OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Department of Employment and Economic Development

Fiscal Year Ended June 30, 2004

MARCH 10, 2005 **05-17**

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:

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, CIA	Auditor
George Deden, CPA	Auditor
Susan Mady	Auditor
Gail Berggren	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 25, 2005:

Dennis Yecke	Deputy Commissioner
Jack Weidenbach	Unemployment Insurance Program Director
Bonnie Elsey	Workforce Services Director
John Stavros	Chief Financial Officer
Tim Langlie	Accounting Director
Judy Kislenger	Accounting Manager

Report Summary

Key Findings:

- The Department of Employment and Economic Development (DEED) needs to improve scrutiny of changes in employer accounts and detailed wage data, and the related impact on unemployment insurance experience ratings and revenue recognition. (Finding 1, page 4)

- Unemployment insurance data integrity controls require improvement to ensure the accuracy of employer tax rate calculations. (Finding 2, page 5)

- DEED did not accurately identify and report expenditures for three federal programs. (Finding 3, page 6)

The audit report contained 4 audit findings relating to internal control or legal compliance. The department resolved three findings included in our prior report.

Audit Scope:

Programs material to the State of Minnesota's financial statements and to federal program compliance for fiscal year 2004.

Selected Audit Areas:

- Unemployment Insurance Fund
- Federal programs, including:
  - Unemployment Insurance Administration
  - Employment Services Cluster
  - Workforce Investment Act Cluster
  - Vocation Rehabilitation
  - Social Security Disability Income

Background:

The Department of Employment and Economic Development recorded unemployment insurance revenues totaling $939 million and benefits of $919 million for fiscal year 2004. As of June 30, 2004, the department had a $271 million loan from 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, 2004. 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 2004, the department accrued $760 million of unemployment tax revenues, collected other revenues of $178 million, and paid unemployment benefits totaling $919 million. In addition, the Unemployment Insurance Fund borrowed $271 million from the federal government to fund unemployment benefits and transferred $56 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, 2004, 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 2004
(in thousands)

CFDA #	Program Name	Federal Expenditures
17.225	Unemployment Insurance [(1)]	$952,465
	Employment Services Cluster:	
17.207	Employment Services	$ 22,971
17.801	Disabled Veterans Outreach	1,589
17.804	Local Veterans Employment Representative	1,309
	Total Employment Services Cluster	$ 25,869
	Workforce Investment Act (WIA) Cluster:	
17.258	WIA-Adult	8,493
17.259	WIA-Youth	8,717
17.260	WIA-Dislocated Workers	17,735
	Total Workforce Investment Act Cluster	$ 34,945
84.126	Vocational Rehabilitation	$ 44,302
96.001	Social Security Disability Income	$ 21,088

Note (1): Expenditures include $906,274,000 of unemployment insurance grants and $46,191,000 of federal administrative reimbursements.

Source: *State of Minnesota Financial and Compliance Report on Federally Assisted Programs* for fiscal year 2004.

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 19, 2004, report included an unqualified opinion on the State of Minnesota's basic financial statements for fiscal year 2004. In accordance with *Government Auditing Standards,* we also issued our report, dated November 19, 2004, 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 our procedures, we identified the following weaknesses in internal control and noncompliance items 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) needs to improve scrutiny of changes to employer accounts and wage detail data, and the related impact on unemployment insurance rates and revenue recognition.

DEED does not adequately analyze employer account information to identify employers that manipulate their unemployment insurance (CFDA #17.225) experience ratings to avoid tax liabilities. Typically, this involves shifting payroll from an entity with a higher experience rate to one with a lower rating. The federal Department of Labor warned states of a nation-wide problem where "some employers and financial advisors have found ways to manipulate state experience ratings so that these employers pay lower state unemployment compensation taxes." It required states to amend state laws to prohibit this activity and impose penalties for violations. The volume and complexity of corporate mergers, acquisitions, and restructuring make this a difficult area to ensure that all unemployment insurance revenue is being submitted.

