OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Management Letter

Department of Employment and Economic Development

Fiscal Year Ended June 30, 2003

MARCH 19, 2004 **04-13**

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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All OLA reports are available at our Web Site: http://www.auditor.leg.state.mn.us

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

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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
Ken Vandermeer, CPA	Auditor-in-Charge
Scott Tjomsland, CPA	Team Leader
Ellen Sibley, CPA	Auditor
Kathy Fisher, CPA	Auditor
John Hakes, CPA	Auditor
Kristen Poore, CPA	Auditor
Sally Tefera	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 March 5, 2004:

Matt Kramer	Commissioner
Dennis Yecke	Deputy Commissioner
John Stavros	Chief Financial Officer
Tim Langlie	Accounting Director
Judy Kislenger	Accounting Manager

Report Summary

Key Findings and Recommendations

- The Department of Employment and Economic Development incorrectly reported federal expenditures on the annual Single Audit schedules provided to the Department of Finance and made minor errors on quarterly financial status reports submitted to the federal government. We recommend the department accurately measure federal program spending and provide supervisory review of expenditure schedules to eliminate financial reporting errors. (Finding 1, page 4)

- The department's unemployment insurance financial statements required large adjustments to conform with generally accepted accounting principles. Adjustments were necessary to correct the reporting of a negative cash balance, intrafund transfers, and noncapital financing activities on the statement of cash flows. Additional adjustments were also necessary to correctly reflect the proper governmental fund that the Unemployment Insurance Fund operating transfers were made into. Recommendations include accurate preparation of the unemployment insurance financial statements and improved coordination of the Unemployment Insurance Fund's operating transfers with the Department of Finance. (Finding 2, page 5)

- The department did not enforce a retainage clause in Social Security Disability Income (CFDA #96.001) program contracts for consultant fees paid to medical doctors. We recommend the department enforce the retainage, or if deemed unnecessary, seek approval from the commissioner of Administration to remove the clause from the contracts. (Finding 3, page 6)

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 Employment and Economic Development focused on financial activities of the Unemployment Insurance Fund and several federal programs administered by the department. The department's response to our recommendations is included in the report.

Representative Tim Wilkin, 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 (formerly the departments of Economic Security and Trade and Economic Development), as part of our audit of the financial statements of the State of Minnesota for the year ended June 30, 2003. 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 2003, unemployment tax revenues totaled $568 million and unemployment benefits exceeded $1 billion. In addition, the Unemployment Insurance Fund borrowed nearly $130 million from the federal government to fund unemployment benefits. 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, 2003, 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.

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Table 1
Major Federal Programs Administered by the
Department of Employment and Economic Development
Fiscal Year 2003
(in thousands)

CFDA #	Program Name	Federal Expenditures
16.523	Juvenile Accountability Incentive Block Grant	$ 4,299
17.225	Unemployment Insurance Administration (1)	$1,092,910
	Employment Services Cluster:	
17.207	Employment Services	$ 22,067
17.801	Disabled Veterans Outreach	1,616
17.804	Local Veterans Employment Representative	2,016
	Total Employment Services Cluster	$ 25,699
	Workforce Investment Act (WIA) Cluster:	
17.255	WIA-Adult & Youth	$ 1,211
17.258	WIA-Adult	9,034
17.259	WIA-Youth	10,236
17.260	WIA-Dislocated Workers (DES)	2,736
17.260	WIA-Dislocated Workers (DTED)	16,857
	Total Workforce Investment Act Cluster	$ 40,074
84.126	Vocational Rehabilitation	$ 41,545
96.001	Social Security Disability Income	$ 19,493

Note (1): Expenditures include $1,044,686,000 of unemployment insurance grants and $48,224,000 of federal administrative reimbursements.

Source: *State of Minnesota Financial and Compliance Report on Federally Assisted Programs* for fiscal year 2003.

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. 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.

Department of Employment and Economic Development

As a result of our procedures, we identified the following weaknesses in internal control and noncompliance items at the Department of Employment and Economic Development.

