LIMITED-SCOPE PERFORMANCE AUDIT REPORT

Office of Information Technology Services: Reviewing the Office's Service and Rate Structures

AUDIT ABSTRACT

The Office of Information Technology Services (OITS) is responsible for providing centralized information processing and technical management services to all state agencies. As an agency that does not generally receive a state appropriation, OITS must cover its expenses by charging agencies for the more than 40 services it provides. To determine whether OITS' service rates accurately reflected its expenses to provide those services, we reviewed 24 service rates—two of which we examined in detail, and 22 that we reviewed more simply. OITS' fiscal year 2019 rates did not accurately reflect prior year expenses for the two services we examined in detail. They also did not accurately reflect forecasted expenses for any of the 24 services we reviewed.

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
February 2019

L-18-018

From the Legislative Post Auditor:

This limited-scope audit was authorized by the Legislative Post Audit Committee at its June 20, 2018 meeting. It addresses the following question: Do OITS' service rates reflect actual expenses for a sample of services?

To answer this question, we interviewed OITS officials and reviewed documentation about OITS' expenses, revenues, and rate-setting methods. We also compared a non-projectable sample of the service rates OITS actually set to the rates they should have charged to cover their costs and reviewed relevant state laws and federal guidelines. We did not verify whether OITS' reported expenses were supported by underlying documentation, nor did we evaluate the extent to which OITS is providing services economically.

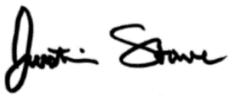
We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Overall, we believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Though we do not believe that it affected our findings, conclusions, or recommendations, we do want to call the reader's attention to one issue regarding auditor independence. Generally accepted government auditing standards require that auditors and audit organizations maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial (and viewed as impartial) by reasonable and informed third parties. Auditors should avoid situations that could lead reasonable and informed third parties to conclude the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

The reader should be aware that as a state agency, the Legislative Division of Post Audit is a consumer of information technology and telecommunications services from OITS. In fiscal year 2018, the division paid OITS approximately $9,000 for various services (out of about $2.3 million in total expenditures for the division). Although changes in the OITS services rates could have a small effect on the division's finances, we do not think this affected the impartiality of our findings, conclusions, judgments, and recommendations.

This audit was requested by Senator Mike Petersen and conducted by Josh Luthi. Kristen Rottinghaus was the audit manager. If you need any additional information about the audit's findings, please contact Josh at (785) 296-3792.

Sincerely,



Justin Stowe
Legislative Post Auditor

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Do OITS' Service Rates Reflect Actual Expenses for a Sample of Services?

Background Information

The Office of Information Technology Services (OITS) provides centralized information processing and technical management services to all state agencies. In 2013, the Legislature passed House Bill 2200, which replaced with Division of Information Systems and Communications (DISC) with OITS. It also named the Executive Chief Information Technology Officer (CITO) as the head of OITS. Under state law, OITS is required to provide all data processing, application hosting, and telecommunications services to all state agencies.

In fiscal year 2018, OITS employed about 75 staff and spent about $41 million. Most of OITS' expenditures (about $27 million, or 67%) were directly related to providing technology services and support to state agencies. Additionally, OITS spent about $3.4 million (8%) for overhead expenses, such as salaries for accounting staff or utilities expenses, and about $10 million (25%) on purchases OITS makes for other agencies, like software. OITS' staff are spread across seven program areas, such as administration, professional services, and network and telecommunication services.

OITS' operations are almost entirely funded by billing state agencies for the services OITS provides. As a fee-funded agency, OITS has not historically received a state appropriation to fund its operations. Instead, OITS must cover its expenses by charging state agencies for the services they use plus overhead. In fiscal year 2018, about $44 million of OITS' revenues (90%) was from the rates OITS charged for its services or purchases it made for other agencies. The remaining revenues include an administrative fee charged for specific services, grant funding, and almost $3.7 million from the State General Fund primarily for one-time costs related to cloud services.

OITS uses a model to estimate the service rates needed to cover expenses for the more than 40 services it provides. OITS provides more than 40 individual services, which generally fall into three major categories: information processing services, telecommunications services, and professional services. It uses a different rate-setting model for each major service category. Each model uses the actual expenses from a prior year to estimate future expenses for up to three years. These expenses include staff salaries, contractual expenses, overhead expenses, and allocations for expenses shared by more than one service (such as a staff member who splits time between a few services). Then, OITS staff divide the total estimated expenditures for a service by the number of units of that service OITS estimates agencies will consume annually. This generates an estimated rate that should allow OITS to recover its expenses.

