Special Report

Statewide Review of Budget Closeout Transactions for Fiscal Year 2007

January 2008

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

- This report and any related follow-up correspondence are available to the public through the Office of Legislative Audits at 301 West Preston Street, Room 1202, Baltimore, Maryland 21201. The Office may be contacted by telephone at 410-946-5900, 301-970-5900, or 1-877-486-9964.

- Electronic copies of our audit reports can be viewed or downloaded from our website at http://www.ola.state.md.us.

- Alternate formats may be requested through the Maryland Relay Service at 1-800-735-2258.

- The Department of Legislative Services – Office of the Executive Director, 90 State Circle, Annapolis, Maryland 21401 can also assist you in obtaining copies of our reports and related correspondence. The Department may be contacted by telephone at 410-946-5400 or 301-970-5400.

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

January 28, 2008

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have conducted a review of the State's budget closeout transactions for the fiscal year ended June 30, 2007. Our review of closeout transactions disclosed general compliance with the applicable laws, regulations, and policies. However, we determined that certain transactions pertaining to the following agencies were not in compliance:

Maryland State Department of Education
Department of Human Resources
Department of State Police
Department of Housing and Community Development
Department of Health and Mental Hygiene

Generally, the non-compliant transactions we identified either suggest that additional State funds may be required to eliminate potential deficits, or resulted in the General Fund being denied certain funds as of June 30, 2007. For example, accrued revenues totaling $27.5 million could not be substantiated. If the revenues are not available for these accruals, general fund appropriations (or deficiency appropriations) may ultimately be needed to eliminate the resulting deficits. A summary of our findings, by agency, is included in Exhibit 1.

Five State agencies reported a total of $22.5 million in unprovided for payables as of June 30, 2007 (Exhibit 2). This situation means that the related expenditures will have to be funded with subsequent year appropriations. According to an opinion of the Attorney General, this is not a violation of State law if the General Assembly enacts a budget bill for the subsequent year containing an appropriation that can be used to fund these expenditures.

The agencies identified in this report generally agreed with our findings. The primary purpose of this annual review is to alert the Maryland General Assembly to significant financial and budgetary closeout practices that do not comply with applicable laws and regulations. The issues identified during this review, as well as relevant recommendations, will be fully addressed, as appropriate, in our fiscal compliance audit reports on the applicable agencies. We wish to acknowledge the cooperation extended to us during the course of our review by the Comptroller of the Treasury – General Accounting Division and by the various State agencies.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

Table of Contents

* Denotes item repeated in full or part from preceding report

Background Information

The Comptroller of the Treasury – General Accounting Division (GAD) annually provides State agencies with instructions for completing the fiscal year-end budget closeout process. State agencies individually report to GAD their fiscal year-end closing transactions that have not been previously recorded in the State's accounting records. GAD is responsible for closing the State's accounting records on a statewide basis and for preparing the State's Comprehensive Annual Financial Report (CAFR).

GAD contracts with an independent accounting firm for the purpose of expressing an opinion on the State's basic financial statements contained in the CAFR. In its audit report dated December 10, 2007, applicable to the fiscal year ended June 30, 2007, the firm stated that the State's basic financial statements presented fairly, in all material respects, the financial position of the State of Maryland as of June 30, 2007, and the respective changes in the financial position and cash flows, for the year then ended in conformity with accounting principles generally accepted in the United States of America (referred to as GAAP).

The State's CAFR states that the General Fund, on a budgetary basis, had a balance of approximately $2.1 billion as of June 30, 2007. This amount represents a decrease of approximately $200 million from the balance reported at the preceding fiscal year-end ($2.3 billion).

Introduction, Objectives, and Scope

We conducted a review of the State's budget closeout transactions for the fiscal year ended June 30, 2007. This review was conducted under the authority of the State Government Article, Section 2-1221 of the Annotated Code of Maryland.

