



DEPARTMENT OF HEALTH AND HUMAN SERVICES

Office of Inspector General
Office of Audit Services

REGION IV
61 Forsyth Street, S.W., Suite 3T41
Atlanta, Georgia 30303

SEP 30 2005

A-04-04-03503

George Bakolia, State Chief Information Officer
North Carolina Office of Information Technology Services
3700 Wake Forest Road
Raleigh, North Carolina 27609

Dear Mr. Bakolia:

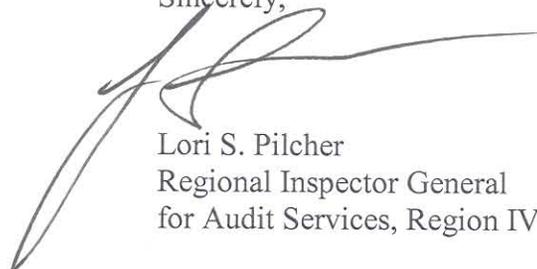
Enclosed are two copies of the Department of Health and Human Services, Office of Inspector General (OIG) report entitled "Audit of the North Carolina Office of Information Technology Services' Internal Service Fund." The objective of our audit was to determine whether North Carolina refunded to the Federal Government the Federal share of all refunds and transfers from the ITS internal service fund. A copy of this report will be forwarded to the action official below for his review and any action deemed necessary.

Final determination as to actions taken on all matters reported will be made by the HHS action official. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. § 552, as amended by Public Law 104-231, OIG reports are made available to members of the public to the extent the information is not subject to exemptions in the Act that the Department chooses to exercise (see 45 CFR part 5).

To facilitate identification, please refer to report number A-04-04-03503 in all correspondence.

Sincerely,

A handwritten signature in black ink, appearing to read "Lori S. Pilcher", is written over the typed name and title.

Lori S. Pilcher
Regional Inspector General
for Audit Services, Region IV

Enclosures: as stated

Direct Reply to HHS Action Official:

Mr. William Logan
Director, Mid-Atlantic Office
Division of Cost Allocation
U.S. Department of Health and Human Services
Wilbur Cohen Building, Room 1067
330 Independence Ave. S.W.
Washington, D.C. 20201

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF THE NORTH CAROLINA
OFFICE OF INFORMATION
TECHNOLOGY SERVICES INTERNAL
SERVICE FUND**



**Daniel R. Levinson
Inspector General**

**SEPTEMBER 2005
A-04-04-03503**

Office of Inspector General

<http://oig.hhs.gov>

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OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of HHS/OIG/OAS. Authorized officials of HHS divisions will make final determination on these matters.



EXECUTIVE SUMMARY

BACKGROUND

Internal service funds account for the financing of goods and services that service centers provide to user agencies on a cost-reimbursable basis. North Carolina's Office of Information Technology Services (ITS) operates an internal service fund that provides centrally managed computing services to State agencies and some county and city governments. ITS also provides other services such as telecommunication, software, and procurement. ITS receives almost all of its funding through fee-for-service arrangements with State and local user agencies. The Federal Government shares in the costs of ITS services when the user agencies claim reimbursement for those costs under Federal programs.

Office of Management and Budget (OMB) Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments," establishes principles and standards for determining the allowable costs of grants and contracts with State and local governments.

We audited refunds and transfers from ITS made in State fiscal years (FYs)¹ 2002 and 2003. At the request of the Division of Cost Allocation (DCA), we also reviewed all transfers that ITS made to the State's Year 2000 Special Fund (Y2K fund) in FYs 1997 and 1998.

Refunds

ITS uses revenues to cover costs. If revenues exceed costs, OMB Circular A-87 requires internal service funds to adjust their billing rates or provide refunds or credits to user agencies. We use the term "refund" to denote the return of funds to their original source. When an internal service fund makes a refund, the Federal Government must receive its share.

Transfers

OMB Circular A-87 does not allow States to transfer excess revenues out of an internal service fund for other uses without refunding to the Federal Government its share of the excess revenues. We consider a "transfer" to be the movement of funds from one entity to another, irrespective of the original source of those funds.

OBJECTIVE

Our objective was to determine whether North Carolina refunded to the Federal Government the Federal share of all refunds and transfers from the ITS internal service fund.

¹The State's fiscal year ran from July 1 through June 30.

SUMMARY OF FINDINGS

Refunds

ITS made cash refunds to user agencies for the Federal share of revenues in excess of costs. During FYs 2002 and 2003, such refunds totaled \$1,444,624 and \$1,698,562, respectively. The North Carolina Department of Health and Human Services (DHHS) received \$1,376,376 (95 percent) and \$1,685,699 (99 percent), respectively, of these refunds. DHHS appropriately credited its Federal programs to comply with OMB Circular A-87.

