

O L A

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

**Department of Employment and
Economic Development**

Fiscal Year 2005



March 9, 2006

06-09

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota state government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of representatives and senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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If you have comments about our work, or you want to suggest an audit, investigation, or evaluation, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

Department of Employment and Economic Development

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
Brad White, CPA, CISA	Audit Manager
Ken Vandermeer, CPA	Auditor-in-Charge
Scott Tjomsland, CPA	Team Leader
Carl Otto, CPA, CISA	Auditor
Tesfaye Negash	Auditor
Jessica Ferraro	Intern

Exit Conference

We discussed the findings and recommendations with the following representatives of the Department of Employment and Economic Development at an exit conference on February 27, 2006:

Ward Einess	Deputy Commissioner
Chuck Hartfiel	Unemployment Insurance Program Director
Paul Moe	Business and Community Services Director
Kimberly Peck	Director of Rehabilitation Services
John Stavros	Chief Financial Officer
Tim Langlie	Accounting Director
Judy Kislenger	Accounting Manager

Report Summary

Key Findings:

- Implementation of a new computerized unemployment insurance system made it difficult for the department to measure year-end revenue and file a required quarterly federal financial activity report. (Findings 1 and 2, pages 4 and 5)
- The department did not consistently monitor and report Community Development Block Grant project expenditures. (Finding 3, page 5)
- Certain organizations receiving federal vocational rehabilitation funds did not file quarterly reports, as specified in their grant agreement. (Finding 4, page 6)

The audit report contained four audit findings relating to internal control or legal compliance. The department resolved two findings included in our prior report. The department is working towards implementing a new computer system in the fall of 2007 to address the other two issues.

Audit Scope:

Programs material to the State of Minnesota's financial statements and to federal program compliance for fiscal year 2005.

Selected Audit Areas:

- Unemployment Insurance Fund
- Federal programs, including:
 - Unemployment Insurance Administration
 - Employment Services Cluster
 - Workforce Investment Act Cluster
 - Vocational Rehabilitation
 - Community Development Block Grant

Background:

The Department of Employment and Economic Development (DEED) recorded unemployment insurance revenues totaling \$928 million and paid benefits of \$678 million for fiscal year 2005. As of June 30, 2005, the department owed \$82 million to the federal government.



Senator Ann. H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Matt Kramer, Commissioner
Department of Employment and Economic Development

We have performed certain audit procedures at the Department of Employment and Economic Development as part of our audit of the financial statements of the State of Minnesota for the year ended June 30, 2005. We also have audited certain federal financial assistance programs administered by the Department of Employment and Economic Development as part of our audit of the state's compliance with the requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement*. We emphasize that this has not been a comprehensive audit of the Department of Employment and Economic Development.

Our financial statement audit work focused on material financial activities of the Unemployment Insurance Fund. For fiscal year 2005, unemployment taxes totaled \$855 million, other revenues totaled \$73 million, and unemployment benefits were \$678 million. In addition, the Unemployment Insurance Fund borrowed \$82 million from the federal government to fund unemployment benefits and transferred \$52 million to fund the department's technology initiative and the state's Workforce Development Fund. We performed certain audit procedures on these programs as part of our objective to obtain reasonable assurance about whether the State of Minnesota's financial statements for the year ended June 30, 2005, were free of material misstatement.

Table 1 identifies the State of Minnesota's major federal programs administered by the Department of Employment and Economic Development. We performed certain audit procedures on these programs as part of our objective to obtain reasonable assurance about whether the State of Minnesota complied with the types of requirements that are applicable to each of its major federal programs. Procedures involved reviewing the department's compliance with federal requirements in areas such as cash management, allowable costs, and financial reporting.

Department of Employment and Economic Development

Table 1
Major Federal Programs Administered by the
Department of Employment and Economic Development
Fiscal Year 2005
(in thousands)

<u>CFDA #</u> ^(Note 1)	<u>Program Name</u>	<u>Federal Expenditures</u>
14.228	Community Development Block Grant	\$ 25,558
17.225	Unemployment Insurance ^(Note 2)	\$717,305
	<u>Employment Services Cluster:</u>	
17.207	Employment Services	\$ 18,917
17.801	Disabled Veterans Outreach	1,592
17.804	Local Veterans Employment Representative	<u>1,316</u>
	Total Employment Services Cluster	\$ 21,825
	<u>Workforce Investment Act (WIA) Cluster:</u>	
17.258	WIA-Adult	\$ 7,991
17.259	WIA-Youth	9,014
17.260	WIA-Dislocated Workers	<u>12,356</u>
	Total Workforce Investment Act Cluster	\$ 29,361
84.126	Vocational Rehabilitation	\$ 40,267

Note 1: The Catalog of Federal Domestic Assistance (CFDA) is a unique number assigned by the federal government to identify its programs.