The objective of our review was to determine whether budget closeout transactions, for the fiscal year ended June 30, 2007, were properly supported and made in accordance with State budgetary laws, regulations, and accounting policies.

Our review consisted of tests of significant year-end transactions for 22 Departments and independent agencies to ascertain if they were properly supported and made in accordance with State budgetary laws, regulations, and accounting policies. We also reviewed, on a limited basis, transactions processed subsequent to June 30, 2007 to determine if they were properly recorded (such as charged or credited to the proper fiscal year). Also, we assessed the status of the findings identified during our review of the budget closeout transactions for the fiscal year ended June 30, 2006, which were reported to the Joint Audit Committee in a special report dated January 18, 2007. As part of our current review, we contacted various officials of State agencies, as well as the independent accounting firm under contract with the State to express an opinion on its financial statements. Our review excluded public colleges and universities and transactions processed through the Transportation Trust Fund because the related financial activity does not involve the State's General Fund and/or because agencies have the authority to retain unspent funds at year-end.

Our conclusions for the aforementioned objective are contained on page 9 of this report. Our follow-up review of the three closeout transactions from the *Statewide Review of Budget Closeout Transactions for Fiscal Year 2006* disclosed that two of the exceptions are repeated in this report, while the third finding was satisfactorily addressed by the applicable agency.

Our review was limited to the procedures necessary to accomplish the aforementioned objective. These procedures did not constitute an audit conducted in accordance with generally accepted government auditing standards (GAGAS). Had we conducted an audit in accordance with GAGAS, those standards would require the issuance of recommendations as part of our reporting process. In addition, other matters may have come to our attention that would have been reported. Our fieldwork was conducted during the period from October 2007 to January 2008.

Findings

Closeout Transactions

Conclusion

Our review of State agencies' budget closeout transactions disclosed that such transactions were generally properly supported and made in accordance with State budgetary laws, regulations, and accounting policies. However, we determined that five departments or units thereof were not in compliance primarily because certain year-end transactions either were not properly recorded or could not be substantiated.

Revenue Transactions

Three State agencies could not substantiate certain revenue transactions totaling \$27.5 million. That is, the agencies could not provide evidence that they were entitled to receive federal or reimbursable funding for the specific expenditures incurred. To the extent that these funds are not received, the resulting deficits would likely require the use of general funds. In addition, one state agency maintained a deficit special fund balance of \$5.5 million as a result of an improper fiscal year 2005 closing transaction. The use of general funds will likely be required to eliminate the deficit. Finally, one agency recorded a negative accrued revenue adjustment totaling \$7.4 million that resulted in transferring non-budgeted fund revenue from fiscal year 2007 to fiscal year 2008.

Expenditure Transactions

One State agency recorded its remaining Medicaid general fund appropriation balance as an accrued expenditure at year-end, which was \$41 million more than its projected incurred but not reported (IBNR) Medicaid claims for fiscal year 2007. If not accrued, the \$41 million would have been reverted to the State's general fund.

A summary of our findings, by agency, is included in Exhibit 1 on page 16 of this report.

Revenue Transactions

Finding 1
Accrued federal, special, and reimbursable fund revenues totaling approximately $27.5 million could not be substantiated.

Analysis
The **Maryland State Department of Education (MSDE),** the **Department of Human Resources (DHR**), and the **Department of State Police (DSP)** recorded unsubstantiated revenues of approximately $13.3 million, $12.4 million and $1.8 million, respectively. If revenues are not available for these accruals, which were recorded to cover expenditures that had been previously incurred, general fund appropriations (or deficiency appropriations) may ultimately be needed to eliminate the resulting deficit. These conditions had been commented upon in our four preceding annual budget closeout reports for DHR and were commented upon in our preceding annual budget closeout report for MSDE and DSP.