1. The department did not accurately identify and report federal program expenditures.

The Department of Employment and Economic Development (DEED) reported inaccurate federal program expenditures to the Department of Finance for inclusion in the state's Single Audit Compliance Report. Several large audit adjustments were necessary to correct the balances reported. In addition, certain quarterly financial reports submitted to the federal government contained minor errors in the federal expenditure and state match amounts reported.

The Single Audit Act of 1984, as amended in 1996, requires states to prepare a supplemental schedule of federal program expenditures identified by Catalog of Federal Domestic Assistance (CFDA) number. The Department of Finance prepares the annual Single Audit Compliance Report based on expenditure information submitted by state agencies. Our audit found that DEED inaccurately determined the federal program expenditures reported to the Department of Finance and did not identify the CFDA number for certain federal expenditures as discussed below.

- DEED inappropriately included state match expenditure amounts in their determination of federal program expenditures. Annual instructions provided by the Department of Finance to DEED and other state agencies explain that state match should not be included in the amounts provided to them. This resulted in an overstatement of federal expenditures reported for Vocational Rehabilitation (CFDA #84.126) of $10.9 million, $0.8 million for the Juvenile Accountability Incentive Block Grant (CFDA #16.523), and $4.7 million for numerous other nonmajor federal programs.

- The department made other errors resulting in federal expenditures being understated by $6.7 million [$6.9 million understated for Vocational Rehabilitation (CFDA #84.126) and $0.2 million overstated for Employment Services (CFDA #17.207)]. The errors involved including expenditures from incorrect accounting ledgers, omitting expenditures from the correct ledgers, not properly updating the cumulative expenditures, and using expenditures from the wrong fiscal year. These types of errors could be prevented by a supervisory review of the supporting schedules prior to submission to the Department of Finance.

- The department did not provide a CFDA number for all federal program expenditures as requested in the Department of Finance annual instructions to agencies. DEED submitted 35 federal program expenditure schedules but failed to identify the CFDA number for expenditures totaling $290,150, including $33,417 at the former Department of Economic Security and $256,733 at the former Department of Trade and Economic Development. CFDA numbers provide a reference to the specific federal program requirements outlined for each federal program. The failure to identify the federal CFDA number causes inaccurate reporting of expenditures.

Due to the unique accounting system used by DEED, improved coordination with the Department of Finance is necessary. DEED prepares schedules to calculate the annual federal expenditures from information in its departmental accounting system. However, the format used to communicate this information to the Department of Finance was confusing and different than the worksheet used by other state agencies. DEED should continue to build these schedules but consider a simplified format to communicate expenditures by federal CFDA number to the Department of Finance.

DEED also misstated federal expenditures on certain quarterly financial status reports directly submitted to the federal government. Quarterly reports submitted for the Workforce Investment Act Cluster programs period ended March 31, 2003, overstated federal expenditures for WIA Adult (CFDA #17.258) and Youth (CFDA #17.259) by $494,784. The amount was offset in the subsequent quarterly financial status report for the period ending June 30, 2003. For the Juvenile Accountability Incentive Block Grant (CFDA #16.523), DEED met its matching level but did not properly report state match of $129,062 and subrecipient match of $962,847 on the federal financial status reports since inception of the program.

Recommendations

- *DEED should accurately measure federal program spending and provide supervisory review of reported federal program expenditures.*

- *DEED should work with the Department of Finance to revise the format of its Single Audit schedules to only include pertinent information needed.*

- *DEED should accurately prepare and provide supervisory review of quarterly financial status reports submitted to the federal government.*

2. The department's Unemployment Insurance Fund financial statements required adjustments to conform with generally accepted accounting principles.

The unemployment insurance financial statement cash balances, intrafund transfers, and cash flows from federal loan activity were not presented in accordance with generally accepted accounting principles. Audit adjustments were necessary to correct the balances reported to the Department of Finance. In addition, unemployment insurance operating transfer activity reported to the Department of Finance was poorly coordinated and resulted in adjustments in other funds.

The Department of Finance incorporated the unemployment insurance financial statements prepared by DEED into the State of Minnesota's Comprehensive Annual Financial Report. We encountered the following problems while examining the draft unemployment insurance financial statements.

