



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Management Letter

Department of Employee Relations
Fiscal Year Ended June 30, 2003



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 Employee Relations

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Audit Participation

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

| | |
|------------------------|----------------------------|
| Claudia Gudvangen, CPA | Deputy Legislative Auditor |
| Brad White, CPA, CISA | Audit Manager |
| Pat Ryan | Auditor-in-Charge |
| Kristen Poore, CPA | Auditor |
| Jacqueline Wessel | Auditor |

Exit Conference

We discussed the finding and recommendation with the following representatives of the Department of Employee Relations at an exit conference on March 2, 2004:

| | |
|--------------|-------------------------------------|
| Cal Ludeman | Commissioner |
| Lorna Smith | Government Relations |
| Liz Houlding | Employee Insurance Division Manager |
| Ed Keimig | Internal Auditor |

Report Summary

Key Finding and Recommendation

Legally mandated transfers to the state's General Fund will significantly reduce the State Employee Group Insurance Program (SEGIP) reserves. In addition, because insurance premiums for some employees were paid from federal funds, regulations require an equitable refund to the federal government for its share of funds transferred. We recommended that the Department of Employee Relations work with the Department of Finance to determine the amount owed and to build reserves beyond the minimum level. (Finding 1, page 3)

Management letters address internal control weaknesses and noncompliance issues found during our annual audit of the state's financial statements and federally funded programs. The scope of work in individual agencies is limited. During the fiscal year 2003 audit, our work at the Department of Employee Relations focused on financial reporting for statewide payroll and fringe benefit costs and liabilities for state employee compensated absences and workers' compensation. We also examined the financial statements for the State Employee Insurance Fund and Public Employee Insurance Fund, which are administered by the department. The department's response to our recommendation is included in the report.



OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

Representative Tim Wilkin, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Cal Ludeman, Commissioner
Department of Employee Relations

We have performed certain audit procedures at the Department of Employee Relations as part of our audit of the financial statements of the State of Minnesota for the year ended June 30, 2003. We emphasize that this has not been a comprehensive audit of the Department of Employee Relations.

The scope of our audit work at the Department of Employee Relations included statewide payroll and related fringe benefit transactions processed through the State Employee Management System (SEMA4) and interfaced into the Minnesota Accounting and Procurement System. Our office performed an information technology audit of SEMA4 and issued a report in August 2003, Legislative Audit Report #03-47, that assessed the adequacy of selected computer general and application controls. State employee payroll costs for fiscal year 2003 totaled \$3 billion. In addition, we performed certain audit procedures on the accrued liabilities for compensated absences and workers' compensation, totaling \$268 million and \$117 million, respectively, at June 30, 2003. We also reviewed the financial statements for the State Employee Insurance Fund and Public Employee Insurance Fund as part of our objective to obtain reasonable assurance about whether the State of Minnesota's financial statements for the year ended June 30, 2003, were free of material misstatement.

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 December 5, 2003, report included an unqualified opinion on the State of Minnesota's general purpose financial statements for fiscal year 2003. In accordance with *Government Auditing Standards*, we also issued our report, dated December 5, 2003, 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.

As a result of our procedures, we identified the following financial observation at the Department of Employee Relations.

Department of Employee Relations

1. Required transfers and related repayments to the federal government will significantly reduce the State Employee Group Insurance Program (SEGIP) contingency reserves.

The state created the SEGIP employee insurance trust fund to self-insure state employee health and dental claims. The fund retains the monies from insurance premiums, generated through employee deductions and employer-paid contributions, and pays the claims when due. In order to have sufficient cash on hand to pay claims and to stabilize health and dental rates, statutes authorize the department to maintain a contingency reserve. Maintenance of an adequate reserve level, or financial cushion, is crucial in a self-insurance environment. We are concerned that transfers of money out of the fund and unforeseen federal obligations could reduce reserves to a level where General Fund assistance or borrowing may be necessary.

The Legislature authorized transfers out of the SEGIP fund to help eliminate the state's General Fund budget deficit. During fiscal year 2003, \$11 million in cash was transferred from SEGIP, and an additional \$23 million is authorized for fiscal year 2005. The \$11 million transfer represented a return of previous state General Fund contributions to SEGIP that were made to build reserves. However, the \$23 million fiscal year 2005 transfer exceeds amounts contributed to SEGIP by the General Fund. The transfer to the General Fund will significantly reduce reserves to a level below that suggested by fund consultants. In addition, because insurance premiums for some employees were paid from federal funds, regulations require an equitable refund to the federal government for its share of funds transferred.

As communicated to the Legislature during the 2003 session, the Department of Employee Relations adopted a policy that establishes a minimum level of reserves based on the SEGIP historical experience and the low probability that certain reserve levels would be exceeded. In developing the policy, the department considered the varying reserve levels and self-insurance arrangements in other states. Minn. Stat. Section 43A.30, Subd. 6 authorizes an employee insurance trust fund contingency reserve to "increase controls over medical plan provisions and insurance costs for the state's employee populations. The reserve consists of appropriations from the general fund, receipts from billings to agencies, and investment gains and losses." The statute does not identify the reserve level nor establish guidelines for the reserve. The department's consultant advised a high-level reserve target of 25-29 percent (3 or more months) of anticipated annual claims, however, the department adopted a minimum target reserve level of 12.5-16.7 percent (1½ to 2 months) of projected annual claims. This low reserve level could increase the need for infusion of General Fund cash, should claims unexpectedly rise, at a time when the General Fund is already facing financial pressure from revenue shortfalls and budget cuts.