MSDE
MSDE recorded unsubstantiated federal fund revenues totaling $13.3 million at June 30, 2007 related to the federal Temporary Assistance to Needy Families (TANF) grant. The unsubstantiated amount totaled $15.4 million at June 30, 2006, as reported in our fiscal year 2006 closeout review; during fiscal year 2007 MSDE reduced this amount by $2.1 million using general funds. This unsubstantiated accrual relates to MSDE's failure to recover TANF-related expenditures incurred during fiscal years 2002 and 2003 and for which TANF funds are no longer available for MSDE expenditure reimbursement.

During fiscal year 2007, MSDE, with the concurrence of the Secretary of the Department of Budget and Management (DBM), accumulated general fund recoveries from MSDE's State aid audit process in a special fund revenue account, and used these funds to help offset the unrecoverable federal fund TANF balance. Because these recoveries represented the return of general fund monies, they should have been recorded as general fund revenue. Furthermore, the *Accounting Procedures Manual* of the Comptroller of the Treasury — General Accounting Division (GAD) requires that the recovery of prior year expenditures be reported as general fund revenue and deposited in the State's General Fund. However, MSDE applied $2.1 million of these general fund recoveries against the TANF balance during fiscal year 2007 and, as of November 2007, had accumulated another $2.1 million during fiscal year 2008 for this same purpose.

DHR

DHR recorded unsubstantiated federal fund revenues totaling approximately $12.4 million relating to the TANF grant ($9.3 million) and the Foster Care Title IV-E training grant ($3.1 million). Both of these conditions have been reported upon in our fiscal year closeout reviews since 2003.

DHR's records indicated that the TANF unsubstantiated accrued revenues totaled approximately $9.3 million as of June 30, 2007, which is a decrease of $12.4 million from the $21.7 million reported in fiscal year 2006. DHR reported to GAD in fiscal year 2006 that it was taking action to eliminate the unfunded receivable by fiscal year 2008. Consequently, DHR used fiscal year 2007 general fund appropriations to reduce $12.4 million of the prior years' unfunded liability. DHR was able to use these general fund appropriations to reduce the unfunded receivable by identifying certain fiscal year 2007 expenditures that could be paid by the TANF grant instead of general fund appropriations as originally budgeted.

DHR records indicated that the portion of unsubstantiated federal fund revenues related to the Title IV-E grant totaled $3.1 million as of June 30, 2007, which is a decrease of $7.4 million from the $10.5 million reported in fiscal year 2006. These unsubstantiated revenues related to accounting entries dating as far back as March 1999, according to DHR records. These entries resulted from DHR charging a percentage of foster care expenditures against the grant beyond that which was allowed and eligible for reimbursement by the federal government. The $7.4 million reduction resulted from a federal audit settlement that reduced the liability by $2.2. million, as well as the application of approximately $3.6 million in general funds DHR had set aside to pay for the questioned foster care expenditures, and approximately $1.6 million in Title IV-E reimbursement funds due from the Department of Juvenile Services related to that federal audit. The Department of Juvenile Services has not recorded this liability.

DSP

DSP recorded unsubstantiated reimbursable and special fund revenues totaling approximately $1.8 million relating to unattained revenue from the Maryland Emergency Management Agency (MEMA) and from other entities. DSP did not have adequate documentation to support a reimbursable fund accrual of $1.2 million that it claims is due from MEMA. The Military Department, which provides accounting support services for MEMA, informed us that no documentation exists that MEMA owes DSP any funds related to this accrual, and that no liability had been recorded. This unsubstantiated accrued revenue was reported upon in our fiscal year 2006 closeout review. DSP also did not have documentation to support a special fund accrual of $560,000 related to DSP providing services to other entities. Accounting detail records were not available to substantiate this assertion or identify the other entities that owed these amounts to DSP.

Finding 2
A general fund deficiency appropriation may be required to eliminate a special fund deficit balance of $5.5 million.