Transfers

ITS transferred \$34.2 million in excess revenues from its internal service fund to the State's Y2K fund and general fund. Contrary to OMB Circular A-87 requirements, the State failed to return the Federal share of \$8.2 million. The State did not return the \$8.2 million because ITS did not have procedures in place to ensure that the Federal Government received its share of all revenues in excess of costs.

Year 2000 Special Fund

For FYs 1997 and 1998, ITS transferred excess revenues totaling \$22.5 million (\$4.5 million Federal share) to the State's Y2K fund. The \$22.5 million consisted of two transfers out of the fund (one for \$9.3 million during FY 1997 and another for \$15 million during FY 1998) and one transfer into the fund (for \$1.8 million during FY 1998). However, the State did not return the Federal share.

General Fund

During FY 2002, ITS transferred \$11.7 million (\$3.7 million Federal share) of excess revenues to the State's general fund. ITS made four transfers (\$3 million on November 3, 2001, \$4 million on February 4, 2002, \$3 million on June 15, 2002, and \$1.7 million on March 20, 2002) without refunding the Federal share.

RECOMMENDATIONS

We recommend that the State:

- refund \$4.5 million to the Federal Government for the estimated Federal share of ITS transfers to the State's Y2K fund and determine whether additional refunds are due the Federal Government for the actual Federal share of those transfers,
- refund \$3.7 million to the Federal Government for the Federal share of ITS transfers to the State's general fund, and
- implement appropriate procedures to ensure that the Federal Government receives its share of any revenues in excess of costs in the future.

STATE'S COMMENTS

In written comments on the draft report, State officials generally disagreed with our computation of the Federal share of monies transferred to the State's Y2K and general funds. The complete text of the State's comments is included in the appendix.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

Despite the State's assertions, we continue to believe that our calculation of the Federal share of Y2K and general fund transfers was accurate.

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INTRODUCTION

BACKGROUND

Internal service funds account for the financing of goods and services that service centers provide to user agencies on a cost-reimbursable basis. North Carolina's Office of Information Technology Services (ITS) operates an internal service fund that provides centrally managed computing services to State agencies and some county and city governments. ITS also provides other services such as telecommunication, software, and procurement. ITS receives almost all of its funding through fee-for-service arrangements with State and local user agencies. The Federal Government shares in the costs of ITS services when the user agencies claim reimbursement for those costs under Federal programs.

Office of Management and Budget (OMB) Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments," establishes principles and standards for determining the allowable costs of grants and contracts with State and local governments.

Refunds

ITS uses revenues to cover costs. If revenues exceed costs, OMB Circular A-87 requires internal service funds to make adjustments through:

- cash refunds to the Federal Government for the Federal share of the adjustment,
- credits to the amounts charged to the individual programs,
- adjustments to future billing rates, or
- adjustments to allocated central service costs if the adjustment is \$500,000 or less.

We use the term "refund" to denote the return of funds to their original source. When an internal service fund makes a refund, the Federal Government must receive its share.

Transfers

OMB Circular A-87 does not allow States to transfer excess revenues out of an internal service fund for other uses without refunding to the Federal Government its share of the excess revenues. We consider a "transfer" to be the movement of funds from one entity to another, irrespective of the original source of those funds.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

Our objective was to determine whether North Carolina refunded to the Federal Government the Federal share of all refunds and transfers from the ITS internal service fund.

Scope

Our audit included all transfers and refunds that ITS made from its internal service fund in State fiscal years (FYs)¹ 2002 and 2003. At the request of the Division of Cost Allocation (DCA), we also reviewed all transfers that ITS made to the State's Year 2000 Special Fund (Y2K fund) in FYs 1997 and 1998.

We did not review ITS's overall internal control structure. Our review of internal controls was limited to obtaining an understanding of ITS procedures regarding charges for services and disposition of revenues in excess of costs. We also did not review the validity of the 20-percent estimated Federal share that the State and DCA agreed to use in the past to settle cost disallowances.

We performed fieldwork from April through December 2004 at the State's ITS, Department of Health and Human Services (DHHS), and Department of Transportation offices in Raleigh, NC. On March 29, 2005, we held an exit conference with State officials to discuss the draft report's findings and recommendations.