Finding #1: OITS' Fiscal Year 2019 Rates Did Not Accurately Reflect Prior Year Expenses for the Two Services We Reviewed

To learn more about how OITS sets its service rates, we asked OITS officials to walk us through how they use their rate models. Then, we requested rate models prepared for fiscal years 2019 through 2021 for two services:

- Network connect service: This service allows state employees to connect to the Internet. One unit of this service represents Internet connectivity at a specific location for one month. In fiscal year 2018, this service generated about $6.5 million in revenues for OITS (or 13% of OITS' total revenues). Based on data from calendar years 2017 and 2018, OITS expects state agencies to consume about 16,000 units of this service each month.

- Web development service: This service allows state agencies to purchase assistance with things like building websites or databases. One unit of this service represents one hour of assistance. In fiscal year 2018, OITS reported revenues of about $11,000 for this service (or less than 1% of OITS' total revenues). OITS estimates state agencies may use up to 500 hours of this service annually.

We selected these two services in consultation with OITS officials, who told us these were services where OITS' rates may not reflect their expenses. We independently reviewed those models to evaluate how well they account for OITS' per-service revenues and expenses. However, we did not review underlying documentation to verify OITS' reported expenses, nor did we evaluate if OITS' expenses reflected the most efficient ways of providing services because these issues were outside the scope of this audit. In other words, we did not determine if the service rates produced by OITS' model accurately reflected their true costs to provide services.

OITS' rates should be based on the actual expenses it incurs to provide those services, such that OITS' per-service revenues and expenses are relatively equal. According to state regulations, the rates for data processing services should be based on agencies' actual costs of using those services and should be fair for users of all services. Additionally, because some agencies use federal dollars to purchase OITS services, OITS must abide by federal regulations related to the use of federal funds. Under these regulations, OITS should adjust for differences between its revenues and its allowable costs on a per-service basis at least annually. If OITS generates a profit, federal law requires OITS to refund agencies or lower their rates in the next year. Conversely, if OITS has a loss, federal law may require OITS to absorb it if it cannot be made up in the subsequent year. Failure to abide by these guidelines could result in the federal government seeking a refund on excess positive balances.

OITS' fiscal year 2019 rates did not account for prior-year balances for the two services we reviewed. These types of inconsistencies reduce the accuracy of OITS' rate estimates, could result in unfair rates for service users, and may cause OITS to violate federal guidelines.

- **OITS did not include their positive prior-year balance in its rate estimate for its network connect service.** At the end of fiscal year 2017, the network connect service had a positive balance of about $8.4 million because agencies paid more for the service in prior years than it cost OITS to provide it. OITS did not factor this balance into its future expense forecast. OITS officials told us this is because they anticipate contracting with an outside vendor to provide these services in the future. OITS officials told us outsourcing the network connect service will keep

OITS' annual costs more consistent, as they will no longer be responsible for significant one-time infrastructure costs. They anticipate significant expenses associated with the migration and want to have a surplus balance so they are prepared for those expenses. However, they acknowledged they may have to pay a refund to the federal government on a portion of this balance.

- **OITS included only a portion of their negative prior-year balance in its rate estimate for its web development service.** At the end of fiscal year 2017, the web development service had a negative balance of about $126,000. OITS included one-fifth of this amount in its expense forecast for fiscal years 2020 and 2021. OITS officials told us it was their intention to account for the balance over five years in order to limit the increase to the service rate. However, if the service continues to operate at a loss, OITS may never be able to fully account for its losses. For example, OITS forecasts up to about $130,000 in annual expenses to provide the web development service (this includes a share of the negative balance) but only generated about $11,000 in revenues for this service in fiscal year 2018.

Additionally, the rate-setting models included a few data entry errors as a result of the data being manually entered by staff. For example, OITS did not include about $700,000 in overhead expenses in the rate it set for the network connect service. OITS officials said this was a mistake and agreed overhead expenses should be included in all service expense estimates.

