MICHIGAN

OFFICE OF THE AUDITOR GENERAL

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY

December 2011

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

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

Audit report information can be accessed at:
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AUDITOR GENERAL

December 29, 2011

The Honorable John Pappageorge, Chair
Senate Appropriations Subcommittee
on General Government
S-2 Capitol Building
and
The Honorable Bert Johnson,
Minority Vice Chair
Senate Appropriations Subcommittee
on General Government
220 Farnum Building
and
Ms. Ellen Jeffries, Director
Senate Fiscal Agency

The Honorable Earl Poleski, Chair
House Appropriations Subcommittee
on General Government
N0998 Anderson House Office Building
and
The Honorable Fred Durhal, Jr.,
Minority Vice Chair
House Appropriations Subcommittee
on General Government
S0685 Anderson House Office Building
and
Ms. Mary Ann Cleary, Director
House Fiscal Agency

Dear Senators, Representatives, and Directors:

This is our report, pursuit to Section 624, Act 63, P.A. 2011, on the feasibility of converting to a Statewide single audit. The act requires that the Office of the Auditor General (OAG), in conjunction with the State Budget Office, submit a report that includes an estimate of the cost savings or increase that would result from the conversion, an analysis of required statutory changes, the impact on legislative audit oversight, the need for organizational changes to centralize coordination, billing and funding structure changes for single audits, and the impact on corrective action for known internal control weaknesses and prior audit findings.

We concluded that converting to a Statewide single audit would result in shifting restricted federal funding of about $500,000 annually from legislative audit oversight to the executive branch for other federal program expenditures, either administrative or direct grants. This shift of restricted federal funding for legislative audit oversight from the OAG to the executive branch would result in a potential loss in OAG audit resources and would reduce State agency accountability and legislative audit oversight related to departmental financial activity and smaller federal programs. However, if the restricted federal funding for legislative audit oversight could be replaced, the OAG could mitigate the loss in legislative oversight at the State level by retaining and redirecting those audit resources to higher impact high risk performance audits, follow-up reports, and other mandated audits. In addition, it would allow the OAG to be more flexible in allocating resources to other mandated audits, such as the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*, increasing the probability that such audits could be completed earlier.

One possible source of replacement for the reduced restricted federal funding for legislative audit oversight would be through the billing of the audit of the *SOMCAFR*. Currently, the OAG does not bill for the *SOMCAFR* audit; however, the Office of Financial Management includes the cost of this audit in determining an indirect cost rate that is used by agencies to bill the federal government for the State's centralized services. Money recouped from this process is then pooled and appropriated to the Department of Technology, Management, and Budget; the Department of Treasury; and the Civil Service Commission. The OAG believes that the restricted federal funding shifted from legislative audit oversight through the conversion could be replaced with amounts recouped through the indirect cost rate process.

The OAG determined that there would be a need to amend Section 18.1461 of the *Michigan Compiled Laws* to allow for an annual Statewide single audit. Also, there would be additional cost in the year of conversion to bring all federal programs onto an annual cycle and to follow up known internal control weaknesses and prior audit findings. In addition, we believe that if the executive branch implemented a centralized coordination function for federal assistance programs, it would have a significant impact on the scope and cost of the single audit, especially in relation to compiling the schedule of expenditures of federal awards and improving the controls over federal program noncompliance and information technology (IT) systems. Improvements in these areas would greatly reduce audit risk, which would reduce the level of required audit procedures and ultimately the cost of the audit.

The State Budget Office concurs with a recommendation that the State convert to a Statewide single audit. In addition, it concurs that improvements in the State's controls over federal program compliance and IT systems may result from the conversion, along with opportunities to centralize some federal financial assistance functions. The State Budget Office does not view these issues as barriers to proceeding with conversion and looks forward to working with the OAG on this project.

Therefore, if the Legislature concurs with this recommendation and makes the required statutory changes, the OAG and the State Budget Office will work together to implement a Statewide single audit.

If you wish to discuss the results of the feasibility study, please contact me or Scott M. Strong, C.P.A., C.I.A., Deputy Auditor General.

Sincerely,

Thomas H. McTavish

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

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GLOSSARY

Background

Single Audit History

The federal Single Audit Act of 1984 was passed to improve the auditing and management of federal funds provided to state and local governments. Prior to this act, each federal agency could require an audit of various federally funded programs and activities within the same entity. Depending on the number of federal programs, a state or department could be required to obtain several different audits to cover different programs and activities. The Single Audit Act of 1984 mandated a single organization-wide financial and compliance audit, unless a government opted to cover each department or agency separately, for any entity receiving $100,000 or more in federal funding.

The State of Michigan decided that departmental audits, completed on a biennial basis, would best suit the needs of this State. The main advantage to performing departmental audits was that it provided a regular audit presence within each department that increased awareness of financial reporting responsibilities and the need for effective internal control over federal programs. In addition, it provided legislative audit oversight of more federal programs because the threshold to define the programs to be audited is calculated based on the total federal expenditures of the entity. As a result, the smaller entities would have a lower threshold encompassing more federal programs.

In 1996, congress amended the Single Audit Act of 1984. The Single Audit Amendments of 1996 were enacted in an effort to streamline and improve the effectiveness of the Single Audit Act. The major changes to the act included changing the requirements for a single audit by focusing on amounts expended rather than received and increasing the threshold for requiring an audit to $500,000 expended in a fiscal year; shortening the audit due date from within 13 months of the close of the fiscal year to within 9 months of the close of the fiscal year; and allowing a risk-based approach for identifying programs for audit. The Single Audit Amendments of 1996 also required that audits be performed annually unless a State or local government was required by constitution or statute (in effect on January 1, 1987) to perform audits less frequently.

Section 18.1461(2) of the *Michigan Compiled Laws* states that biennial audits of State departments and agencies shall be performed for purposes of complying with the requirements of the Single Audit Act. This section was effective March 29, 1985. Therefore, Michigan was able to continue to perform biennial departmental audits under the Single Audit Amendments of 1996. Currently, 47 states perform a statewide single audit and 3 states, including Michigan, Hawaii, and New Mexico, perform departmental single audits.

<u>Statewide Single Audit Conversion - Prior Analysis</u>

In spring 1998, the Office of the Auditor General (OAG) conducted an analysis related to the benefits of an annual Statewide single audit rather than departmental biennial single audits. In that analysis, the OAG determined that, although the departmental single audits had served the State well in focusing the departments' attention on their responsibilities for financial reporting and the need for effective internal control, the OAG would still be able to address the high risk areas within the State through an annual Statewide single audit. In addition, the OAG felt that the change to an annual Statewide single audit would free up valuable audit resources that could be used to conduct other mandated audits as well as high impact performance audits. The OAG also made suggestions to improve the effectiveness and efficiency of the single audit process by focusing not only on changes to the scope and frequency of the audit, but also on ways to improve the effectiveness and efficiency of the processes used by the State to ensure federal program compliance and the documentation of those processes. In addition, the OAG provided potential amendment language for the Management and Budget Act (Act 431, P.A. 1984). At that time, the Legislature chose not to make any changes to the biennial departmental audit process.

In 2008, the State Budget Office established a Statewide Single Audit Workgroup to analyze the impact of changing to a Statewide single audit. The Workgroup consisted of representatives from nine state agencies, including the State Budget Office, the Judiciary, and the Departments of Community Health; History, Arts and Libraries; Human Services; Labor and Economic Growth; Military and Veterans Affairs; Natural Resources; and Transportation. The Workgroup provided a report to the State Budget Director in December 2008. The report recommended that the State adopt a Statewide single audit approach, obtain an Attorney General opinion on whether statutory changes were necessary to do so, and develop a coordinated process for the receipt and review of single audits from the State's subrecipients. The OAG reviewed the study and shared its concerns regarding the analysis and conclusions with the State Budget Office and the legislative leadership. As a result, the Legislature enacted boilerplate language requiring a report regarding the feasibility of converting to a Statewide single audit.

<u>Statewide Single Audit Feasibility Conversion - Current Analysis</u>

Section 624, Act 63, P.A. 2011, requires that the Auditor General, in conjunction with the State Budget Office, submit a report regarding the feasibility of converting to a Statewide single audit. The report shall include an estimate of the cost savings or increase that would result from the conversion, an analysis of required statutory changes, the impact on legislative audit oversight, the need for organizational changes to centralize coordination, billing and funding structure changes for single audits, and the impact on corrective action for known internal control weaknesses and prior audit findings. This document contains the results of that feasibility study.

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FEASIBILITY STUDY

ESTIMATED COST SAVINGS OR INCREASE

Background

A single audit is a compliance requirement that a state agency agrees to when it accepts federal financial assistance. Federal and State laws consider the single audit an allowable cost of the grant, similar to other allowable costs that the federal financial assistance is used for, such as payroll and applicable administrative costs, grant expenditures, and payments to subrecipients to carry out the purpose of the grant. Because the audit is a requirement of the federal grant, State law requires that the cost of the audit be covered by the federal grant. Therefore, State agencies generally set aside a portion of their federal award to cover the cost of the single audit.

