties were included in the SWCAP for fiscal year 1994-95.	29
SWCAP - Allocated Costs	Eligible expenditures for fiscal year 1993-94 were included in expenditures for fiscal year 1994-95.	117,296
SWCAP - Billed Costs,	Eligible expenditures for fiscal year 1995-96 were included in expenditures for fiscal year 1994-95. Expenditures were overstated for fiscal year 1994-95.	124,912
SWCAP - Billed Costs, Building Space Costs	Eligible expenditures for fiscal year 1995-96 were included in expenditures for fiscal year 1994-95. Expenditures were understated for fiscal year 1995-96.	(124,912)
SWCAP - Billed Costs, Building Space Costs	Expenditures were not reduced for revenue received for special maintenance projects for fiscal year 1994-95.	81,847
SWCAP - Billed Costs, Building Space Costs	Expenditures for penalties were included in the building space costs for fiscal year 1994-95.	7,796

This schedule continued on next page.

STATEWIDE COST ALLOCATION PLAN
Department of Management and Budget
Schedule of Questioned Costs
Fiscal Years Ended September 30, 1997, 1996, and 1995
Continued

Program	Finding	Questioned Costs (A)(B)
SWCAP - Billed Costs, Microfilm Operations	Retained earnings as of September 30, 1997 exceeded the amount allowed by federal guidelines that allow up to 60 days of an internal service fund's cash operating expenses, and the excess was not adjusted.	$ 443,223
SWCAP - Billed Costs, Purchased Services	Retained earnings as of September 30, 1997 exceeded the amount allowed by federal guidelines that allow up to 60 days of an internal service fund's cash operating expenses, and the excess was not adjusted.	637,280
	Total Questioned Costs	$1,249,912

(A) "Questioned Costs" are defined as amounts potentially due to the federal government because of reimbursements for unallowable, undocumented, unapproved, or unreasonable costs or amounts potentially due from the federal government for reimbursements that were not claimed or were claimed for less than the eligible amount. Amounts potentially due from the federal government are presented as (negative) questioned costs.

(B) Departments allocate Statewide indirect costs to federal and nonfederal programs; therefore, only part of questioned costs presented would be applicable to federal programs. The federal share of Statewide indirect costs is determined by each department's method of billing indirect costs for different federal programs.

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.
financial related audit	An audit that includes determining whether (1) financial information is presented in accordance with established or stated criteria, (2) the entity has adhered to specific financial compliance requirements, or (3) the entity's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives.
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	federal Office of Management and Budget.
reportable condition	A matter coming to the auditor's attention that, in his/her judgment, should be communicated because it 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.