Employer tax rate calculations, authorized in Minn. Stat. Chapter 268, are very complex. Employers are charged a tax rate based on their industry type and unemployment experience. DEED maintains computerized systems that accumulate historical data on employers. Employer accounts accumulate current employee wage detail that employers submit quarterly as well as unemployment benefits paid by the department to former employees. This key information is used to calculate each employer's tax rate and monitor that the correct tax amount is submitted.

Changes in corporate ownership and the underlying wage data that employers submit requires better department scrutiny and analysis. Minn. Stat. Section 268.051, Subd. 4 provides authority for the department to make experience rating transfers between predecessor and successor companies when there is a 25 percent or more common ownership. It also calls for the department to transfer all or part of the experience rating if a transaction was done to avoid a higher experience rating. DEED currently conducts informal reviews of corporate acquisitions, successions, and joint powers agreements to detect improper employer filing. For fiscal year 2004, DEED staff identified additional unemployment insurance revenue of $12.8 million from several companies found in violation. However, the department did not have clear policies regarding when to recognize this revenue in the annual financial statements for the Unemployment Insurance Fund. DEED assessed the additional amounts, but has not developed procedures for reviewing employer account changes nor an on-going computerized process to alert staff to possible manipulation of wage data. A key barrier has been incomplete information regarding corporate ownership and associated business units. We noted instances where DEED's computerized system contained no address or federal identification number for some employers.

Recommendations

- *DEED should develop procedures for reviewing employer account changes and use computerized methods to analyze the propriety of large wage detail adjustments.*

- DEED should review applicable accounting principles and develop a process to estimate revenue accruals resulting from inappropriate experience rating transfers.

2. DEED's data integrity controls require improvement to ensure the accuracy of employer unemployment insurance tax rate calculations.

DEED calculated employer tax rates for unemployment insurance (CFDA #17.225) without assuring the integrity of the underlying data used to derive the rates. Accurate processing and posting of benefits to employer accounts is crucial to produce accurate tax rate calculations. Although the rates were not materially misstated for most employers, errors caused both under and over charges. In addition, computer application maintenance and adjustments to modify data were not always authorized and controlled.

Unemployment insurance computerized systems are currently in a state of change with the development of a new information system planned for 2006. During the system transition period, DEED needs to mitigate key risks to ensure that inaccurate employer tax rate calculations do not adversely impact revenues. The following items discuss weaknesses in controlling the underlying data posted to an employer's account:

- **Benefit Reconciliation and Adjustments** – The current computerized system that pays unemployment benefits is not fully compatible with the system used to charge those benefits to employer accounts for tax calculation purposes. In the past, DEED reconciled activity and adjusted differences between actual benefit payments and benefits charged, prompting amended notices to employers; however, it appears that DEED now only makes adjustments when an employer complains about the adverse affect on their tax rate. For example, staff corrected two different duplicate updates of charges after an employer alerted them eight months later. We encountered two differences where DEED was unable to resolve small variances between benefits paid and charged for one employer. Since benefit data is such an important part of the unemployment tax rate calculation, a formal reconciliation would improve the reliability of key benefit data charged to employer's accounts.

- **Application and Data Maintenance** – DEED did not always control certain computer application modifications with authorized change requests and did not oversee data corrections with service request forms. In addition, users requesting the change did not receive notification that a system change or data correction was completed. Maintenance of computer application logic and data require structured management oversight and approval to avoid errors or manipulation.

Recommendation

- *DEED should improve data integrity controls by reconciling and adjusting benefit charges posted to employer accounts when different than actual benefits paid and controlling computer application and data changes.*

3. DEED did not accurately identify and report federal program expenditures.

DEED reported inaccurate federal program expenditures to the Department of Finance for inclusion in the state's Single Audit Financial and Compliance Report. It has no mechanism to ensure that the full population of federal expenditures in its accounting system is properly captured. Our audit found that DEED incorrectly determined the federal program expenditures as follows:

- DEED omitted two national emergency grants totaling $2.2 million for the Workforce Investment Act-Dislocated Worker (CFDA #17.260) program. The federal government instructed DEED to report the emergency grants in the WIA program. It appears that the department overlooked these expenditures since the accounting system ledgers had ended or were closed out prior to June 30, 2004.