A single audit is defined as an audit that includes both the agency's financial statements and its federal awards. Therefore, the biennial agency single audits included a financial audit of the agency along with an audit of major federal program compliance. The single audit requires the auditor to test 14 compliance requirements for each major federal program. Further, the auditor is required to reach a conclusion for each major federal program audited. Consequently, the auditor is required to audit at a much lower dollar threshold than if an overall conclusion could be reached for all federal programs administered by the department.

Under the biennial agency single audit approach, 24 State agencies were required to obtain a single audit in fiscal years 2009-10 and 2010-11 (see Exhibit 1). There were 69 major federal programs audited in fiscal year 2009-10 and 64 audited in fiscal year 2010-11 for an average of 66.5 major federal programs audited each year of the two-year period. The audits of these major federal programs covered $23.7 billion of $24.1 billion (98%) in federal expenditures (see Exhibit 2). The audits resulted in 106 unqualified, 23 qualified, and 5 adverse opinions on major federal program compliance. All agencies received unqualified opinions on their financial statements and/or schedules.

Analysis

We determined that the OAG would bill the agencies approximately $500,000 less under the Statewide approach. From an overall Statewide perspective, the conversion to an annual Statewide single audit would decrease the amount of restricted federal funds used for legislative audit oversight by the $500,000 annually and increase the federal funds available for State agencies to use for other program purposes by $500,000 annually. As a result, there is not a net cost savings or increase to converting to an annual Statewide single audit.

Our analysis showed that if the State were to convert to an annual Statewide single audit, the threshold for identifying a major federal program would be $36 million in federal program expenditures. Under the biennial agency approach, the threshold varied by agency and, for audits completed in fiscal years 2009-10 and 2010-11, ranged from $300,000 to $30 million (see Exhibit 1). Based on the threshold of $36 million, the OAG estimated that, during fiscal years 2009-10 and 2010-11, there would have been 34 major federal programs audited annually rather than the average of 66.5 programs audited annually under the biennial agency approach. The major programs over the $36 million threshold would have been spread over 11 agencies and accounted for $23.2 billion of the $24.1 billion (96%) in federal expenditures (see Exhibits 3 and 4). The estimate of major programs will fluctuate each year depending on the level of federal expenditures made by the State agencies for each federal program.

Although there would be fewer major federal programs subject to audit under a Statewide approach, the major programs that would be subject to audit would be the largest, most complex, and highest risk federal programs. Generally, these programs account for a large number of audit recommendations. As a result, the amounts billed for the federal compliance portion of the audit would not change significantly. The reduction of $500,000 in billed amounts primarily relates to the amounts that were previously billed for the audit costs related to examination of the agencies' financial statements. Under the Statewide approach, the agencies' financial statements will be replaced by the *State of Michigan Comprehensive Annual Financial Report* (*SOMCAFR*), which is already annually audited by the OAG. The reduction in amounts billed to State agencies is also affected by the OAG's practice of billing audit hours related to the financial statement portion of the audit at a shared or reduced rate per hour. In addition to sharing the cost of these audit hours, the OAG has not always billed for all audit costs due to program and budget constraints on the agency side. Even though the projected reduction in the billed audit costs do not seem significant because of the shared or unbilled hours, converting to a Statewide single audit would result in a significant increase in audit resources available for other legislative audit oversight responsibilities. We estimated that we have billed an average of 12,400 hours annually at a shared average rate of $40 per hour rather than our full rate of $82 per hour. Because these shared hours will no longer be billed, there is a reduction in audit costs to State agencies of about $500,000. We further calculated that we have spent an average of 12,600 audit hours annually that we have not billed to agencies for various reasons. Under a Statewide audit approach, these 25,000 audit hours would be available for performance audits, follow-up reports, and other State-mandated audits. However, this could only be accomplished if the shift in restricted federal funding for legislative audit oversight can be replaced (see the billing and funding changes section and the impact on legislative audit oversight section).

Under the annual Statewide single audit approach, the *SOMCAFR* would take the place of the agency financial statement audits. Individual agencies would no longer need to prepare stand-alone financial statements and/or schedules, unless otherwise required by law. Consequently, the executive branch should see a reduction in work load related to preparing agency financial statements and in preparing for and participating in the audit of major federal programs. The State Budget Office indicated that it could not develop a complete and accurate estimate of these time savings; however, it does believe that any saved resources could be shifted to other priorities and assignments.

There would also be some additional audit charges related to converting from the biennial agency single audit approach to an annual Statewide single audit approach. Because agencies are currently audited every other year, in the first year of the conversion to an annual Statewide single audit, there would be some programs for which an audit would be due for an additional year or a "stub period" audit. For example, if the conversion occurred for fiscal year 2012-13, there would be 17 programs that were audited on a biennial basis through fiscal year 2010-11, but not audited in fiscal year 2011-12. For the conversion year, the OAG estimated that it would need to audit fiscal year 2011-12 for these programs and that there would be additional audit charges of about $738,000 to complete the stub period audits. The stub period audit charges would be a one-time cost in the first year of the conversion. If an annual Statewide single audit is implemented, the implementation should be in an odd-numbered year to minimize the number of programs that would need a stub period audit.

Also, the OAG is required to conduct audit procedures related to prior audit recommendations, even if the program no longer meets the major program threshold. The OAG estimated that the audit procedures related to prior audit recommendations would result in additional audit charges of $114,800 (see the known internal control weaknesses and prior audit findings section). The audit procedures to cover the review of prior audit recommendations would continue each year until the recommendations were complied with or no longer applicable.

Conclusions

Implementation of an annual Statewide single audit would not result in an overall cost savings, but it would result in a reallocation of restricted federal funding from legislative audit oversight to State agencies for other federal program expenditures. Once fully implemented, we determined that the OAG would bill agencies about $500,000 less for single audit services under the Statewide approach. From the State's perspective, this will result in a reallocation of restricted federal funding as the agencies will likely receive the same award amount but, because there are lower audit costs, they will likely spend that funding for other federal program purposes.

There would be an overall increase of about $238,000 in federal funding to cover the audit charges for the programs requiring an audit of a stub period in the first year of the implementation ($738,000 for the audit procedures related to stub period audits less the $500,000 reduction in billed amounts). Also, until all prior audit recommendations were resolved, the funding shift of $500,000 would be reduced to $385,200 ($500,000 reduction in billed amounts less the $114,800 increase in charges for the audit procedures related to the prior audit recommendations).

BILLING AND FUNDING CHANGES

Section 18.1461(3) of the *Michigan Compiled Laws* requires that the funding for single audits be from the respective federal grants audited in accordance with Public Law 104-156. It further requires that the chief executive officer of each principal department ensure that sufficient amounts are encumbered from the appropriate federal grants to finance the cost of the audits. The OAG bills each agency that receives a single audit directly for audit hours related to federal program compliance. The OAG also bills the agency a portion of the hours related to the audit of its financial statements. The OAG calculates the portion to be billed for the financial statement audit hours based on the percentage of total direct federal hours compared to total audit hours. The purpose of the shared hours is to acknowledge that the State has chosen a more detailed level of oversight by using the agency rather than the Statewide approach. Therefore, a portion of the cost for the agency financial statements and schedules is shared by the General Fund via the OAG's General Fund/general purpose appropriation.

OAG Changes

Under a Statewide approach, the OAG would bill the Office of Financial Management (OFM) for the audit procedures related to completing the audit of major federal program compliance at a direct hourly rate. However, as noted in the cost savings or increase section, the agency financial statements and schedules will no longer be required under a Statewide single audit approach. As a result, the amounts billed to OFM, and ultimately to the federal government, will be reduced by about $500,000 annually. If this restricted funding source is not replaced, the OAG would have to reduce staffing levels by approximately 7 auditors. As a result, there would be a negative impact on the level of legislative audit oversight because a majority of the audit resources that would be available to conduct high risk audits as a result of the conversion would be significantly reduced by the loss of staff auditors.

The OAG has experienced drastic staffing reductions since fiscal year 1999-2000. The OAG currently has 131 full-time employees, down 47 (26%) from the 178 full-time employees in fiscal year 1999-2000. The severe reduction has contributed to a large backlog of audits (see the impact on legislative audit oversight section). Further staff reductions would increase this backlog.

One possible source of replacement for the reduced restricted federal funding for legislative audit oversight would be through the billing of the audit of the *SOMCAFR*. Currently, the OAG does not bill for the *SOMCAFR* audit; however, OFM includes the cost of this audit in determining an indirect cost rate that is used by agencies to bill the federal government for the State's centralized services. Even though the cost of the *SOMCAFR* audit is covered by the OAG's General Fund appropriation, none of the costs recouped by the State of Michigan through the indirect cost rate process are appropriated to the OAG. Instead, money recouped from this process is then pooled and appropriated to the Department of Technology, Management, and Budget (DTMB), the Department of Treasury, and the Civil Service Commission. We believe that the restricted funding shifted from legislative audit oversight through the conversion could be replaced with amounts recouped through the indirect cost rate process.