Note 2: Expenditures included \$667,707,000 of unemployment insurance grants and \$49,598,000 of federal administrative reimbursements.

Source: Department of Employment and Economic Development's (DEED) accounting system for fiscal year 2005.

We conducted our audit in accordance with 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.

Conclusions

Our November 18, 2005, report included an unqualified opinion on the State of Minnesota's basic financial statements for fiscal year 2005. In accordance with *Government Auditing Standards*, we also issued our report, dated November 18, 2005, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. At a later date, we will issue our report on compliance with requirements applicable to each major federal program and internal control over compliance in accordance with OMB Circular A-133.

As a result of audit work, we identified the following weaknesses in internal control and instances of noncompliance with federal program requirements at the Department of Employment and Economic Development.

Department of Employment and Economic Development

Findings and Recommendations

1. The Department of Employment and Economic Development (DEED) did not effectively identify certain Unemployment Insurance Fund accruals and transfers.

DEED had difficulty measuring some year-end revenue accruals for the Unemployment Insurance Fund (CFDA #17.225) and did not provide a clear trail for money it sent to other governmental funds. These problems caused delays in financial reporting to the Department of Finance for inclusion in the State of Minnesota's *Comprehensive Annual Financial Report*.

The department's implementation of a new computerized unemployment tax system in June 2005 complicated its ability to estimate certain year-end revenue accruals. The new system calculated and collected employer taxes beginning in the second quarter of 2005; those taxes were due July 31, 2005. Financial accounting staff reconciled cash collections to amounts reported in the new tax system for this quarter and properly accrued cash received after June 30, 2005. However, staff had difficulty measuring other year-end revenue accruals for employer accounts with credit balances and uncollected amounts owed by employers. A recent change in unemployment tax law eliminated estimated billings sent to taxpaying employers who have not filed. The law change created a need for the department to develop other estimation methods, such as determining historical patterns for delinquent tax collections. Accounting staff did not have access to data in the new tax system and had to rely on other means to estimate approximately \$20 million of year-end revenue accruals. For one type of estimate, they used the prior year's amount. Poor estimation methods and a lack of refinement based on subsequent collection patterns could lead to inaccurate financial reporting of fund revenues and receivables.

In a second concern, DEED staff did not always clearly identify which governmental funds they transferred unemployment insurance monies into. Unemployment insurance collections included other revenues authorized to fund the department's technology initiative and the state dislocated worker program. The department accumulated these collections in a bank account outside the state treasury and periodically transferred money to the state treasury for deposit. However, they did not clearly identify the state treasury fund and accounts where \$1.8 million of receipts were deposited. Furthermore, the department inconsistently recorded a \$1 million transfer into the Workforce Development Fund as a nondedicated rather than dedicated receipt. Additional scrutiny and review of unemployment insurance transfers by DEED before submitting the information to the Department of Finance would improve the control over and the efficiency of the reporting process.

Recommendation

- *The department should improve unemployment insurance financial reporting by developing methods for estimating year-end revenue accruals and work with the Department of Finance to develop an effective process to ensure accurate recording and tracking of transfers to other governmental funds.*

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2. DEED did not submit a required quarterly unemployment insurance financial activity report to the federal government and could not locate documentation supporting a separate report.

The department did not file required unemployment insurance (CFDA #17.225) federal financial reports for the quarters ending June 30, September 30, and December 31 of 2005. The federal Employment Training Act Report on Contribution Operations (ETA 581) was properly filed in previous quarters; however, since implementing its new unemployment insurance tax system in June 2005, the department encountered difficulties developing accurate financial activity information for the report.