Table 1-1 shows projected reserves at the different reserve policy levels and a comparison to surplus reserves required by Minnesota Rules 2765.1200 for private plans.

Department of Employee Relations

**Table 1-1
Comparison of SEGIP Reserve Levels to Different Targets**

| | SEGIP Financial Statements | | | |
|---------------------------------------|---------------------------------------|--------------------|---------------------|---|
| Net Assets Before Transfer | | | \$85,183,000 | |
| FY 2003 Transfer Out | | | <u>(11,000,000)</u> | |
| Actual Reserves @ 6/30/2003 | | | 74,183,000 | |
| Transfer Authorized for FY 2005 | | | <u>(23,000,000)</u> | |
| Adjusted Reserves ^(Note 1) | | | <u>\$51,183,000</u> | |
| Reserve Policy Levels: | Low | High | | Private Plan Comparison (Note 2) |
| Base (Annual claims or revenue) | \$365,268,000 | \$365,268,000 | | \$393,210,000 |
| Reserve Policy Period | 1 ½ - 2 months | 3+ months | | 3 months |
| Reserve Target | \$46-\$61 million | \$91-\$106 million | | \$98 million |

Note 1: The above measurements exclude federal government obligations, which have not yet been determined.

Note 2: Minnesota Rules require a private plan to protect itself from cash flow difficulties by maintaining a surplus equal to three times the average paid monthly premiums during the most recent fund year.

Source: SEGIP balances reported in the State of Minnesota Comprehensive Annual Financial Report (CAFR) for fiscal year 2003.

Federal officials have met with the departments of Employee Relations and Finance regarding the moneys removed from the state’s internal service funds, including SEGIP. Federal judgments have been made against other states that similarly removed funds from self-insurance programs. Office of Management and Budget (OMB) Circular A-87 indicates “*Whenever funds are transferred from a self-insurance reserve to other accounts (e.g., general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer.*” Since the \$23 million authorized transfer to the General Fund exceeds amounts contributed to SEGIP by the General Fund, the federal government is entitled to receive an equitable share of reserves returned. The departments are currently working to determine amounts owed to the federal government.

Recommendation

- *The Department of Employee Relations should continue to work with the Department of Finance to determine the amount owed by SEGIP to the federal government and to build reserves beyond the minimum level.*

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Employee Relations. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 12, 2004.

/s/ James R. Nobles

/s/ Claudia J. Gudvangen

James R. Nobles
Legislative Auditor

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 5, 2003
Report Signed On: March 9, 2004

**Status of Prior Audit Issues
As of December 5, 2003**

Most Recent Audit

Legislative Audit Report #03-47, issued in August 2003, involved an information technology audit of selected areas of the State Employee Management System (SEMA4). The audit assessed the adequacy of selected computer general and application controls. The audit found that the departments of Employee Relations and Finance have adequate controls protecting the integrity of SEMA4 payroll and personnel data and ensuring that employees are paid the appropriate rates. The departments have adequate controls to ensure that employees are paid at the appropriate rates, and payroll is accurately processed and recorded in the state's general ledger. The audit report identified three areas where the department could further enhance the SEMA4 security infrastructure. The departments are working to resolve the issues.

Fiscal Year 2002 Statewide/Single Audit

We examined the Department of Employee Relation's activities and programs material to the State of Minnesota's basic financial statements for the fiscal year ended June 30, 2002. The purpose of the audit was to render an opinion on the State of Minnesota's financial statements for fiscal year 2002. The report cited two findings or concerns pertaining to the Department of Employee Relations. One recommendation, involving the need to clarify responsibilities and residual funding arrangements with independent billing units should they terminate from SEGIP, is in the process of being resolved. The second recommendation, requesting improved reporting of required supplementary information (RSI) for the Public Employee Insurance Program, was fully implemented.

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 9, 2004

TO: James R. Nobles, Legislative Auditor
Office of the Legislative Auditor

FROM: Cal R. Ludeman
Commissioner

RE: **Audit Findings**

We have reviewed the audit results as noted in your letter of March 4, 2004, and our joint meeting. Our response is noted below.

Financial Observation

Required transfers and related repayments to the federal government will significantly reduce the State Employee Group Insurance Program (SEGIP) contingency reserves.

Recommendation

- *The Department of Employee Relations should continue to work with the Department of Finance to determine the amount owed by SEGIP to the federal government and to build reserves beyond the minimum level.*

DOER Response:

DOER will continue to work with the Department of Finance to estimate the Federal Government's share/percentage of the required transfers. The estimated percentage owed to the Federal Government, and related supportive documentation, will then be provided to the federal auditor. While the federal auditor may require additional documentation, we anticipate that an agreement will be reached regarding the Federal Government's percentage before the next annual audit report. The timing of an agreement with the Federal Government will be contingent upon how long it takes to agree to a percentage that DOER and the Federal Government considers appropriate.

DOER appreciates the concern of the Legislative Auditor and agrees that it is critical in a self-insurance environment to maintain an adequate level of reserves. We will continue to take the necessary steps to ensure that reserves are sufficient to pay the obligations of the state employee health and dental plans.

Please let us know if further information is needed at this time.

Cc: Claudia Gudvangen, Deputy Legislative Auditor
Brad White, Audit Manager
Pat Ryan, Auditor-In-Charge