Agency Changes

As noted, 24 agencies are currently billed for individual single audits. Under a Statewide approach, the OAG estimates that audit effort would be expended in approximately 11 agencies, even though the Statewide single audit would meet the requirements for a single audit for all of the State's federal programs. Therefore, it will be necessary to develop a new billing model. The OAG and the State Budget Office evaluated three potential billing options:

1. Bill only the State agencies with major federal programs based on the audit effort at each agency. Under this methodology, one or two agencies with major programs would see a significant increase in the amount paid for single audit services, all other agencies with major programs would see a decrease in single audit fees, and departments without a major federal program would not be billed for single audit services. This methodology would be consistent with the current statute requiring payment from the respective federal grants audited.

2. Bill only the State agencies with major federal programs based on the percentage of total major program expenditures. Under this methodology, one or two agencies with major programs would see a significant increase in the amount paid for single audit services, all other agencies with major programs would see a decrease in single audit fees, and departments without a major federal program would not be billed for single audit services. This methodology could be justified under the current statute because the audit fees would be charged to State agencies that had major federal programs audited and most likely those agencies would charge the fees against the grants that were audited.

3. Bill all State agencies based on the percentage of total federal expenditures for the State. Under this methodology, one or two agencies would see a significant increase in the amount paid for single audit services. All other agencies would see a decrease in the amount that is currently paid for single audits, but all would share in the cost of the audit as it meets the federal audit requirement for all federal programs. Under this methodology, the current law would need to be modified from requiring payment from "the respective federal grants audited" to clarify that funding be derived from federal programs based on an allocation methodology that is in accordance with federal compliance requirements.

Conclusions

Implementing a Statewide single audit will reduce the amounts the OAG bills to the State agencies by about $500,000 annually, ultimately resulting in a reallocation of restricted federal funding from the legislative audit oversight to State agencies with federal programs. However, these amounts could be recouped through the indirect rate process and appropriated to the OAG as reimbursement for its cost to audit the *SOMCAFR* and to replace the restricted federal funding that was previously earned by conducting separate agency financial audits. If this restricted funding source is not replaced, the OAG would have to reduce staffing levels by approximately 7 auditors.

The Legislature and the Governor would need to determine how they should allocate the cost of the Statewide single audit to the agencies. Depending on the change, the current law would need to be modified from requiring payment from "the respective federal grants audited" to clarify that funding be derived from federal programs based on an allocation methodology that is in compliance with federal compliance requirements.

IMPACT ON LEGISLATIVE AUDIT OVERSIGHT

If the OAG were to conduct a Statewide single audit, it would eliminate financial and federal program compliance audits completed at several agencies. This would reduce the level of legislative audit oversight and State agency accountability. Currently, single audits are conducted at 24 agencies over a two-year cycle. Based on our estimates, under the Statewide approach, single audit procedures would be conducted at about 11 agencies annually.

The OAG issued unqualified opinions on the financial statements and/or schedules of the individual agencies for the audits completed in fiscal years 2009-10 and 2010-11. This shows that, generally, agency financial reporting is materially correct and could support the decision to eliminate this additional level of auditing. Also, because the Statewide single audit covers the State's largest federal programs, it would still cover 96%, rather than 98%, of the State's federal expenditures.

If the State were to adopt the annual Statewide single audit approach, it would allow the OAG to shift resources otherwise spent on the agency financial audits and smaller federal program compliance audits to higher risk, higher impact performance audits and follow-up reports. This shift in resources would also allow the OAG to be more flexible in allocating resources in relation to other mandated financial audits, such as the *SOMCAFR*, increasing the potential to complete the mandated audits faster. The redirection of audit resources to performance audits, follow-up reports, and

State-mandated audits would increase the legislative audit oversight and State agency accountability related to higher risk State-funded program areas. However, to do so, there would need to be a mechanism to replace the loss in restricted financing resulting from the conversion (see the estimated cost savings or increase section and the billing and funding changes section).

We estimated that we could redirect approximately 25,000 audit hours to these other types of audits. For example, the OAG currently has a backlog of over 250 performance audits. Based on our estimates, at current staffing levels, the OAG could redirect resources to complete an additional 5 to 10 performance audits each year. Our performance audits have produced $24.6 million and $614.0 million in known and projected cost savings, respectively, over the last four fiscal years. We calculated the average known cost savings per performance audit during that time period to be $942,000. Assuming that an additional 5 to 10 performance audits would produce similar results, our nonstatistical projections indicate that these additional audits could potentially generate $4.7 million to $9.4 million in known cost savings suggestions annually. In addition to cost savings suggestions, performance audits have also provided important oversight for critical issues involving public safety and trust.

Conclusions

Under a Statewide approach, legislative audit oversight would be reduced as it relates to State agency financial and smaller federal program compliance audits. However, legislative audit oversight could be increased if the associated restricted federal funding was reallocated to the OAG. This would enable the OAG to conduct performance audits and follow-up reports of high risk program areas within the State. In addition, it would allow the OAG to be more flexible in allocating resources to mandated audits, such as the *SOMCAFR*, increasing the probability that mandated audits could be issued faster.

KNOWN INTERNAL CONTROL WEAKNESSES AND PRIOR AUDIT FINDINGS

Federal guidance states that auditees are responsible for maintaining internal control over federal programs that provides reasonable assurance that the audits are managing federal awards in compliance with laws, regulations, and the provision of contracts or grant agreements that could have a material effect on each of their federal programs. In addition, auditees are responsible for following up and taking corrective action on audit recommendations.

Auditing standards and federal guidance require that the auditor follow up the status of prior audit recommendations to help ensure that the auditee has met these responsibilities. Prior audit recommendations related to federal programs that would still be considered a major program under an annual Statewide approach would be followed up during the Statewide single audit of the major federal program. Accordingly, even if the State of Michigan adopts the Statewide approach, prior audit recommendations related to federal programs that would not be deemed major federal programs under the Statewide approach would still require follow-up within the scope of the Statewide single audit. Prior audit recommendations related to financial statements would be followed up within the scope of the *SOMCAFR* audit.

There were 154 prior audit findings with 185 corresponding recommendations reported in the single audits conducted in fiscal years 2009-10 and 2010-11 (see Exhibit 1). Of the 185 recommendations, 80 would be followed up during a Statewide single audit because they relate to programs that would likely still be considered major programs. Also, there would be 30 recommendations related to financial statements that would be followed up within the scope of the *SOMCAFR* audit.

In addition, there would be 75 recommendations related to federal programs that would no longer be considered major federal programs under an annual Statewide approach that would also have to be followed up. We estimated that there would be additional audit charges of $114,800 to conduct the necessary audit procedures related to these recommendations. These additional audit procedures will be required in subsequent years if the agencies do not resolve the recommendations. For example, of the 185 recommendations, 60 (32%) have been repeated or rewritten from prior audits. Therefore it is unlikely that all prior audit findings will be resolved within a one-year time frame (see the estimated cost savings or increase section).

Conclusions

If a Statewide approach is adopted, we estimated that there would be additional audit charges of $114,800 to conduct follow-up procedures for prior audit recommendations related to programs that would no longer meet the major program threshold. These additional charges would continue each year until the recommendations were resolved.

REQUIRED STATUTORY CHANGES

<u>Background</u>

U.S. Office of Management and Budget (OMB) Circular A-133, Section 220 states that, except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period. Paragraph (a) states that a state or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period.

Section 18.1461 of the *Michigan Compiled Laws* became effective March 29, 1985 (see Exhibit 5). This section requires that ". . . For fiscal years beginning October 1, 1985 and thereafter, biennial audits of state departments and agencies shall be performed for the purposes of complying with the requirements of Public Law 104-156 pertaining to audit evaluation of the internal controls of this state and the state's compliance with material features of laws and regulations related to major federal assistance programs." The Statewide Single Audit Workgroup concluded that, because OMB Circular A-133 requires audits of nonfederal agencies that expend more than $500,000 and defines a nonfederal agency as a state, local government, or nonprofit organization, this statute allows for a Statewide single audit. Other State agencies have indicated that, because the law refers to audits of "this state" and the "state's compliance," the statute allows for a Statewide audit. Therefore, the Workgroup and other State agencies have concluded that a statutory change is not necessary to convert to a Statewide single audit.

<u>Analysis</u>

We reviewed OMB Circular A-133, Section 500 and noted that it allows for an audit of the operations of the entire nonfederal entity or, at option of the nonfederal entity, the audit can include a series of audits that cover departments and agencies that expend or administer federal awards. Therefore, the fact that the federal guidance defines a state as a nonfederal entity does not drive whether the state is required to conduct a statewide or departmental/agency single audit.