- The department reported the Unemployment Insurance Fund's June 30, 2003, cash balance as a negative $11 million and an outstanding federal loan of $119 million. However, the substance of the negative cash balance involved additional federal borrowing to fund unemployment benefits. An audit adjustment was made to eliminate the negative cash and increase the federal loans payable to $130 million.

- The Unemployment Insurance Fund's statement of revenues, expenses, and changes in fund balance did not properly eliminate intrafund transfer activity. We found that operating transfers in and out included transfers between Unemployment Insurance Fund accounts totaling $1.965 million. The department should eliminate intrafund transfers from both the transfer-in and transfer-out balances reported.

- The Unemployment Insurance Fund's statement of cash flows prepared by DEED did not distinguish between operating versus noncapital financing activities. In fiscal year 2003, payments for unemployment benefits exceeded unemployment tax collections, which resulted in the need to borrow from the federal Unemployment Insurance Trust Fund. In accordance with Governmental Accounting Standards Board (GASB) Statement #9 *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, loan borrowing is considered noncapital financing activity and must be separated from operating activities on the statement of cash flows. Adjustments of $339 million and $220 million were made to properly report proceeds and repayment of federal loans.

Additional adjustments were necessary to coordinate the Unemployment Insurance Fund's operating transfers made between the state's General Fund, Federal Fund, and other special revenue funds. DEED properly presented $2.823 million of incoming transfers and $53.445 million of outgoing transfers on the Unemployment Insurance Fund's financial statements, but did not clearly identify the other governmental funds impacted nor provide any supporting schedules. The Department of Finance typically identifies fund transfers using the state's accounting system. However, unemployment insurance Fund monies are not maintained in the state treasury or recorded in the state's centralized accounting system. As a result, DEED needs to provide additional information on unemployment insurance Fund transfers to the Department of Finance.

Recommendations

- *DEED should ensure that the Unemployment Insurance Fund's financial statements are prepared in accordance with generally accepted accounting principles.*

- *DEED should work with the Department of Finance to coordinate the proper presentation of unemployment insurance Fund operating transfers to and from other governmental funds.*

3. The department did not retain 10 percent of the payment amount as called for in the medical consultant service contracts for one federal program.

The department's Social Security Disability Income (CFDA #96.001) program contracts include a retainage clause for medical consultant fees; however, the department did not withhold a portion of the payment as called for in the contracts. Minn. Stat. Section 16C.08, Subd. 5(b) requires that no more than 90 percent of the contract amount be paid until work is completed and deemed satisfactory, unless the commissioner of Administration provides a written waiver of the requirement. In the case of medical consultant fees, it appears that all work is complete at the time the medical contractor submits the invoice to the department. As a result, retaining a portion of the payment serves no purpose. However, the Department of Employment and Economic Development has sought no waiver of the retainage requirement from the Department of Administration. Alternatively, in cases where further work or reports are due, the retainage clause should be enforced, and the department should retain a portion of the amount invoiced pursuant to the contract.

Recommendation

- *The department should withhold the retainage amount called for in medical consultant contracts or, if deemed unnecessary, seek written approval from the Department of Administration to remove the clause from the contracts.*

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 19, 2004.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: January 16, 2004

Report Signed On: March 15, 2004

Status of Prior Audit Issues
As of January 16, 2004

Fiscal Year 2002 Statewide/Single Audit

The Department of Economic Security and the Department of Trade and Economic Development, which were merged into the new Department of Employment and Economic Development (DEED), were separate departments in fiscal year 2002. We examined each department's activities and programs material to the State of Minnesota's *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2002. The purpose of the audits was to render an opinion on the State of Minnesota's financial statements for fiscal year 2002. We issued an unqualified opinion on the State of Minnesota's *Comprehensive Annual Financial Report* for the year ended June 30, 2002. We identified three concerns as a result of our audit work at the Department of Economic Security and one reportable issue at the Department of Trade and Economic Development.