Analysis
The **Department of State Police (DSP)** may require a general fund deficiency appropriation to eliminate a special fund deficit balance of $5.5 million that existed as of June 30, 2007. Specifically, DSP mistakenly recorded certain transactions as both accrued revenue and actual revenue during fiscal year 2005. This resulted in a special fund surplus of $5.6 million which DSP transferred to the general fund during the fiscal year 2005 closeout because it did not have legal authority to retain any balance in this special fund. When this mistake was discovered during fiscal year 2006, DSP was left with a special fund deficit balance of $5.6 million at the end of fiscal year 2006 due to the automatic reversal of the previously recorded accrued revenue transaction at the beginning of fiscal year 2006. During fiscal year 2007 excess revenues of $100,000 were retained in the fund, which reduced the negative balance to $5.5 million. Consequently, a general fund deficiency appropriation may be required to eliminate this deficit. This condition was commented upon in our preceding annual budget closeout report.

Finding 3
A $7.4 million negative revenue accrual was made by the Department of Housing and Community Development to shift non-budgeted fund revenues from fiscal year 2007 and preceding years to fiscal year 2008 revenue.

Analysis
The **Department of Housing and Community Development (DHCD)** recorded a non-budgeted fund revenue adjustment totaling $7.4 million relating to incentive fund revenue received by DHCD in fiscal year 2007 and prior years for managing Section 8 housing subsidies for the U.S. Department of Housing and Urban Development (HUD). This adjustment improperly zeroed-out the non-budgeted fund balance in which the revenues had been recorded, making it appear that no net revenues existed at the end of fiscal year 2007. Since DHCD's attorney provided reference to State law that allows DHCD's Community Development Administration to retain the balance in the non-budgeted fund account rather than transferring the balance to the General Fund, there was no

need for this journal entry that masked the balance from proper disclosure. This transaction also resulted in a violation of proper revenue recognition principals since revenues were being recorded for a period in which they were not earned (that is, shifting revenues earned in prior years into fiscal year 2008).

Expenditure Transactions

Finding 4
Fiscal year 2007 Medicaid general fund accrued expenditures exceeded the Department of Health and Mental Hygiene's projected fiscal year 2007 Medicaid unreported claims by $41 million.

Analysis
The **Department of Health and Mental Hygiene (DHMH)** recorded the remaining fiscal year 2007 Medicaid appropriation balance of $231 million as general fund accrued expenditures at year-end, even though it was $41 million more than its projected $190 million of incurred but not reported (IBNR) Medicaid claims. If not accrued, the $41 million would have been reverted to the State's General Fund.

Medicaid providers have nine months from the date of service to report claims to DHMH for reimbursement, which results in a portion of the each fiscal year's claims being paid in the next fiscal year. Since the total cost of services provided in a given fiscal year that will be paid in the following year cannot be exactly determined, DHMH has used a consistent calculation methodology for many years based on historical data to estimate the IBNR and to record its year-end accruals. The $41 million of excess retained general fund appropriations, which is approximately 2 percent of the $2 billion fiscal year 2007 general fund Medicaid expenditures, represents a potential amount subject to reversion to the General Fund.

DHMH management believes that its calculated estimate is lower than what will actually be needed due to the effects of a claims processing backlog on its calculations, but has no documentation to show the effect.

The "State Policy on Accounts Payable, Accrued Expenditures, and Encumbrances" requires State agencies to maintain proper detail documentation to support all accrued expenditure transactions.

Other Issue

Conclusion

A liability of $49.2 million resulting from federal audit disallowances has been recorded that may have to be paid with general funds.

Liability for Federal Disallowances

Finding 5
Federal audit disallowances totaling approximately $49.2 million may have to be paid with general funds.