The OAG discussed the current statutory language with the Department of Attorney General. As a result of those discussions, the OAG concluded that the statute requires the OAG to conduct biennial single audits of State departments and agencies. Based on these discussions, we concluded that the language requiring biennial audits of State departments and agencies, on its face, is requiring the OAG to conduct biennial audits of each department and agency. We further concluded that the language referring to the internal controls of "this state" and the "state's compliance" would likely be read more broadly and, if it was viewed as conflicting to the departmental and agency audit approach, the more specific language requiring the biennial audit by department and agency would be the controlling language. Finally, if challenged, the intent of the section would be reviewed and, because the OAG helped to draft the original language, it clearly understands that the intent of the statute is to perform biennial departmental single audits.

If Section 18.1461 of the *Michigan Compiled Laws* is amended, OMB Circular A-133, Section 220 would prohibit Michigan from converting back to biennial audits. It would still be able to conduct departmental audits; however, they would be required annually. The OAG believes that conducting annual departmental audits would not be efficient. As a result, once the State has converted to an annual Statewide single audit, the decision to change to an annual basis would be irrevocable and reverting back to the agency approach inadvisable.

Also, Section 18.1461 of the *Michigan Compiled Laws* establishes a deadline for State agencies to submit the schedule of federal financial assistance (now called the schedule of expenditures of federal awards [SEFA]) by February 1. The current deadline for submitting single audits is 9 months after the close of the fiscal year. The federal government is proposing that this deadline be moved to 6 months after the close of the fiscal year. Therefore, to complete the Statewide single audit by June 30 or possibly sooner, it would be beneficial to receive the SEFA information within 90 days of the close of the fiscal year. As a result, it will be necessary to amend this section of the statute when converting to an annual Statewide single audit.

Conclusions

Prior to converting to a Statewide single audit approach, Section 18.1461 of the *Michigan Compiled Laws* must be amended to allow for an annual Statewide single audit. Also, the law should be amended to require the SEFA to be submitted within 90 days of the close of the fiscal year.

In addition, as noted in the billing and funding changes section, the law may need to be modified from requiring payment for audit services from "the respective federal grants audited" to clarify that funding be derived from federal programs based on an allocation methodology that is in accordance with federal compliance requirements.

ORGANIZATIONAL CHANGES TO CENTRALIZE COORDINATION

To maximize the efficiencies related to conducting single audits and to establish strong internal control over federal grant management, the OAG has recommended several times over the last two decades that the State Budget Office establish a centralized coordination function for federal assistance programs. The OAG believes that these items should be addressed regardless of a change in audit approach. The centralized coordination function for federal assistance programs should include, but would not be limited to:

- Requiring the identification and accounting for federal program expenditures by the *Catalog of Federal Domestic Assistance* number and other identifying factors required by federal law within the State's central accounting system.

- Preparing the Statewide schedule of expenditures of federal awards (SEFA) and providing it to the Auditor General no later than 90 days following the close of the State's fiscal year.

- Coordinating and monitoring each principal department's plan of corrective action submitted to the federal government as a part of the Statewide single audit.

- Coordinating the appeal and settlement process for federal audit disallowances.

- Assisting departments in establishing processes that demonstrate their accountability and compliance with federal program requirements.

- Implementing changes in internal control to minimize the risk of federal program noncompliance.

- Encouraging departments to place a priority on completion of the single audit.

- Working with DTMB information technology to strengthen both general and application controls.

Conclusions

We recommend that the executive branch implement a centralized coordination function for federal assistance programs. A centralized coordination function for federal assistance programs would have a significant impact on the scope and cost of the single audit, especially in relation to compiling the SEFA and improving the controls over federal program noncompliance and IT systems. Improvements in these areas would greatly reduce audit risk, which would reduce the level of required audit procedures and ultimately the cost of the audit.

RECOMMENDATION

Implementing an annual Statewide single audit would not result in overall cost savings to the State; rather, it would result in a reallocation of restricted federal funding from legislative audit oversight to State agency federal programs. In addition, it would reduce State agency accountability and legislative audit oversight related to departmental financial activity and smaller federal programs. However, if the OAG's restricted federal funding source could be replaced, the OAG could redirect a significant amount of resources to higher impact audits, which could help to increase State agency accountability and legislative audit oversight of programs and issues that are important at the State level.

Implementing a Statewide single audit would be consistent with 47 other states but would require changes to Michigan's law. In addition, a Statewide approach would provide the opportunity for the State Budget Office to begin centrally coordinating the State's federal financial assistance programs in an effort to improve internal control over federal compliance and IT systems, to improve resolution of prior audit recommendations, and to provide consistency in SEFA preparation and federal reporting. Improvements in these areas would greatly reduce audit risk, which would reduce the level of required audit procedures and ultimately the cost of the audit. The State Budget Office also concurs that improvements in the State's controls over federal program compliance and IT systems may result from the conversion, along with opportunities to centralize some federal financial assistance functions. The State Budget Office does not view these issues as barriers to proceeding with conversion.

Conclusions

Although there would be no overall cost savings in implementing the Statewide single audit approach, we would recommend converting to a Statewide approach if the corresponding statutory changes include shifting resources to the OAG to cover the loss of restricted federal funding. Under this scenario, we believe that the OAG could redirect a significant amount of resources to higher impact audits that would greatly increase State agency accountability and legislative audit oversight in areas of interest to the State rather than the federal government. However, if the reallocation of restricted federal funding is not replaced, it would significantly reduce audit resources, thereby reducing the level of State agency accountability and legislative audit oversight. There would be no benefit in converting to a Statewide approach if there were no cost savings in conjunction with a reduction in State agency accountability and legislative audit oversight. The State Budget Office concurs with the recommendation that the State convert to a Statewide single audit.

Therefore, if the Legislature concurs with this recommendation and makes the required statutory changes, the OAG and the State Budget Office will work together to implement a Statewide single audit.

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EXHIBITS

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
Summary of Single Audits Issued in Fiscal Years 2009-10 and 2010-11

Project Number	Agency	Report Title	Report Date	Number of Findings	Number of Recommendations	Number of Material Findings	Number of Repeat and Rewritten Recommendations
791-0100-11	Agriculture	Michigan Department of Agriculture	06/30/2011	5	5	0	1
111-0100-11	Attorney General	Department of Attorney General	05/06/2011	0	0	0	0
151-0100-11	Civil Rights	Department of Civil Rights	05/05/2011	0	0	0	0
391-0100-10	Community Health	Department of Community Health	06/30/2010	35	46	10	21
471-0100-10	Corrections	Department of Corrections	06/15/2010	1	1	0	0
313-0100-10	Education	Michigan Department of Education	06/30/2010	17	20	1	11
641-0100-11	DELEG (2)	Department of Energy, Labor & Economic Growth	06/28/2011	14	16	1	2
N/A (3)	DELEG (2)	Unemployment Insurance Agency	11/18/2009	1	1	0	0
761-0100-10	Environmental Quality	Department of Environmental Quality	06/30/2010	6	10	5	5
251-0100-10	HAL (5)	Department of History, Arts and Libraries	03/29/2011	5	5	0	0
431-0100-11	Human Services	Department of Human Services	06/30/2011	13	19	7	11
950-0150-11	Judiciary/Courts	State-Funded Judicial Operations	06/15/2011	5	5	5	0
511-0100-10	Military and Veterans Affairs	Department of Military and Veterans Affairs	06/30/2010	9	11	5	3
751-0100-10	Natural Resources	Department of Natural Resources	06/30/2010	7	10	2	4
231-0100-11	State	Department of State	05/11/2011	3	3	0	2
551-0100-10	State Police	Michigan Department of State Police	06/30/2010	7	7	0	0
071-0100-11	Technology, Management, and Budget	Department of Technology, Management, and Budget	04/06/2011	0	0	0	0
591-0100-11	Transportation	Michigan Department of Transportation	06/30/2011	9	9	1	0
271-0100-11	Treasury	Department of Treasury	06/22/2011	4	4	1	0
271-0405-11	Treasury	Michigan Economic Development Corporation	05/10/2011	2	2	2	0
271-0341-11	Treasury	Michigan Finance Authority	06/17/2011	2	2	0	0
641-0425-11	Treasury	Land Bank Fast Track Authority	06/22/2011	4	4	3	0
N/A (3)	Treasury	Michigan State Housing Development Authority	10/22/2009	3	3	2	0
271-0400-11	Treasury	Michigan Strategic Fund	04/27/2011	2	2	1	0
				154	185	46	60

(1) Total federal expenditures are as reported in the single audit, including all expended and distributed for the agency for the two-year audit period.

(2) Effective April 25, 2011, Executive Order No. 2011-4 transferred various programs to other State departments, including workforce programs and energy and labor market information programs. Also, the Department of Energy, Labor & Economic Growth (DELEG) became the Department of Licensing and Regulatory Affairs.

(3) These audits were conducted by other auditors whose reports have been furnished to us.