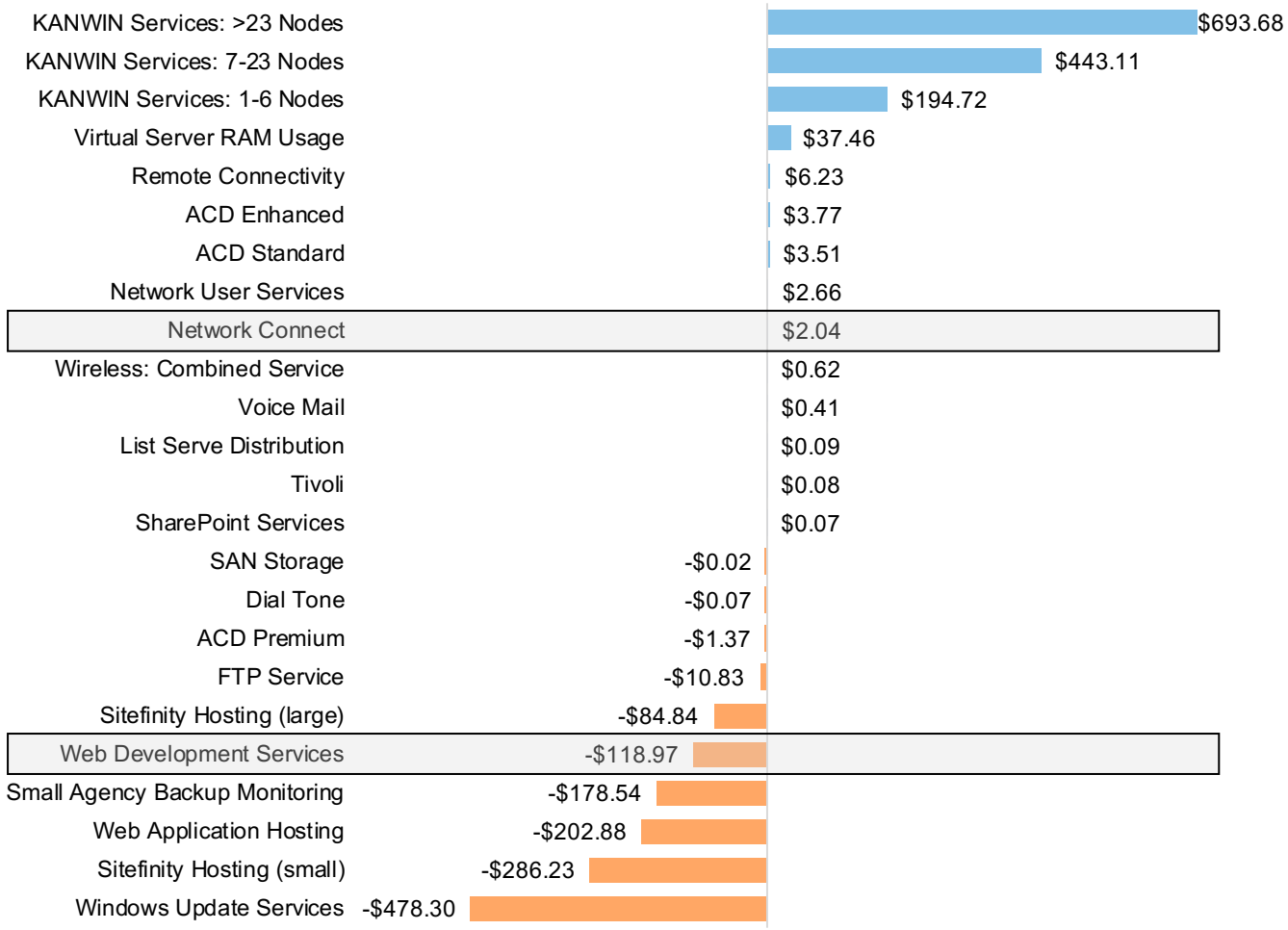
Finding #2: OITS' Fiscal Year 2019 Service Rates Also Did Not Accurately Reflect Forecasted Expenses for 24 Services We Reviewed

We reviewed OITS' service rates for two major service categories in fiscal year 2019: telecommunications and professional services. As previously explained, we requested rate models for two specific services: the network connect service and the web development service. The rate models for those services also included calculations for 22 additional services in the telecommunications and professional services categories. For example, the web development service is in the professional services category, which includes other services like web application hosting and windows update services. This selection is not projectable, so our findings may not be applicable to the other services OITS offers. To evaluate the extent to which OITS' service rates reflect its expenses for the services, we compared the service rates OITS estimated with its model to the service rates in the Division of Budget's budget instructions for fiscal year 2020. That document includes service rate estimates for fiscal years 2019 through 2021.