Methodology

To accomplish our audit objective, we:

- reviewed applicable Federal and State laws and regulations;
- reviewed ITS policies and procedures regarding charges for services and disposition of revenues in excess of costs;
- reviewed related work performed by and conversed with officials of DCA and the North Carolina Office of the State Auditor;
- analyzed the ITS methodology for calculating revenues in excess of costs and the Federal share refunded to user agencies;
- determined whether the State agency that received the largest refunds² from ITS credited the Federal Government for its share;
- analyzed operating, nonoperating, and Y2K fund transfers from ITS; and
- reviewed the State's central service cost allocation plans for 1996 through 2003.

We conducted our audit in accordance with generally accepted government auditing standards.

¹The State's fiscal year ran from July 1 through June 30.

²DHHS received 95 percent and 99 percent, respectively, of the FY 2002 and 2003 refunds to user agencies.

FINDINGS AND RECOMMENDATIONS

During FYs 2002 and 2003, ITS made cash refunds to user agencies for the Federal share of revenues in excess of costs consistent with OMB Circular A-87 requirements. However, contrary to OMB Circular A-87, ITS transferred \$34.2 million from its internal service fund to the State's Y2K fund and general fund but failed to return the Federal share of \$8.2 million. ITS did not return these funds because it did not have procedures in effect to ensure that the Federal Government received its share of all revenues in excess of costs.

REFUNDS

ITS made cash refunds to user agencies for the Federal share of revenues in excess of costs. During FYs 2002 and 2003, such refunds totaled \$1,444,624 and \$1,698,562, respectively. DHHS received \$1,376,376 (95 percent) and \$1,685,699 (99 percent), respectively, of these refunds. DHHS appropriately credited its Federal programs to comply with OMB Circular A-87.

TRANSFERS

Year 2000 Special Fund

Costs are allocable to Federal programs only to the extent of the relative benefits that the programs receive (OMB Circular A-87, Attachment A, section C.3(a)).

ITS transferred \$22.5 million for FYs 1997 and 1998 from its internal service fund to the Y2K fund. The \$22.5 million consisted of two transfers out of the fund (one for \$9.3 million during FY 1997 and another for \$15 million during FY 1998) and one transfer into the fund (for \$1.8 million during FY 1998). The State established the Y2K fund to cover the cost of the year 2000 conversions that took place in all State departments and agencies. The charges for internal services were unallowable to the extent that they were allocated to Federal programs but ultimately used for State-only purposes (e.g., Y2K fund and general fund). Therefore, the State should have returned the Federal share.

The Office of the State Controller requires State agencies to report contingent liabilities for possible disclosure in the State's Comprehensive Annual Financial Report. In FY 2000, ITS established a contingent liability for the Federal share of the Y2K transfers. ITS estimated the Federal share to be \$4.5 million (20 percent). The 20 percent was an estimate of the Federal share that the State and DCA had agreed to use in the past to settle cost disallowances.

General Fund

General government costs are unallowable for Federal reimbursement (OMB Circular A-87, Attachment B, section 23(a)).

Pursuant to North Carolina Sessions Law 2001-424, "Current Operations and Capital Improvements Act of 2001," ITS transferred a total of \$11.7 million (\$3.7 million Federal share) in excess revenues from its internal service fund to the State's general fund. The general fund covers the State's operating expenses. The \$11.7 million consisted of the following transfers:

- Sessions Law 2001-424, section 2.2(i) required ITS to transfer \$10 million (\$3.2 million Federal share) from its internal service fund to the State's general fund to support general fund appropriations for FY 2002. The law required three transfers: \$3 million on November 3, 2001, \$4 million on February 4, 2002, and \$3 million on June 15, 2002.
- Sessions Law 2001-424, section 15.8(a) required the North Carolina Office of State Budget and Management (OSBM) to reduce expenditures in the Telephone, Telecommunications Data, and Computer Data Processing accounts equal to \$4 million of general fund appropriations. However, OSBM was able to obtain only \$2.3 million in general fund appropriation savings from the rate reductions. To achieve the \$4 million goal, OSBM required ITS to transfer \$1.7 million (\$0.5 million Federal share) from its internal service fund to the State's general fund.

These transfers to the general fund were generated by billings that were reimbursed under Federal programs, and the State used the transfers to reduce general fund expenditures. However, the State did not refund the \$3.7 million Federal share of these transfers.

IMPROVEMENT NEEDED IN STATE PROCEDURES

The State did not return the \$8.2 million Federal share of the transfers discussed above because ITS did not have procedures in place to ensure that the Federal Government received its share of all revenues in excess of costs.