(4) This includes the total for the Unemployment Insurance Agency's Unemployment Compensation Fund ($18,647,444) and its Administration Fund ($3,000,000).

(5) Effective October 1, 2009, Executive Order No. 2009-36 abolished the Department of History, Arts and Libraries (HAL) and transferred its functions and budgetary resources to several other principal departments and agencies within the State. As a result of this order, HAL's federally funded programs were transferred to the Michigan Department of Education, the Michigan State Housing Development Authority, the Department of Natural Resources, and the Michigan Strategic Fund. In addition, the order transferred any authority, powers, duties, functions, and responsibilities not otherwise provided for in the order to the Department of Natural Resources.

Exhibit 1
UNAUDITED

Federal Programs	Total Federal Expenditures for Two-Year Audit Period (1)	Major Program Threshold	Single Audit Compliance Opinions: Unqualified	Qualified	Adverse	Disclaimer	Opinion on Financial Statements and/or Schedules
8	$ 17,028,021	$ 510,841	8				Unqualified
1	$ 7,548,045	$ 300,000	1				Unqualified
2	$ 3,983,649	$ 300,000	2				Unqualified
11	$ 15,207,736,308	$ 30,000,000	7	2	2		Unqualified
2	$ 199,311,534	$ 3,000,000	2				Unqualified
18	$ 3,734,350,824	$ 11,203,052	18				Unqualified
15	$ 1,289,781,862	$ 3,869,346	14	1			Unqualified
2	$ 6,215,814,561	$ 21,647,444 (4)	2				Unqualified
8	$ 265,548,434	$ 3,000,000	4	4			Unqualified
3	$ 7,534,809	$ 300,000	3				Unqualified
13	$ 9,438,524,000	$ 28,366,840	7	4	2		Unqualified
5	$ 8,868,050	$ 300,000	2	3			Unqualified
5	$ 154,773,755	$ 3,000,000	2	3			Unqualified
7	$ 92,403,599	$ 2,772,108	6	1			Unqualified
2	$ 12,147,857	$ 364,436	2				Unqualified
10	$ 278,175,489	$ 3,000,000	10				Unqualified
1	$ 359,339,000	$ 3,000,000	1				Unqualified
5	$ 2,728,290,000	$ 8,184,858	5				Unqualified
2	$ 3,758,023	$ 300,000	1		1		Unqualified
2	$ 1,077,370	$ 300,000		2			Unqualified
4	$ 298,844,612	$ 300,000	4				Unqualified
2	$ 9,331,461	$ 300,000		2			Unqualified
5	$ 989,534,592	$ 3,000,000	5				Unqualified
1	$ 83,704,638	$ 2,511,139		1			Unqualified
			106	23	5	0	

Exhibit 2
UNAUDITED

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY

Number of Major Programs and Expenditures for Most Recent Cycle of Agency Audits

Agency	Number of Major Programs Under Agency Single Audit Issued in Fiscal Year (1) 2009-10	2010-11	Total Major Program Expenditures Audited in Prior Cycle	Total Federal Expenditures (2)	Percentage of Estimated Agency Federal Expenditures	Pass-Through and ARRA Expenditures Audited in Prior Cycle (1)
Michigan Department of Agriculture and Rural Development		8	$ 7,855,986	$ 8,286,166	95%	$ 474,432
Department of Attorney General		1	3,772,575	3,772,575	100%	
Department of Civil Rights		2	2,105,146	2,105,146	100%	
Department of Community Health	11		8,199,537,765	8,318,048,873	99%	1,252,605,047
Department of Corrections	2			3,265,611	0%	1,645,415
Michigan Economic Development Corporation		2	1,077,370	1,077,370	100%	
Michigan Department of Education	18		1,533,006,286	1,627,288,620	94%	830,475,551
Department of Energy, Labor & Economic Growth/Licensing and Regulatory Affairs (3)		15	378,727,759	430,883,243	88%	233,872,115
Department of Environmental Quality	8		80,870,804	93,928,564	86%	170,992,272
Michigan Finance Authority		4	142,836,110	142,836,110	100%	
Department of History, Arts and Libraries (4)	3				0%	
Department of Human Services		14	4,755,563,190	4,829,934,311	98%	374,336,263
Judiciary/Courts		5	820,833	935,445	88%	3,572,213
Land Bank Fast Track Authority		2			0%	9,079,095
Department of Military and Veterans Affairs	5		102,422,156	102,422,156	100%	7,861,755
Department of Natural Resources	7		16,691,361	48,247,921	35%	1,542,654
Department of State		2	7,147,549	8,353,930	86%	
Michigan State Housing Development Authority	4		481,333,902	486,480,505	99%	14,379,557
Michigan Department of State Police	10		63,519,347	87,433,462	73%	16,235,823
Michigan Strategic Fund		1	47,507,072	48,346,227	98%	66,064
Department of Technology, Management, and Budget		1		409,000	0%	70,223,000
Michigan Department of Transportation		5	887,837,021	896,176,927	99%	544,176,023
Department of Treasury		2	2,958,757	2,968,757	100%	
Unemployment Insurance Agency (5)	1		6,965,035,705	6,965,725,694	100%	19,067,287
	69	64	$ 23,680,626,695	$ 24,108,926,614	98%	$ 3,550,604,564

Total number of programs audited for two-year cycle	133
Average number of programs per year	66.5

(1) Pass-through and American Recovery and Reinvestment Act of 2009 (ARRA) expenditures were included in determining the number of major programs under agency single audits but would not be included for purposes of an annual Statewide single audit.

(2) Total federal expenditures include direct federal expenditures and do not include pass-through expenditures between State departments or ARRA expenditures. Therefore, some programs previously audited do not have any direct federal expenditures listed.

(3) Effective April 25, 2011, Executive Order No. 2011-4 transferred various programs to other State departments, including workforce programs and energy and labor market information programs. Also, the Department of Energy, Labor & Economic Growth (DELEG) became the Department of Licensing and Regulatory Affairs.

(4) Effective October 1, 2009, Executive Order No. 2009-36 abolished the Department of History, Arts and Libraries (HAL) and transferred its functions and budgetary resources to several other principal departments and agencies within the State. As a result of this order, HAL's federally funded programs were transferred to the Michigan Department of Education, the Michigan State Housing Development Authority, the Department of Natural Resources, and the Michigan Strategic Fund. In addition, the order transferred any authority, powers, duties, functions, and responsibilities not otherwise provided for in the order to the Department of Natural Resources.

(5) One program was audited as a major program in both the Unemployment Insurance Agency's Unemployment Compensation Fund and its Administration Fund. This was counted as one program.

Source: Fiscal year 2009-10 audited schedule of expenditures of federal awards (SEFA), if available, or draft SEFA provided by the agencies as required by Section 18.1461 of the *Michigan Compiled Laws.*

Exhibit 3
UNAUDITED

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY

Estimated Number of Major Programs and Expenditures for Annual Statewide Single Audit

Agency	Estimated Number of Major Programs Under Statewide Single Audit (1)	Major Program Total Expenditures	Total Federal Expenditures (2)	Percentage of Estimated Agency Federal Expenditures
Michigan Department of Agriculture and Rural Development		$	$ 8,286,166	0%
Department of Attorney General			3,772,575	0%
Department of Civil Rights			2,105,146	0%
Department of Community Health	7	8,135,014,763	8,318,048,873	98%
Department of Corrections			3,265,611	0%
Michigan Economic Development Corporation	2	253,214,955	254,292,325	100%
Michigan Department of Education	7	1,463,501,344	1,627,288,620	90%
Department of Environmental Quality			93,928,564	0%
Michigan Finance Authority	2	136,214,753	142,836,110	95%
Department of Human Services	9	4,729,073,778	4,829,934,311	98%
Judiciary/Courts			935,445	0%
Department of Licensing and Regulatory Affairs	1	101,242,218	177,668,288	57%
Department of Military and Veterans Affairs	1	50,786,076	102,422,156	50%
Department of Natural Resources			48,247,921	0%
Department of State			8,353,930	0%
Michigan State Housing Development Authority	2	453,415,414	486,480,505	93%
Michigan Department of State Police			87,433,462	0%
Michigan Strategic Fund	1	47,507,072	48,346,227	98%
Department of Technology, Management, and Budget			409,000	0%
Michigan Department of Transportation	1	823,756,165	896,176,927	92%
Department of Treasury			2,968,757	0%
Unemployment Insurance Agency	1	6,965,035,705	6,965,725,694	100%
	34	$ 23,158,762,243	$ 24,108,926,614	96%

(1) Estimated major federal programs/clusters were determined using a $36 million threshold as required in U.S. Office of Management and Budget (OMB) Circular A-133.

(2) Total federal expenditures include direct federal expenditures and do not include pass-through expenditures between State departments or American Recovery and Reinvestment Act of 2009 (ARRA) expenditures.