In addition, DEED did not retain documentation supporting its 2004 federal unemployment tax (FUTA) report filed January 2005. The FUTA report certifies the department's comparison of employer unemployment tax payments to credits claimed by employers on their IRS 940 FUTA tax form. The federal government requires auditors of unemployment insurance to verify the procedures and tests performed to support the comparison. The department provided documentation showing that they ran the computer program; however, they could not find evidence supporting their tests of the computerized comparison. As a result, we were unable to determine the department's compliance in certifying FUTA tax credits. Record retention policies require the department to retain this documentation for a minimum of three years or until audited.

Recommendations

- *DEED should comply with unemployment insurance federal reporting requirements by developing system reports that facilitate accurate and timely federal reporting.*
- *The department should retain documentation supporting its testing of the FUTA certification report for a minimum of three years or until audited.*

3. The department did not consistently monitor and report project expenditures for the federal Community Development Block Grant Program (CFDA #14.228).

The Community Development Block Grant Program provides federal grants to small cities for housing and economic improvement projects. Under federal authority, the state has issued rules to govern grant application, awarding, and monitoring. The department employed 'program monitors' to monitor project progress and verify that cities comply with federal grant requirements. However, program monitors did not consistently authorize reimbursement of project payments nor obtain and review independent audits of funded projects. In addition, the department filed a key federal financial report late and incorrectly included project expenditures made after the reporting period. Without consistent monitoring, authorizing, and reporting practices, ineligible project costs and noncompliance with federal regulations could occur without detection.

Department of Employment and Economic Development

The department encountered the following problems with the block grant program:

- The department requires two signatures to authorize draw requests for federal reimbursement of block grant project costs. However, for 2 of 11 draw requests tested, the department received federal funds and reimbursed project costs without obtaining two authorizations. Supervisory approvals were made, but signatures from program monitors that review projects for compliance with program requirements were missing.
- The department did not fulfill its oversight responsibility ensuring that independent audits were conducted. Program monitors did not obtain audit reports for 6 of 11 subrecipients receiving over \$500,000 per year, as required by federal guidelines. The department did not have evidence that one subrecipient had a qualifying federal audit, and five did not submit an audit report to the department until requested during our review. In fact, one audit raised some concerns that should have been investigated and resolved by program monitors.
- The department submitted the program evaluation review report over 60 days late to the federal Housing and Urban Development Agency. The report for the period ending September 30, 2004, was due on December 31, 2004; however, it was not submitted until March 2005. In addition, the report incorrectly included at least \$1.7 million of expenditures paid from October 2004 through March 2005. The department should have included these subsequent expenditures in the next federal reporting period.

Recommendation

- *The department should improve the federal Community Development Block Grant Program's compliance by:*
 - *obtaining two authorizations before requesting federal funds for project reimbursement;*
 - *ensuring subrecipient audit requirements are met, and any audit issues are adequately monitored and resolved; and*
 - *submitting a timely and accurate federal program evaluation review report.*

4. DEED did not ensure that all organizations submitted quarterly financial reports for the federal Vocational Rehabilitation Program.

The department did not receive quarterly financial status reports from all organizations receiving vocational rehabilitation (CFDA #84.126) program funding. These reports are due 30 days after the end of each reporting quarter, as specified in their grant agreements. The department uses these reports to monitor cash advances and record program expenditures, and they ultimately become the basis for the department's vocational rehabilitation program expenditures reported to the federal government. However, three of nine organizations tested continued to receive cash advances during fiscal year 2005 even though they did not file quarterly financial status reports

Department of Employment and Economic Development

with DEED. For these organizations, DEED's accounting system reflected the cash advances as unpaid obligations until they reported actual expenditures at year-end.

Federal regulations require the department to monitor cash management and spending by organizations receiving federal funds. To enforce these provisions, the department has the authority to discontinue or delay federal program funding until requested reports are filed. The inability of these organizations to file these financial status reports increases the risk of excessive cash balances or inappropriate program expenditures. In addition, weaknesses in entity financial management could compromise their ability to deliver an appropriate level of service to eligible recipients.