Analysis
Two federal audits of local school-based Medicaid expenditures have resulted in disallowed claims totaling approximately $49.2 million that may have to be paid with general funds. The first audit report, dated March 2003, which focused on expenditures claimed in fiscal year 2000, recommended the refund of $19.9 million of federal Medicaid funds used to pay costs of health-related services provided in school settings. The federal recommendations were principally based on the lack of adequate supporting documentation at the local school systems that were the providers of the disallowed health services claims. The **Maryland State Department of Education (MSDE)** and the **Department of Health and Mental Hygiene (DHMH)**, which processed the Medicaid claims for MSDE, disagreed with the federal audit report findings and appealed the refund recommendation in July 2005. While an appropriation to fund this disallowance was not included in the State's budget, during the fiscal year 2007 closing, the $19.9 million was reported to GAD as a liability with the appeal pending. In July 2007, a final determination of the appeal was made resulting in the federal government reducing its claim to $16.4 million; this reduced liability was recorded in the State's fiscal year 2007 *Comprehensive Annual Financial Report* (CAFR).

The second federal audit report dated May 2007, which focused on similar Medicaid expenditures that were claimed in fiscal years 2002 through 2004, recommended the refund of an additional $32.8 million. These recommendations were principally based on the lack of adequate support for the rates claimed for school-based health services. These rates had been established by DHMH in conjunction with MSDE and were uniformly charged by all local school systems as instructed by MSDE. DHMH and MSDE disagreed with the federal audit report findings and appealed the refund recommendation in June 2007. During the fiscal year 2007 closing, DHMH reported the $32.8 million to GAD as a liability with the appeal pending, and the full amount was recorded by GAD in the

State's fiscal year 2007 *Comprehensive Annual Financial Report*. As of January 4, 2008, there had been no final determination by the federal government of the appeal. We were informed by a federal representative that a final decision should be made in 2008.

Accordingly, funding of the $49.2 million in federal audit disallowances has not been included in the State's budget but the associated liability has been recorded in the State's fiscal year 2007 *Comprehensive Annual Financial Report.* To the extent the liability is not reduced and disallowances are not recovered from the respective local school systems, it will need to be paid with State general funds.

Exhibit 1

Summary of Fiscal Year 2007 Closeout Review
Findings by State Agency

Agency	Finding Number	Finding Description
Maryland State Department of Education	**1**	$13.3 million in unsubstantiated federal fund accrued revenues were recorded.
Department of Human Resources	**1**	$12.4 million in unsubstantiated federal fund accrued revenues were recorded.
Department of State Police	**1**	$1.8 million in unsubstantiated reimbursable and special fund accrued revenues were recorded.
	2	$5.5 million special fund deficit balance exists, which will require a general fund deficiency appropriation to cover.
Department of Housing and Community Development	**3**	$7.4 million non-budgeted fund negative revenue adjustment was recorded to eliminate a positive year-end fund balance and to shift revenue to fiscal year 2008.
Department of Health and Mental Hygiene	**4**	$41 million of general fund appropriations were recorded as accrued expenditures in excess of projected Medicaid fiscal year unreported claims.
	5	$49.2 million in general funds may be needed to cover disallowed federal claims.[1]

[1] This liability was transferred from the Maryland State Department of Education to the Department of Health and Mental Hygiene.

Exhibit 2

Schedule of Unprovided for General Fund Payables
According to the General Accounting Division

Agency	Amount of Reported Unprovided for Payables
Maryland Higher Education Commission	$8,969,980
Department of Juvenile Services	8,827,949
Department of Human Resources	2,580,859
Department of State Police	1,340,034
Office of Public Defender	840,715
Total	**$22,559,537**

Audit Team

Timothy R. Brooks, CPA, CFE
Audit Manager

Catherine M. Easter
James M. Fowler
Nelson W. Hopkins, CPA
Senior Auditors

Ronnette L. Bailey
Amin N. Berrah
Lauren R. Crue
Terry S. Gibson
Henry H. Startzman, IV
Adam J. Westover, CPA
Staff Auditors

OTHER STAFF WHO CONTRIBUTED TO THIS REPORT
Jonathan H. Finglass, CPA
Matthew L. Streett, CPA, CFE
Richard L. Carter, CISA
Edwin L. Paul, CPA