RECOMMENDATIONS

We recommend that the State:

- refund \$4.5 million to the Federal Government for the estimated Federal share of ITS transfers to the State's Y2K fund and determine whether additional refunds are due the Federal Government for the actual Federal share of those transfers,
- refund \$3.7 million to the Federal Government for the Federal share of ITS transfers to the State's general fund, and
- implement appropriate procedures to ensure that the Federal Government receives its share of any revenues in excess of costs in the future.

STATE'S COMMENTS

In written comments on the draft report, State officials generally disagreed with our computation of the Federal share of monies transferred to the State's Y2K and general funds. The complete text of the State's comments is included in the appendix. A summary follows.

Year 2000 Special Fund

State officials said that the Y2K fund expenditures were necessary and proper and were not limited to State-only purposes. However, State officials said that they were not able to provide

accurate figures to support an alternative Federal share calculation. In addition, the State acknowledged that its cost allocation plan did not include the Y2K fund.

General Fund

In regard to the Federal share of amounts transferred to the State's general fund, State officials expressed their belief that our refund calculation was overstated. State officials said that during FY 2002, computer services overrecovered costs (i.e., revenues from billings for computer services exceeded expenses for those services), but telecommunications services did not. State officials opined that the computer services overrecovery should be factored into the computation of the amount to be repaid. According to the State's calculations, the refund should be \$1.7 million rather than \$3.7 million.

OFFICE OF INSPECTOR GENERAL'S RESPONSE

Despite the State's assertions, we continue to believe that our calculation of the Federal share of Y2K and general fund transfers was accurate.

Year 2000 Special Fund

OMB Circular A-87, Attachment C, section C requires that to be reimbursable by the Federal Government, central service cost allocation plans must include all central service costs that will be claimed under Federal awards. Because the Y2K fund was not included in the State's cost allocation plans for 1996 through 2003, ITS's transfers to the Y2K fund were not allowable for Federal reimbursement.

As discussed on page 3 of this report, we used an estimated 20-percent Federal participation rate. The State and DCA have agreed in the past to use this estimate of the Federal share to settle cost disallowances. Because of the age of the records, the actual Federal participation rate for FYs 1997 and 1998 cannot be readily reconstructed. Therefore, we continue to recommend that the State refund \$4.5 million to the Federal Government for the estimated Federal share of ITS transfers to the State's Y2K fund and that the State determine whether additional refunds are due the Federal Government for the actual Federal share of those transfers.

General Fund

The State's recalculation of the general fund overpayment from \$3.7 million to \$1.7 million confused the issue of internal service fund surpluses and deficits with the actual transfer of \$11.7 million from ITS's internal service fund to the State's general fund. The table on the next page compares our calculation with that of the State.

Calculation of General Fund Overpayment

	Office of Inspector General	State
Amount transferred	\$11.7M	\$11.7M
Percentage of revenues from computer services	-	46.15% ³
Adjusted base	\$11.7M	\$5.4M
Federal share percentage	31.7%	31.7%
Recommended refund	\$3.7M	\$1.7M

The internal service fund provides, in part, services to Federal programs, whereas the general fund covers the State’s operating expenses. Once the \$11.7 million was transferred to the general fund and commingled with other State revenues, there was no direct link demonstrating how those funds benefited Federal programs. Therefore, the Federal share should be calculated on the full \$11.7 million without considering the computer services overrecovery. Moreover, any computer and telecommunications service costs that are overbilled or underbilled should be adjusted annually through cash refunds, credits to users, or adjustments, as described on page 1.

Because the State could not demonstrate that it had credited the Federal Government with the Federal share of the transferred funds, we continue to recommend that the State refund \$3.7 million for the Federal share of ITS transfers to the State’s general fund.

³See page 3 of the appendix.

APPENDIX



State of North Carolina
Office of Information Technology Services

Michael F. Easley, Governor

George Bakolia, State Chief Information Officer

25 July 2005

Ms. Lori S. Pilcher
Regional Inspector General
Office of Audit Services, Region IV
61 Forsyth St., S.W., Ste. 3T41
Atlanta, GA 30303

Re: Report No. A-04-04-03503

Dear Ms. Pilcher:

This letter comprises the official response to the draft audit report in the abovementioned matter dated 24 June 2005, titled Audit of the North Carolina Office of Information Technology Services' Internal Service Fund. I have reviewed the draft report together with members of my staff. Based upon this review and in consultation with ITS staff, we believe certain adjustments are necessary to accurately reflect an appropriate refund.

ITS revenues are generated through two separate and distinct operations. These are Telecommunications Services (TS) and Computing Services (CS). ITS is statutorily charged with providing services in both operational areas to state agencies. During the audit period the Information Resources Management Council (IRMC) functioned as the rate setting body for ITS' operations. Service rates for each operational area were submitted and approved by the IRMC. Hence, a potential has existed for each operational area to over-recover, or under-recover, for the costs of services delivered in any year of operation.