None of the service rates OITS set for the 24 telecommunications and professional services we reviewed matched the rates calculated by its model. Although OITS has a model to estimate the service rates needed to cover their expenses, officials did not use it to set the rates we reviewed. Instead, OITS management manually set rates so they were consistent with rates in past years. As ***Figure 1***, on page 4, shows, none of the service rates we evaluated aligned with what OITS' rate models showed OITS should charge. For example, OITS' rate is $80 per unit for the web development service (equivalent to one hour of a service like website design). However, its model showed it should be $198.97 in order to recover their current expenses and some of its prior-year losses. When multiplied by the expected utilization, the $119 shortfall suggests a projected loss of about $60,000 for this service in fiscal year 2019. In contrast, OITS' rate is

about $2 more for network connect than its model calculated, a service for which it has significant prior-year profits. This suggests a projected profit of almost $400,000 for this service. ***Appendix B*** includes additional details about the rates OITS set.

Figure 1
Differences Between OITS' Estimated Per-Unit Service Rates and the Rates OITS Set for Fiscal Year 2019



Source: LPA comparison of OITS' service rate models to Division of the Budget documentation.

According to OITS officials, OITS management is reluctant to change rates from their historical levels because of budgeting difficulties it may create for state agencies. OITS officials acknowledged their rates did not always reflect their estimated expenses. They told us OITS management is generally reluctant to change rates, particularly when doing so would result in significant rate increases. According to OITS officials, OITS must set its service rates two to three years in advance to work within the state's budget cycle. Agencies use the service rates OITS sets to determine how much they need to budget for IT services for the next two to three fiscal years. Therefore, officials felt it would be bad practice to increase rates because it could disrupt agencies' budgets. OITS officials reported they are evaluating other ways of providing

some of the services they feel they cannot provide economically. However, they also said they want to be cautious and balance security and quality concerns with cost.

Setting service rates that do not reflect OITS' expenses could cost the state money. Because service rates do not always reflect OITS' expenses, various agencies may be paying more or less than they should pay for the services they use. When some services consistently operate at a loss, OITS must use other excess revenues to cover those losses. Federal law does not allow OITS to generate profits on the services they offer because some agencies use federal funds to pay OITS for services. For OITS to have the excess revenues to cover losses, it must be generating profits on some services. The federal government may, as a result, penalize the state by requesting a refund on the federal share of those excess revenues. We did not evaluate the extent to which the state may be at financial risk as part of this limited scope audit. However, based on our 2013 audit of OITS' rate setting process, the federal government assessed and collected a $2.5 million refund from the state because its rates had resulted in unallowed profits.

Recommendations

1. To address the issues with the accuracy of OITS' rate-setting models (pages 2 to 3), OITS should:
    a. Include all prior-year balances in its models.
    b. Periodically review the accuracy and completeness of its rate models.

2. To address the issues with OITS' service rates not reflecting its forecasted expenses (pages 3 to 5), OITS should:
    a. Develop a plan for improving the rate-setting process to address:
        i. How to balance OITS' need to periodically adjust rates to cover its expenses against agencies' needs for budget stability.
        ii. How to streamline, eliminate, or otherwise cover OITS' expenses for services that consistently operate at a loss.
        iii. Any other obstacles that currently prevent OITS from setting service rates equal to those produced by its rate-setting model.
    b. Present the final plan to the Legislature for their consideration by April 2019.

Potential Issues for Further Consideration

We identified one issue that might be worth evaluating in more detail, but because of the limited scope of the audit, we did not have time to fully develop it. Although we had unresolved questions about the following issue, more audit work would be needed to determine whether it represents an actual problem.

1. The results of our limited review identified some of the same problems we encountered in our 2013 audit of OITS' rate-setting process. The rate-setting process is complex and involves numerous steps and federal requirements. Although we looked at these items to the extent needed to address our audit objectives, we did not delve into the complexities of OITS' rate setting models or federal requirements as part of our limited review.

Because our limited work in this audit identified some of the same problems from our 2013 audit, a more thorough review could be warranted. Additional work could more fully explore the challenges OITS faces in complying with federal requirements while also meeting its own financial needs and the needs of other agencies.

APPENDIX A
Agency Response

On December 14, 2018, we provided copies of the draft audit report to OITS for an official response. The agency did not provide a written response to our findings, but it did provide its implementation plan for each recommendation as shown on the next page. OITS agreed to work toward charging rates that more accurately reflect its costs and discussed the challenges associated with doing so. Although the specific steps OITS will take to address each recommendation are unclear, officials agreed to prepare a plan for the Legislature about how to address the challenges.