- DEED made other errors resulting in federal expenditures being overstated by $431,000 for the Trade Adjustment Act (CFDA # 17.245). The errors involved double-counting expenditures from the same accounting ledger.

In addition, funding from other state agencies requires special treatment. We found that DEED inappropriately included $1.9 million of Temporary Aid for Needy Families (CFDA #93.558) subgrant funding in its Employment Services (CFDA #17.207) program expenditures. The state Department of Human Services provided TANF administrative money to DEED to fund the one stop operating system. To avoid double-counting these expenditures, only the originating agency should record the federal program expenditures.

Recommendation

- *DEED should develop a method to identify the full population of federal expenditures in its accounting system to ensure accurate reporting by federal program. Expenditures subgranted from another state agency should only be recorded by the originating agency.*

4. DEED did not comply with contract requirements for two federal programs.

DEED paid for professional services provided by medical vendors for the Vocational Rehabilitation (CFDA #84.126) program without written contracts. In addition, the department did not ensure that contractors for the Employment Services Cluster (CFDA #17.207, #17.801, and #17.804) were not suspended or debarred from receiving federal funds.

DEED paid for medical consultant services (including psychologists, mental health professionals, chemical dependency counselors, nurses, and career counselors) without a formal professional and technical contract. Federal compliance requirements indicate that states "shall use the same State policies and procedures used for procurement from non-federal funds." However, we found that DEED did not follow Minn. Stat. Sections 16C.05 and 16C.08 requiring written contracts for vendor services exceeding $5,000 annually. In fact, Minn. Stat. Section

Department of Employment and Economic Development

16C.05, Subd. 3 provides authority for the DEED commissioner to expedite contracts directly without approval of the Department of Administration or the Attorney General's Office. Instead of using the standard state contract, the department used client authorization forms to specify the services sought. However, the vendor does not sign the client form, and it excludes key contract features designed to protect public interests.

Federal regulations prohibit states from procuring items with federal money from vendors who are suspended or debarred. The federal government suspends or debars vendors when it determines, or is informed, that the vendors have abused public trust or perhaps violated program provisions. The federal government has a process to identify suspended or debarred vendors and requires states to prevent them from receiving federal funds in the future. We found that neither DEED nor the state Department of Administration take the steps to verify that a vendor is not suspended or debarred. In addition, the department does not include standard contract language requiring subrecipients to certify it refrains from subcontracting with suspended or debarred vendors. Without the proper certification, DEED is liable for all disallowed costs resulting from any payments to suspended or debarred vendors.

Recommendations

- *DEED should prepare written contracts for all professional and technical services anticipated to exceed $5,000 each year.*

- *DEED should ensure that federal funds are not paid to vendors who are suspended or debarred by the federal government*

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 10, 2005.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 23, 2004

Report Signed On: March 7, 2005

Status of Prior Audit Issues
As of December 23, 2004

Fiscal Year 2003 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, 2003. We issued an unqualified opinion on the *State of Minnesota's Comprehensive Annual Financial Report* for the year ended June 30, 2003. We identified three concerns as a result of our audit work at the Department of Employment and Economic Development.

The fiscal year 2003 audit cited the department for incorrectly reporting federal expenditures on the annual Single Audit schedules provided to the Department of Finance and submitting minor errors on the quarterly financial status reports submitted to the federal government. DEED took corrective action on this problem; however, we encountered other isolated problems as reported in Finding 2 of this report. The second finding involved the department's Unemployment Insurance (UI) financial statements which required large adjustments to conform with generally accepted accounting principles. DEED implemented improvements. Finally, DEED addressed our concerns regarding the enforcement of a retainage clause in Social Security Disability Income (CFDA #96.001) program contracts with medical consultants.