Recommendation

- *The department should ensure that all organizations receiving federal vocational rehabilitation funds submit quarterly financial status reports. It should evaluate the financial reliability of organizations unable to meet the quarterly reporting requirement specified in their grant agreement.*

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Employment and Economic Development. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 9, 2006.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: January 31, 2006

Report Signed On: March 6, 2006

Department of Employment and Economic Development

Status of Prior Audit Issues As of January 31, 2006

Fiscal Year 2004 Statewide/Single Audit

We examined the Department of Employment and Economic Development's activities and programs material to the State of Minnesota's *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2004. An unqualified opinion was issued on the State of Minnesota's *Comprehensive Annual Financial Report* for the year ended June 30, 2004. Four issues were identified as a result of our audit work at the Department of Employment and Economic Development:

- The department needed to better scrutinize changes to employer accounts and wage detail data and the related impact on unemployment insurance rates and revenue recognition. The recommendation was based on federal Department of Labor warnings about a nationwide problem with employer's manipulating their tax experience ratings. In June 2005, the department implemented the first phase of a new unemployment insurance tax system and developed revenue recognition policies for companies found in violation.
- The department needed to improve data integrity controls. The new system's redesign of the rate calculation process and automation of benefits paid to benefits charged should improve data integrity controls; however, full implementation of the new system is not expected until late in 2007.
- The department needed to more accurately identify and report federal program expenditures. The department resolved this finding.
- The department needed to make some changes to ensure compliance with contract requirements of two federal programs. The department resolved these issues.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the metropolitan agencies, or the State Agricultural Society, the state constitutional officers, or the judicial branch.

March 7, 2006

Mr. James R. Nobles
Legislative Auditor
First Floor, Centennial Office Building
658 Cedar Street
St Paul, MN 55155

Dear Mr. Nobles:

The following information is in response to your draft audit report for the fiscal year ended June 30, 2005.

Auditor's Finding 1. The Department of Employment and Economic Development (DEED) did not effectively identify certain Unemployment Insurance Fund accruals and transfers.

Auditor's Recommendation:

- The department should improve unemployment insurance financial reporting by developing methods for estimating year-end revenue accruals and work with the Department of Finance to develop an efficient process to ensure accurate recording and tracking of transfers to other government funds.

Response: We agree. DEED will use the ETA 581 report for estimating the revenue accrual for non-filers. DEED continues to develop the UI TIP credit and accrual, reporting capabilities.

DEED will communicate with the Department of Finance regarding a clear format to identify funds accrued to the state treasury. DEED will work with the Executive Budget Officer to correctly classify receipts available for transfer.

Responsible Person: Kathy Nelson 651-296-1692

Responsible Person: John Stavros 651-296-3965

Auditor's Finding 2. DEED did not submit a required quarterly unemployment insurance financial activity report to the federal government and could not locate documentation supporting a separate report.

Auditor's Recommendations:

- DEED should comply with unemployment insurance federal reporting requirements by developing system reports that facilitate accurate and timely federal reporting.
- The department should retain documentation supporting its testing of the FUTA certification report for a minimum of three years or until audited.

Response: We agree. DEED has now submitted all required reports and will properly retain all supporting documentation.

Responsible Person: Kathy Nelson 651-296-1692

Auditor's Finding 3. The department did not consistently monitor and report project expenditures for the federal Community Development Block Grant Program (CFDA #14.228).

Auditor's Recommendations:

- The department should improve the federal Community Development Block Grant Program's compliance by:
 - Obtaining two authorizations before requesting federal funds for project reimbursement;
 - Ensuring subrecipient audit requirements are met, and any audit issues are adequately monitored and resolved; and
 - Submitting a timely and accurate federal program evaluation review report.

Response: We Agree. DEED will use only the form that requires both the monitor and supervisor's signatures for reimbursement requests.

DEED has received the required qualifying federal audit reports from the subrecipients cited in the report. DEED will ensure that subrecipient's audits met standards and the audits are reviewed and resolved.

DEED submitted the program evaluation review report after the due date and included expenditures after the reporting period. HUD has accepted this report without exceptions. We will submit future reports in a timely manner.

Responsible Person: Paul A. Moe 651-297-1391

James R. Nobles

March 3, 2006

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Auditor's Finding 4: DEED did not ensure that all organizations submitted quarterly financial reports for the federal Vocational Rehabilitation Program.

Auditor's Recommendation:

- The department should ensure that all organizations receiving federal vocational rehabilitation funds submit quarterly financial status reports. It should evaluate the financial reliability of organizations unable to meet the quarterly reporting requirement specified in their grant agreement.

Response: We agree. DEED will monitor subrecipients to ensure that financial status reports are timely.

Responsible Person: Kim Peck 651-296-7510

If you have questions or comments, please contact John Stavros, Chief Financial Officer.

Sincerely,

/s/ Matt Kramer

Matt Kramer
Commissioner