Source: Fiscal year 2009-10 audited schedule of expenditures of federal awards (SEFA), if available, or draft SEFA provided by the agencies as required by Section 18.1461 of the *Michigan Compiled Laws.*

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
Estimated Major Federal Programs for Statewide Single Audit by Agency (1)

Agency/Cluster	CFDA Number	Program
Department of Community Health		
Aging Cluster	93.044	Special Programs for the Aging - Title III, Part B - Grants for Supportive Services and Senior Centers
Aging Cluster	93.045	Special Programs for the Aging - Title III, Part C - Nutrition Services
Aging Cluster	93.053	Nutrition Services Incentive Program
Immunization Cluster	93.268	Immunization Grants
Immunization Cluster	93.268	Immunization Grants
Medicaid Cluster	93.777	State Survey and Certification of Health Care Providers and Suppliers
Medicaid Cluster	93.778	Medical Assistance Program
N/A	10.557	Special Supplemental Nutrition Program for Women, Infants, and Children
N/A	93.069	Public Health Emergency Preparedness
N/A	93.767	Children's Health Insurance Program
N/A	93.959	Block Grants for Prevention and Treatment of Substance Abuse
Michigan Economic Development Corporation		
WIA Cluster	17.258	WIA Adult Program
WIA Cluster	17.259	WIA Youth Activities
WIA Cluster	17.260	WIA Dislocated Workers
WIA Cluster	17.278	WIA Dislocated Worker Formula Grants
N/A	17.245	Trade Adjustment Assistance
Michigan Department of Education		
Child Nutrition Cluster	10.555	National School Lunch Program
Child Nutrition Cluster	10.555	Food Donation
Child Nutrition Cluster	10.556	Special Milk Program for Children
Child Nutrition Cluster	10.559	Summer Food Service Program for Children
Child Nutrition Cluster	10.559	Food Donation
Title I, Part A Cluster	84.010	Title I Grants to Local Educational Agencies

This schedule continued on next page.

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
Estimated Major Federal Programs for Statewide Single Audit by Agency (1)

Agency/Cluster	*CFDA* Number	Program
Michigan Department of Education (*continued*)		
Special Education Cluster (IDEA)	84.027	Special Education - Grants to States
Special Education Cluster (IDEA)	84.173	Special Education - Preschool Grants
N/A	10.558	Child and Adult Care Food Program
N/A	84.048	Career and Technical Education - Basic Grants to States
N/A	84.287	Twenty-First Century Community Learning Centers
N/A	84.367	Improving Teacher Quality State Grants
Michigan Finance Authority		
N/A	84.032G	Federal Family Education Loans - Guaranty Agency
N/A	84.032L	Federal Family Education Loans - Lender
Department of Human Services		
SNAP Cluster	10.551	Supplemental Nutrition Assistance Program
SNAP Cluster	10.561 (2)	State Administrative Matching Grants for the Supplemental Nutrition Assistance Program
SNAP Cluster	10.561	Supplemental Nutrition Assistance Program (Administrative Costs)
TANF Cluster	93.558	Temporary Assistance for Needy Families (TANF)
CCDF Cluster	93.575	Child Care and Development Block Grant
CCDF Cluster	93.596	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Disability Insurance/SSI Cluster	96.001	Social Security - Disability Insurance
N/A	93.563	Child Support Enforcement
N/A	93.568	Low-Income Home Energy Assistance
N/A	93.658	Foster Care - Title IV-E

This schedule continued on next page.

Exhibit 4
(Continued)

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
Estimated Major Federal Programs for Statewide Single Audit by Agency (1)

Agency/Cluster	*CFDA* Number		Program
Department of Human Services (*continued*)			
N/A	93.659		Adoption Assistance
N/A	93.667		Social Services Block Grant
Department of Licensing and Regulatory Affairs			
Vocational Rehabilitation Cluster	84.126		Rehabilitation Services - Vocational Rehabilitation Grants to States
Department of Military and Veterans Affairs			
N/A	12.401		National Guard Military Operations and Maintenance (O&M) Projects
Michigan State Housing Development Authority			
N/A	14.182		Lower Income Housing Assistance Program: Section 8 - Contract Administration
N/A	14.871		Lower Income Housing Assistance Program: Section 8 - Housing Choice Voucher
Michigan Strategic Fund			
CDBG - State-Administered Small Cities Program Cluster	14.228		Community Development Block Grants/State's Program and Non-Entitlement Grants in Hawaii
Michigan Department of Transportation			
Highway Planning and Construction Cluster	20.205	(2)	Highway Planning and Construction
Highway Planning and Construction Cluster	20.219	(3)	Recreational Trails Program
Unemployment Insurance Agency			
N/A	17.225		Unemployment Insurance
N/A	17.225		Employment and Training Administration: Unemployment Insurance

(1) Estimated major federal programs/clusters were determined using a $36 million threshold as required in U.S. Office of Management and Budget (OMB) Circular A-133.

(2) This program administered by the Department of Community Health.

(3) This program administered by the Department of Natural Resources.

Source: Fiscal year 2009-10 audited schedule of expenditures of federal awards (SEFA), if available, or draft SEFA provided by the agencies as required by Section 18.1461 of the *Michigan Compiled Laws*.

Exhibit 5

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
Section 18.1461 of the *Michigan Compiled Laws*

THE MANAGEMENT AND BUDGET ACT (EXCERPT)
Act 431 of 1984

18.1461 Audit of federal grants awarded to state; funding for audit; single audits; encumbering amounts to finance cost of audits; carrying over unexpended amounts; submitting schedule of federal financial assistance; "public law 104-156" defined.

Sec. 461. (1) As required by federal law, all federal grants awarded to the state shall be audited by the auditor general, an independent accounting firm selected by the auditor general, or an auditor approved by the appropriate federal agency. The funding for each audit shall be from the respective federal grants audited.

(2) Each audit performed pursuant to Public Law 104-156 shall be conducted by an independent auditor in accordance with generally accepted government auditing standards. Single audits for this state shall be conducted in accordance with Public Law 104-156 by the auditor general, an independent accounting firm selected by the auditor general, or an independent auditor approved by the appropriate federal agency. For fiscal years beginning October 1, 1985 and thereafter, biennial audits of state departments and agencies shall be performed for purposes of complying with the requirements of Public Law 104-156 pertaining to audit evaluation of the internal controls of this state and the state's compliance with material features of laws and regulations related to major federal assistance programs.

(3) The funding for single audits shall be from the respective federal grants audited, in accordance with Public Law 104-156. The chief executive officer of each principal department shall ensure that sufficient amounts are encumbered from the appropriate federal grants to finance the cost of the audits. Any unexpended amounts of encumbered funds may be carried over into succeeding years to cover the cost of the single audits.

(4) Before February 1 of each year, the director of each principal department shall submit to the director, fiscal agencies and the auditor general a schedule of federal financial assistance for the last completed fiscal year in a form approved by the auditor general.

(5) As used in this section, "Public Law 104-156" means chapter 75 of title 31 of the United States Code, 31 U.S.C. 7501 to 7507.

History: 1984, Act 431, Eff. Mar. 29, 1985;—Am. 1986, Act 251, Imd. Eff. Dec. 4, 1986;—Am. 1999, Act 8, Imd. Eff. Mar. 22, 1999.

Popular name: Act 431

Popular name: DMB

STATEWIDE SINGLE AUDIT FEASIBILITY STUDY
State Agencies' Workgroup Report on
Converting to a Statewide Single Audit

JENNIFER M. GRANHOLM
GOVERNOR

STATE OF MICHIGAN
DEPARTMENT OF TRANSPORTATION
LANSING

KIRK T. STEUDLE
DIRECTOR

December 15, 2008

Mr. Robert Emerson
Director of the State Budget Office
Romney Building, 6th Floor
111 South Capitol Avenue
Lansing, Michigan 48933

Dear Mr. ~~Emerson~~: Bob

Pursuant to the request of the State Budget Office, a Statewide Single Audit Workgroup (SSAW) was formed to make recommendations as to whether the State of Michigan should pursue a change from individual agency single audits to a statewide single audit.

We are pleased to submit the enclosed report from the SSAW and are making the three following recommendations:

1. The State of Michigan should adopt a statewide single audit approach.
2. The Attorney General should be requested to opine on whether PA 431 of 1984 would need to be amended to implement a statewide single audit.
3. A statewide coordinated process of receipt and review of single audits from sub-recipients should be undertaken.

If you need any additional information, or if the SSAW can assist with implementing the recommendations, please contact me at 517-373-1527.

Sincerely,

Ed Timpf

Edward A. Timpf, Chair
Statewide Single Audit Workgroup

Enclosures
cc: M. Moody
N. Duncan
SSAW Members

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LH-LAN-0 (01/03)

Statewide Single Audit Workgroup
Report and Recommendations

This report is being presented by the Statewide Single Audit Workgroup (workgroup) responding to your request to provide recommendations to create efficiencies and reduce costs for the State of Michigan (SOM) related to single audits.