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 4, 2005

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, 2004.

Auditor's Finding 1. The Department of Employment and Economic Development (DEED) needs to improve scrutiny of changes to employer accounts and wage detail data, and the related impact on unemployment insurance rates and revenue recognition.

Auditor's Recommendations:

- DEED should develop procedures for reviewing employer account changes and use computerized methods to analyze the propriety of large wage detail adjustments.

- DEED should review applicable accounting principles and develop a process to estimate revenue accruals resulting from inappropriate experience rating transfers.

Response:

DEED has been working on major systems and business process reengineering for the Unemployment Insurance program the past three years, with a major deployment of new technology and business processes scheduled for June, 2005. The new systems and business processes will adequately address the concerns raised in the report.

Responsible Person: Jack Weidenbach 651-296-1692

We agree that DEED needs to better define the recognition of State Unemployment Tax Avoidance (SUTA) Accounts Receivable. DEED will review and determine the appropriate revenue recognition timing and estimates.

Responsible Person: John Stavros 651-296-3965

Department of Employment and Economic Development
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Auditor's Finding 2. DEED's data integrity controls require improvement to ensure the accuracy of employer unemployment insurance tax rate calculations.

Auditor's Recommendations:

- DEED should improve data integrity controls by reconciling and adjusting benefit charges posted to employer accounts when different than actual benefits paid and controlling computer application and data changes.

Response:

We agree. The issues raised in the audit have existed for at least the past 25 years due to the inability of automated systems to completely deal with discrepancies. Knowing this, one of the major goals of DEED's current reengineering effort for the Unemployment Insurance program is to link wage detail, benefit payments, and employer rate calculations in the same integrated automated system. Much of that new system will be operational in June of 2005, with the balance due in 2007.

Responsible Person: Jack Weidenbach 651-296-1692

Auditor's Finding 3. DEED did not accurately identify and report federal program expenditures.

Auditor's Recommendations:

- DEED should develop a method to identify the full population of federal expenditures in its accounting system to ensure accurate reporting by federal program. Expenditures subgranted from another state agency should only be recorded by the originating agency.

Response:

We agree. DEED will retain all grants in our accounting system through June 30th of each year to prevent missing any grant. We will review our single audit schedules for accuracy.

Responsible Person: John Stavros 651-296-3965

Auditor's Finding 4. DEED did not comply with contract requirements for two federal programs.

Auditor's Recommendations:

- DEED should prepare written contracts for all professional and technical services anticipated to exceed $5,000 each year.

- DEED should ensure that federal funds are not paid to vendors who are suspended or debarred by the federal government.

Response:

Minn. Stat. Sections 16C.05 and 16C.08 requires written contracts for vendor services exceeding $5,000 annually. The audit report states that "the vendor does not sign the client form, and it excludes key contract features designed to protect public interests." Through the Vocational Rehabilitation program, DEED annually receives services from over 130 medical providers for approximately 1200 evaluations.

Through an agreement with the Department of Administration, the ongoing practice has been to publish in the State Register, prior to the start of the fiscal year, the fee schedule for which DEED will reimburse service medical providers for evaluations. When an evaluation is then needed, individual authorizations (client forms), based on the published fee schedule, are provided by Vocational Rehabilitation counselors to the medial service provider. We believe this process provides value for the taxpayer and has protected the public interest. DEED will work with the Minnesota Department of Administration and its federal partners to evaluate this process and determine if further changes are needed.

Responsible Person: Bonnie Elsey 651-296-1822

DEED made no payments to suspended or debarred vendors. DEED will work with the Minnesota Department of Administration to develop an approach to review the federal government's debarred and suspended list. Additionally, DEED will add to all contacts the required federal debarment and suspension language.

Responsible Person: John Stavros 651-296-3965

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

Sincerely,

Matt Kramer
Commissioner