Itemized Response to LPA Recommendations

Audit Title: **Reviewing OITS' Service and Rate Structures**

Agency: **Office of Information Technology Services**

LPA Recommendation	Agency Action Plan
Question 1	
1. To address the issues with the accuracy of OITS' rate-setting models, OITS should:	
a. Include all prior-year balances in its models.	Prior balances are considered when calculating all rates. However, sometimes management makes decisions that limit the extent to which they are included in the rates. OITS can include all prior-year balances in its models.
b. Periodically review the accuracy and completeness of its rate models.	Rates are reviewed on an annual basis. Due to the biennial budget process, Division of Budget highly discourages increasing rates in the second year as the agencies' budgets are already set. OITS can lower the rates when appropriate. The rate models have only been developed over the last three years. They continue to be reviewed and perfected.
2. To address the issues with OITS' service rates not reflecting its forecasted expenses, OITS should:	
a. Develop a plan for improving the rate-setting process to address:	
i. How to balance OITS' need to periodically adjust rates to cover its expenses against agencies' needs for budget stability.	Division of Budget highly discourages increasing rates in the middle of the biennial budget cycle due to the effect on other agencies' budgets. Rates cannot be raised without their approval. OITS will lower rates when appropriate. As OITS moves to "as a service" offerings, there should be less volatility in the expenses paid by OITS. This will help in projecting the rates for out years.
ii. How to streamline, eliminate, or otherwise cover OITS' expenses for services that consistently operate at a loss.	A year ago, a plan was developed to include 20% of the loss of a rate annually in the rate so that the loss would be gone within 5 years. This seemed like a compromise with the agencies to flatten recovery of the loss to help their budgets and yet recover the loss for OITS. However, management decisions that reduce the rate below what it needs to be undermine this plan. OITS also understands that they need to focus on what they are good at and not try to provide all services especially when it is not cost effective to do so. OITS will determine a list of vendors that will be able to provide some of the professional services (e.g. web development and web hosting) that will meet the security standards of the State and provide a cost effective alternative to OITS providing services.
iii. Any other obstacles that currently prevent OITS from setting service rates equal to those produced by its rate-setting model.	Rate setting is not an exact science. Expenses must be estimated up to three years in advance. Usage varies from month to month so it must be estimated based on trends that may or may not reflect future technologies. Technology changes on a constant basis. OITS is moving from a capital expenditure model to an operating expenditure model. All of these are factors that influence the rates that are produced by its rate-setting model. OITS will continue to work towards solidifying its model and consistently reporting expenditures. OITS will strive to charge the rate produced by its model.
b. Present the final plan to the Legislature for their consideration by April 2019.	OITS will be ready to present a plan.

APPENDIX B
Comparison Between OITS' Modeled Rates and the Rates They Actually Set

This appendix shows the extent to which the service rates OITS set for fiscal year 2019 differ from the service rates OITS calculated with its models. The estimated rate refers to the rates OITS calculated with its model. The actual rate refers to the rates listed in the Division of the Budget's fiscal year 2020 budget instructions document, which lists OITS' rate estimates for fiscal years 2019 through 2021.

Appendix A
Comparison of OITS' Estimated Per-Unit Service Rates to the Rates Actually Set for Fiscal Year 2019

Service Name	Estimated Per-Unit Rate	Actual Per-Unit Rate	Difference from Estimated Rate
KANWIN Services: >23 Nodes	$506.43	$1,200.11	$693.68
KANWIN Services: 7-23 Nodes	$363.34	$806.45	$443.11
KANWIN Services: 1-6 Nodes	$161.05	$355.77	$194.72
Virtual Server RAM Usage	$22.54	$60.00	$37.46
Remote Connectivity	$4.96	$11.19	$6.23
ACD Enhanced	$26.24	$30.01	$3.77
ACD Standard	$20.27	$23.78	$3.51
Network User Services	$98.05	$100.71	$2.66
Network Connect	$40.07	$42.11	$2.04
Wireless: Combined Service	$54.11	$54.73	$0.62
Voice Mail	$2.39	$2.80	$0.41
List Serve Distribution	$0.01	$0.10	$0.09
Tivoli	$0.92	$1.00	$0.08
SharePoint Services	$27.93	$28.00	$0.07
SAN Storage	$0.37	$0.35	-$0.02
Dial Tone	$14.23	$14.16	-$0.07
ACD Premium	$12.05	$10.68	-$1.37
FTP Service	$23.10	$12.27	-$10.83
Sitefinity Hosting (large)	$345.09	$260.25	-$84.84
Web Development Services	$198.97	$80.00	-$118.97
Small Agency Backup Monitoring	$204.38	$25.84	-$178.54
Web Application Hosting	$300.14	$97.26	-$202.88
Sitefinity Hosting (small)	$517.12	$230.89	-$286.23
Windows Update Services	$581.01	$102.71	-$478.30

Source: LPA comparison of OITS' service rate models to Division of the Budget documentation.