Background Information

The State Budget Office (SBO), Office of Financial Management (OFM), requested that a workgroup be organized to determine if the SOM should convert to a consolidated statewide single audit approach. Currently, all SOM agencies are subject to separate single audits and single audit reports, rather than one audit and one report for the SOM as a whole.

Performing single audits at the agency level, rather than statewide, results in a lower materiality threshold. This results in more federal programs being subject to single audit review than would otherwise be the case. The overall objective of the workgroup was to explore whether this extra audit coverage of federal programs is cost beneficial and essential to the SOM.

The SOM has utilized the agency level approach since the inception of the Single Audit Act and passage of implementing State legislation in the 1980s. All but three states perform single audits on a statewide basis.

Reasons for Considering a Change in Approach

1. The costs of meeting the requirements of the single audit act would be significantly lower using the statewide approach. Fewer programs would require specific testing and fewer reports would need to be prepared.

2. The audit costs of the Office of the Auditor General (OAG) for the federal testing and reporting required for these audits have increased dramatically in recent years and this is expected to continue. These costs are billed to SOM agencies and reduce the amount of funds available for their programs.

3. The American Institute of Certified Public Accountants' Auditing Standards Board issued new Statements on Auditing Standards, which require increased testing and more extensive reporting for each federal program tested than was previously the case. This will only increase the cost of the current agency-by-agency approach.

4. Although not typically tracked and accounted for, the costs associated with SOM agency personnel hours have increased greatly as more time is required to work with auditors and respond to the more detailed reporting that is now required.

5. The amount of time spent auditing smaller federal programs and agencies appear disproportionately high compared to the associated risks.

6. Currently, there is a redundancy of audit findings and reports across programs and SOM agencies. The same, or similar, problems are reported multiple times in multiple SOM agencies. Audit findings that can be best addressed in a statewide manner may not be as effectively and efficiently addressed in a timely manner using the agency by agency approach. A statewide report could provide a more useful report and have increased impact.

7. SOM agency single audit reports and related financial information are not as useful for SOM purposes as they could be and were in prior years. The increased focus on federal programs and federal compliance is a distraction from other issues. More attention and effort is focused on federal funds and issues than on non federal funds and issues. Reports are longer and more technical in nature than they otherwise would be and are less useful and understandable for non federal readers.

8. SOM agencies are attempting to streamline, standardize, and generate efficiencies in their accounting and audit operations. Moving to a statewide single audit report is consistent with this effort. Currently, forty-seven states perform single audits at a statewide level.

Workgroup Recommendations

1. The SOM should adopt a statewide single audit approach.

   Significant savings can be achieved and reporting much improved. Major (type A) federal programs are those where the expenditures are greater than an auditor determined dollar threshold based on materiality with a cap of $30 million set by A-133. The audit savings from not performing an individual single audit on those agencies with all major (type A) programs under $30 million is approximately $934,000. Additional significant savings would result from not performing a single audit on another 93 federal programs. We could not quantify the potential savings since the programs are within agencies where currently audits are performed on federal programs both above and below $30 million.

   Both SOM single audit users and users of other audits of State agencies would benefit from this approach. Federal audit requirements would be satisfied, just as they are in the 47 other states that have statewide audits.

2. The SOM Attorney General should determine whether Public Act 431 of 1984 (MCL 18.1461) should be amended to implement a statewide approach. If an amendment is required, such changes should be requested of the legislature.

3. Statewide coordinated process of receipt and review of single audits from sub-recipients should be undertaken.

Detailed Information about the Workgroup and Its Findings

A number of agencies expressed concerns about the increased auditing of federal programs by the OAG. In addition to the rapidly increasing costs, concerns were raised regarding decreasing audit coverage of non federal funded programs. The OAG informed OFM and SOM agencies that such a change to a statewide single audit was considered and proposed by them previously but was not acted upon by the Legislature. The OAG no longer pursued that option. The OAG also believes converting to a statewide single audit would require a statutory change to MCL 18.1461.

A workgroup was created through the Chief Financial Officers Council to explore the SOM's current practice and determine whether, from an efficiency, financial reporting and risk standpoint, the SOM should continue its current practice or convert to a statewide approach. The workgroup commenced meetings on July 8, 2008, and completed its work in November 2008.

SOM agencies, including the OAG, were asked to volunteer to be part of the workgroup. The OAG declined, citing the potential for creating a lack of independence. The workgroup ultimately consisted of participants from nine SOM agencies. These agencies were State Budget Office, Human Services, Military and Veterans Affairs, Transportation, Labor and Economic Growth, History, Arts and Libraries, Community Health, Natural Resources and Judiciary. See Attachment A for members serving on this workgroup. Other SOM agencies were kept abreast of the activities by distribution of minutes and participated on occasion by providing data and input to workgroup members.

Federal and State Law Requirements

The initial step in the workgroup's process was to identify and understand state and federal laws pertaining to single audits of state governments. MCL 18.1461 is the Michigan statute that pertains to single audits. See Attachment B. MCL 18.1461 requires biennial audits of SOM agencies that receive federal grants. This section is interpreted by the OAG to mean that each SOM agency must obtain a biennial single audit, therefore a statewide audit is currently not allowed under Michigan statute. The workgroup disagrees with this interpretation of statute and believes MCL 18.1461 allows for a statewide single audit to be performed. The Federal Office of Management and Budget issued Circular Number A-133 (A-133) pursuant to the Single Audit Act of 1984, P.L. 98-502, as amended and is the applicable federal law for single audits. A-133 sets forth standards of obtaining consistency and uniformity among federal agencies for the audit of states, local governments, and non-profit organizations expending federal awards. A-133 requires a single audit for non-federal entities that expend $500,000 or more in a year in federal awards. A-133 defines non-federal entity as a state, local government, or non-profit organization which is interpreted to mean A-133 allows either a statewide single audit or an agency single audit.

Results from Nationwide Survey

Currently, 47 states conduct the single audit at a statewide level. Only New Mexico, Hawaii, and SOM conduct single audits at the agency level. The workgroup determined that single audit information from other states would provide important data to support the final recommendation. Survey questions were developed and sent to all state comptrollers and auditor generals. Twenty-nine states responded to the survey. The responses showed that most states have always had a statewide single audit or converted from an agency single audit to a statewide single audit. A second survey was then sent to the eleven states who converted to obtain more information about the reasons for the conversion as well as the conversion process. Nine responses were received. No states have changed from the state-wide approach to an agency level approach.

Efficiencies and costs savings were noted as the major reasons for maintaining or converting to a statewide single audit. See Attachment C for copies of the surveys.

Quotes from the Nationwide Survey

Missouri - Our statewide single audit is linked to our audit of the statewide CAFR each year. We also felt it was more efficient as it should result in fewer type A programs when calculated at a statewide level than at an agency level.

New Hampshire - It seems to be a very efficient and effective process for New Hampshire and consistent with the purpose of the Act.

New York - New York State implemented a statewide single audit approach versus departmental/agency single audit in order to make the most effective/efficient use of limited audit financial resources.

North Dakota - It is more efficient.

Oklahoma - The statewide single audit is more efficient (staffing and costs).

Pennsylvania - More efficient use of time and money.

Virginia - We feel that it is more efficient for the Commonwealth of Virginia to produce one single audit and that we are more effective by producing different types of performance reports on individual agencies.

Attachment D has the complete survey results.

Number of Major (Type A) Programs

The workgroup reviewed the federal programs audited in the SOM compared to the other states federal programs. For the SOM, approximately 122 programs were audited, most with no audit findings or qualifications noted. For other states, a maximum of 41 federal programs were audited. Considering many of the programs currently audited at the SOM agency level result in no material audit findings, the workgroup determined that the number of federal programs audited could be reduced without adding additional risk.

It is reasonable to assume that the SOM audit costs would be reduced if it converted to a statewide single audit. The SBO asked for a 2% reduction in each SOM agency's fiscal year 2010 budget request and a 10% overall reduction by fiscal year 2013. Converting to a statewide single audit could help reduce costs as part of budget savings. Eliminating the agency single audits with all federal programs less than $30 million of expenditures would save approximately $934,000. Together with eliminating the single audit on 93 additional federal programs, would result in well over one million dollars of estimated audit cost savings by implementing a statewide single audit.

Each state's single audit costs, size of federal programs, and number of major programs as defined in A-133 (agencies that expend $500,000 or more in federal awards) were reviewed and compared to the SOM's collective single audit information. Attachment E provides information on Michigan's single audit and those of other states. The number of federal programs audited in Michigan is nearly triple the number of federal programs audited in other states.

The percentage of the single audit cost to the federal expenditures for major programs varies greatly in Michigan, ranging from a high of approximately four percent (3.8%) to a low of less than one percent (0.0066%). The percentage of the total single audit cost to the total federal expenditures for major programs was less than one percent (0.0193%). It appears that audit costs of smaller major programs result in a higher cost of audit per federal dollar expended.