The audit of the Department of Economic Security questioned use of federal Workforce Investment Act Cluster (CFDA #17.258 - #17.259) program funds used to pay the entire cost of a consulting contract that involved duties and responsibilities related to the department's merger and not directly related to the federal program. The United States Department of Labor permitted the cost since they felt that the department's reorganization assisted the establishment and operation of the one-stop delivery systems and allowed it to be more efficient in providing the needed services to its clients.

A second finding cited the Department of Economic Security for a significant error made compiling the Unemployment Insurance (CFDA #17.225) expenditure schedule for the federal Single Audit report. Another concern sought improvements in defining the nature of the department's relationship with one recipient of federal moneys from the Employment Services Cluster. The department resolved both issues in fiscal year 2003.

The audit of the Department of Trade and Economic Development identified the need for improved monitoring of subrecipient audits for the federal Workforce Investment Act (CFDA #17.260) program. The department resolved the issue by working with the Department of Economic Security to coordinate monitoring of subrecipient audits.

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.

positively Minnesota Department of Employment and Economic Development

March 12, 2004

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 offered in response to your draft report for the fiscal year ended June 30, 2003.

Auditor's Finding 1. The department did not accurately identify and report federal program expenditures.

Auditor's Recommendations:

DEED should accurately measure federal program spending and provide supervisory review of reported federal program expenditures.

DEED should work with the Department of Finance to revise the format of it Single Audit schedules to only include pertinent information needed.

DEED should accurately prepare and provide supervisory review of quarterly financial status reports submitted to the federal government.

Response:

We agree. We will work with the Department of Finance to revise DEED's single audit format so that it does not include any match expenditure information. We are confident that the inaccurate single audit schedules and quarterly financial status report errors were isolated incidents. However, DEED will increase oversight review to prevent possible future errors. While past efforts have not always been successful, DEED will work with the federal government to identify CFDA numbers for all programs.

Responsible Person: John Stavros 651-296-3965

Auditor's Finding 2. The department's Unemployment Insurance Fund financial statements required adjustments to conform with generally accepted accounting principles.

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Auditor's Recommendations:

DEED should ensure that the Unemployment Insurance Fund's financial statements are prepared in accordance with generally accepted accounting principles.

DEED should work with the Department of Finance to coordinate the proper presentation of unemployment insurance Fund operating transfers to and from other governmental funds.

Response:

We agree. We place a higher priority and devote more resources to this work. Current generally accepted accounting principles (GAAP) do not adequately disclose all Fund activity. For example, in DEED's case the book balance of a negative $11 million was shown as a result of a requirement of the Cash Management Improvement Act which requires cash to be managed at the bank float level. On future reports, a footnote disclosure may be used to explain this unique situation wherein the negative cash balance is not actually a loan.

DEED will work with the Department of finance to provide additional schedules in regards to the elimination of transfers to improve tracking of transfers for correct financial presentation.

We reported the Federal UI loan on the cash flows statement under " Loans Received, Operating Activities." We agree the loan should have been classified as "Non-Capital Financing Activities ."

The following changes will be made to improve future financial statement presentations: (1) initiate face to face meetings with the Department of Finance to discuss presentation and schedules, (2) start to construct the financial statements soon er so that the Department of Finance and DEED can have adequate time to discuss presentation, and (3) no longer rely on the Legislative a uditors as the last review for proper financial reporting.

Responsible Person: John Stavros 651-296-3965

Auditor's Finding 3. The department did not retain 10 percent of the payment amount as called for in the medical consultant service contracts for one federal program.

Auditor's Recommendations:

The department should withhold the retainage amount called for in medical consultant contracts or, if deemed unnecessary, seek written approval from the Department of Administration to remove the clause from the contracts.

Response:

We agree. In the case of medical consultant fees, all work is complete at the time the medical contractor submits the invoice to the department. As a result, retaining a portion of the payment serves no purpose. We will seek written approval from the Department of Administration to remove the clause from the contracts.

Responsible Person: John Stavros 651-296-3965

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

Sincerely,

/s/ Matt Kramer

Matt Kramer
Commissioner