Two audit periods were examined: FY 1997, 1998 for transfers of funds from the Internal Service Fund to the State's Year 2000 Fund (Y2K, budget code 24160, 24660) and FY 2001- 2002 for transfers of funds from the Internal Service Fund to the State's General Fund. The draft audit report concludes that the State should refund \$4.5 million for the FY 1997, 1998 period and \$3.7 million for the FY 2001-2002 period. We believe the calculations for the latter sums should be revised to be consistent with over-recovery associated with ITS operations in Computing Services.

During FY2001-2002, Telecommunications Services did not over-recover, but Computing Services did. Revenues from Computing Services during this period comprised 46.15% of ITS revenues. Using the computed Federal Funds Participation percentage calculated by the auditors (31.7%), we believe the correct refund for FY 2002 is \$1.7 million. We also respectfully observe that no additional refunds based on your review of FY 2002-2003 were recommended, and therefore request that the final audit report restate the audit findings accordingly.

We fully believe similar logic should be applied to the Y2K transfers in FY 1997, 1998, and that the recommended refund of \$4.5 million is overstated. We also believe that the Y2K Fund expenditures were necessary and proper, and that such expenditures were not limited to State-only purposes. However, we are not able to present accurate figures regarding Federal Funds participation from Telecommunications Services and Computing Services for FY 1997, 1998 to support an alternative refund at this time. We also acknowledge that the State's Cost Allocation Plan did not include the Y2K Fund.

Since the transfer of ITS from the Dept. of Commerce to the Office of the Governor in 2000, ITS has been able to more accurately examine rates and calculate refunds, and to issue refunds when an over-recovery becomes apparent (as was done in FY2002-2003).

Please contact David Rossi, ITS Chief Financial Officer, at 919-981-5330 or by e-mail at David.Rossi@ncmail.net with questions or for further details relating to the State's position. Thank you for consideration of this letter. I look forward to the final report and resolution of these matters.

Sincerely,



George Bakolia
State Chief Information Officer

cc: Robert Powell, State Controller
Richard Bradford, Asst. Attorney General
Leslie Merritt, State Auditor
David Rossi, ITS CFO

Enc

North Carolina Office of Information Technology Services
 Support Documentation
 Federal Audit Finding FY 01-02

Appendix
 Page 3 of 3

(1) Original FFP \$ Amount	\$ 35,148,996.95
(2) ADD: ESC	\$ 5,877,123.23
	\$ 41,026,120.18
(3) (LESS: Auditor's Revision for NCCSSMS)	\$ (127,346.61)
Revised FFP \$ Amount	\$ 40,898,773.57
(4) Total State Agency Billings	\$ 129,006,040.44
(5) Computed FFP %	31.70%
(6) Transferred from ISF to General Fund (Non-Operating Transfer)	\$ 11,700,000
(7) Area with Over-Recovery % of Computing Services' FFP Billings to total Billings (\$59,532,873.82/\$129,006,040.44)	Computing Services 46.15%
ITS' Recommended Refund (\$11,700,000*46.15%*31.70%)	\$ 1,711,657

- (1) FY 01-02 State Agencies Billings - \$35,148,996.95
 (2) Employment Security Commission's 01-02 Billings originally omitted from ITS' calculation
 (3) Federal Auditor (B. Rouse) advised NC School of Math & Science should not be included as a State Agency.
 (4) Total 01-02 State Agencies Billings by Office of Information Technology Services
 (\$135,830,688.51-6,824,648.07 = \$129,006,040.44)
 (University Systems billings omitted from State Agencies calculation, by Federal Auditor and ITS.)
 (5) Total State Agencies Billings divided by Federal Financial Participation Percentage computed:
 (\$40,898,773.57/\$129,006,040.44 = 31.7%)
 (6) \$11,700,000 transferred from ISF to General Fund per official FY 01-02 Financial Report
 (7) ITS' revenues basically generated through two separate and distinct operations - Computing Services and Telec. Services
 Computing Services was the operation in FY 01-02 with an over-recovery status.
 ITS' total State Agencies billings comprised of approximately 46.15% of Computing Services billings

ACKNOWLEDGMENTS

This report was prepared under the direction of Lori S. Pilcher, Regional Inspector General for Audit Services. Other principal Office of Audit Services staff who contributed included:

John T. Drake, Sr., Audit Manager
Mark L. Wimple, Senior Auditor
Betty C. Rouse, Auditor-in-Charge

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