Risk Consideration

Risk within the current process and the potential new risks, if the SOM moves to a statewide single audit, were considered and discussed at each workgroup meeting. Several federal programs currently considered to be material at a SOM agency level would not be considered material at a statewide level and would not be subject to audit so it could be argued that the risk of missing irregularities increases. Currently a SOM agency single audit threshold is as low as $300,000, thereby requiring an audit of that federal program. At a statewide single audit this level would increase to $30 million. It is important to note that A-133 allows a statewide audit as demonstrated by the 47 states which currently have a statewide single audit.

The workgroup discussed current controls that would reduce the risk of auditing fewer programs. All financial transactions, whether federal or state, are subject to audit for the SOMCAFR. In addition, the statewide internal control evaluation and biennial reporting processes help to determine risks and corresponding control activities within each agency, for a variety of key internal controls. SBO's Office of Internal Audit Services (OIAS) reviews the departments' processes and identifies weaknesses in their mechanisms for identifying and mitigating risks within state government.

The evaluation and biennial reporting processes are not specific to federal programs, but rather relate to the SOM agency's overall controls, which include federal programs.

OIAS and the OAG could perform other types of audits that would give additional assurance to the work performed during the single audit. Performance audits, horizontal audits, SOMCAFR audit, and other financial audit work could be used to assess risk and internal controls to complement a statewide single audit. Beginning in fiscal year 2010, OIAS will be charging their annual costs via the statewide cost allocation plan (SWCAP); therefore no additional costs would be incurred by the agency during the fiscal year, if OIAS performed more or different audits to reduce the risk of converting to a statewide single audit.

If the SOM converted to a statewide single audit, more audit work could be directed at high risk programs and non-federal programs. OIAS is willing to coordinate its audit efforts with the OAG to accommodate any potential increased risk exposure.

<u>Required A-133 Sub-recipient Monitoring</u>

Each state agency currently performs an independent review to ensure that their sub-recipients had a single audit completed if $500,000 or more of federal dollars were received in a year. However, it could be a combination of several federal programs in multiple agencies whose payments that takes a sub-recipient over this dollar amount. This process, we believe, would be more efficiently performed if done once on a statewide basis. However, if audit comments are noted in the single audit reports, the individual agencies would be best to follow up on them, but ensuring that each sub-recipient had a single audit performed and whether findings were noted should be done on a statewide basis.

<u>Conclusion</u>

The workgroup recommends that the SOM pursue conversion to a statewide single audit. The workgroup concluded the entire single audit process would be simplified to minimize audit costs and maximize efficiencies. The workgroup also concludes that there would be costs savings when comparing costs of other state's single audits. Forty-seven states conduct a statewide single audit and respondents indicated it achieves efficiencies and cost savings.

The workgroup questions whether MCL 18.1461 would need to be amended, and recommends that an Attorney General opinion be requested to obtain a legal opinion. The workgroup prefers a biennial statewide single audit over an annual statewide single audit depending on the Attorney General's response.

The level of internal controls in place within each agency, internal control review by OIAS, and other audits performed by the OAG and OIAS would complement a statewide audit. Conversion to a statewide single audit would not expose the SOM to increased risk, compliance with A-133 would be maintained and federal funds would not be lost.

Based on the current costs of SOM's single audits compared to other state's single audits, the SOM would achieve cost savings and increase efficiencies.

If you have any questions, please contact the chair of the workgroup, Edward A. Timpf at 517 373-1527.

Enclosures (8):

- Attachment A (SSAW Membership Listing)
- Attachment B (Act 431 of 1984, MCL 18.1461)
- Attachment C (Single Audit Survey; Single Audit Survey Follow-Up)
- Attachment D (Summary of Audit Survey Questions; Summary of Audit Survey Follow-Up Survey Questions)
- Attachment E (Summary of Michigan's Single Audits; Summary of Federal Dollars & Major Programs)

Note: Attachments A through E are available upon request.

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GLOSSARY

Glossary of Commonly Used Financial Audit Terms
(Including Single Audit Terms)

adverse opinion

See "auditor's opinion" for definition.

auditor's opinion

The Office of the Auditor General issues opinions, as applicable, on financial statements, financial schedules, supplemental financial information, and compliance with requirements for major federal programs. The types of auditor's opinions are:

a. Unqualified opinion:

(1) Financial presentation: An unqualified opinion states that the financial statements, financial schedules, or supplemental financial information are fairly presented in conformity with generally accepted accounting principles.

(2) Compliance: An unqualified opinion states that the audited agency complied, in all material respects, with the cited compliance requirements applicable to each major federal program.

b. Qualified opinion:

(1) Financial presentation: A qualified opinion identifies a scope limitation or one or more instances of misstatements that impact the fair presentation of the financial statements, financial schedules, or supplemental financial information.

(2) Compliance: A qualified opinion identifies a scope limitation or material noncompliance with one or more of the cited compliance requirements applicable to each major federal program.

c. Adverse opinion:

(1) Financial presentation: An adverse opinion states that the financial statements, financial schedules, or supplemental financial information are not fairly presented in conformity with generally accepted accounting principles.

(2) Compliance: An adverse opinion states that the audited agency did not comply, in all material respects, with the cited compliance requirements applicable to each major federal program.

CFDA — *Catalog of Federal Domestic Assistance*; the catalog that provides a full listing, with detailed program descriptions, of all federal programs available to state and local governments.

CFR — *Code of Federal Regulations*; the codification of the general and permanent rules published by the departments and agencies of the federal government.

cluster — A grouping of closely related federal programs that have similar compliance requirements. Although the programs within a cluster are administered as separate programs, a cluster of programs is treated as a single program for the purpose of meeting the audit requirements of OMB Circular A-133.

deficiency in internal control over federal program compliance

The design or operation of a control over compliance that does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. These deficiencies are typically categorized as significant or material:

a. Significant deficiency in internal control over federal program compliance: A deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

b. Material weakness in internal control over federal program compliance: A deficiency, or a combination of deficiencies, in internal control over compliance such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

deficiency in internal control over financial reporting

The design or operation of a control that 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. These deficiencies are typically categorized as significant or material:

a. Significant deficiency in internal control over financial reporting: 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.

b. Material weakness in internal control over financial reporting: A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial schedules and/or financial statements will not be prevented, or detected and corrected, on a timely basis.

financial audit An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.

GAAP generally accepted accounting principles; a technical accounting term that encompasses the conventions, rules, guidelines, and procedures necessary to define accepted accounting practice at a particular time. Also cited as "accounting principles generally accepted in the United States of America."

GASB Governmental Accounting Standards Board; an arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities.

internal control A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

low-risk auditee	As provided for in OMB Circular A-133, an auditee that may qualify for reduced federal audit coverage if it receives an annual single audit and it meets other criteria related to prior audit results. In accordance with State statute, this single audit was conducted on a biennial basis; consequently, this auditee is not considered a low-risk auditee.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material noncompliance	Violations of laws, regulations, contracts, and grants that could have a direct and material effect on [*insert* "major federal programs or on" *for single audits*] financial schedule and/or financial statement amounts.
material weakness in internal control over federal program compliance	See "deficiency in internal control over federal program compliance" for definition.
material weakness in internal control over financial reporting	See "deficiency in internal control over financial reporting" for definition.
OMB	U.S. Office of Management and Budget; a cabinet-level office that assists the President in overseeing the preparation of the federal budget and in supervising its administration in executive branch agencies.

other noncompliance

Violations of contracts or grant agreements that are not material to the financial schedules or financial statements but should be communicated to management in accordance with *Government Auditing Standards*. Other noncompliance also includes violations of laws, regulations, contracts, or grant agreements; fraud; abuse; or other internal control deficiencies that may be communicated to management in accordance with *Government Auditing Standards*.

qualified opinion

See "auditor's opinion" for definition.

questioned cost

A cost that is questioned by the auditor because of an audit finding: (1) which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (2) where the costs, at the time of the audit, are not supported by adequate documentation; or (3) where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

After the audit report is filed with the federal audit clearinghouse, the responsible federal agency is required to issue a management decision within six months of the receipt of the audit report. The management decision may include a request for the return of the known questioned costs.

significant deficiency in internal control over federal program compliance

See "deficiency in internal control over federal program compliance" for definition.

significant deficiency in internal control over financial reporting	See "deficiency in internal control over financial reporting" for definition.
single audit	A financial audit, performed in accordance with the Single Audit Act Amendments of 1996, that is designed to meet the needs of all federal grantor agencies and other financial report users. In addition to performing the audit in accordance with the requirements of 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, a single audit requires the assessment of compliance with requirements that could have a direct and material effect on a major federal program and the consideration of internal control over compliance in accordance with OMB Circular A-133.
SOMCAFR	*State of Michigan Comprehensive Annual Financial Report.*
subrecipient	A nonfederal entity that expends federal awards received from another nonfederal entity to carry out a federal program.
unqualified opinion	See "auditor's opinion" for definition.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL