Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Members of the Minnesota State Legislature

The Honorable Tim Walz, Governor

Mr. Jim Schowalter, Commissioner, Minnesota Management and Budget

We have audited the basic financial statements of the State of Minnesota, as of and for the year ended June 30, 2021, and have issued our report thereon dated December 17, 2021. The financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Minnesota, and the related notes to the financial statements, collectively comprise the state's basic financial statements. We conducted our audit in accordance with the 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.

Our report includes a reference to other auditors who audited the financial statements of the Minnesota State Colleges and Universities, Minnesota State Lottery, Housing Finance Agency, Metropolitan Council, University of Minnesota, Minnesota Sports Facilities Authority, Office of Higher Education, Public Facilities Authority, and Workers' Compensation Assigned Risk Plan, as described in our report on the state's financial statements. The financial statements of the Housing Finance Agency and Workers' Compensation Assigned Risk Plan were not audited in accordance with Government Auditing Standards. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the state's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the state's internal control. Accordingly, we do not express an opinion on the effectiveness of the state's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did identify a certain deficiency in internal control, described in the accompanying *Findings and Recommendations* section as Finding 1, that we consider to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the state's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the state's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the state's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Lori Leysen, CPA
Deputy Legislative Auditor

Scott Tjomsland, CPA
Audit Director

December 17, 2021
Saint Paul, Minnesota

Finding and Recommendations

FINDING 1

Prior Finding Not Resolved: The Department of Employment and Economic Development did not have adequate internal controls to ensure it properly classified receipts from the federal government and accurately reported the cash balance in the Unemployment Insurance Fund financial statements.

The Department of Employment and Economic Development (DEED) made four accounting errors that resulted in misstatements in the Unemployment Insurance Fund financial statements. Two of the errors misclassified federal receipts between revenue and unearned revenue. Under generally accepted accounting principles, receipts should be classified as unearned revenue until the unemployment benefit obligations are incurred. Once those obligations are incurred, the receipts should be classified as revenue.[1] The net effect of the errors was an overstatement of revenue and understatement of unearned revenue by $115.75 million, as follows:

- DEED misclassified $259.84 million in federal receipts as revenue instead of unearned revenue. During fiscal years 2020 and 2021, DEED received $7.37 billion from the federal government as advances under the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Disaster Relief and Emergency Assistance Act for anticipated unemployment benefit obligations.[2] As of June 30, 2021, DEED had $395.71 million remaining from the federal advances for unemployment benefit obligations not yet incurred. However, DEED only classified $135.87 million as unearned revenue. DEED made a similar error last year, reported as a material weakness in our prior report, that misclassified $1.12 billion as revenue instead of unearned revenue.

- DEED misclassified $144.09 million in federal receipts that it applied as credits to reimbursing employer accounts as unearned revenue instead of revenue. Since obligations were incurred when DEED applied the credits, the receipts should be classified as revenue.

The other two errors understated the cash balance as of June 30, 2021, by a total of $65.80 million, as follows:

- DEED incorrectly reduced cash by $54.15 million for some of the credits posted to reimbursing employer accounts. Since those credits offset insurance premiums owed by the employers, no cash was disbursed.

- In its accounting records for Fiscal Year 2020, DEED properly recorded a cash-in-transit adjustment to reduce cash by $21.63 million for federal receipts recorded but not yet received as of June 30, 2020. In its accounting records for Fiscal Year 2021, the amount of the corresponding adjustment to record that cash was only $9.98 million.

[1] Statement No. 33 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 21.

[2] 15 *U.S. Code*, secs. 9023-4 (2020); and 42 *U.S. Code*, sec. 5174(e)(2) (2020).

DEED's secondary review of the Unemployment Insurance Fund financial statements and underlying accounting records was not sufficient to identify and correct the errors. In addition, DEED did not reconcile the actual cash in Unemployment Insurance Fund bank accounts to the cash recorded in the accounting records during Fiscal Year 2021. As of December 2021, the last completed monthly cash reconciliation was for June 2020. If completed, those reconciliations would have identified the cash misstatements in the accounting records.

The Department of Management and Budget posted the proposed audit adjustments to reclassify $115.75 million from revenue to unearned revenue, and to recognize an additional $65.80 million in cash. As a result, the total net position reported for the Unemployment Insurance Fund decreased from negative $725.23 million to negative $775.18 million.

RECOMMENDATIONS

- **The Department of Employment and Economic Development should strengthen internal controls to ensure any accounting errors are identified and corrected.**
- **The Department of Employment and Economic Development should complete timely reconciliations of cash in Unemployment Insurance Fund bank accounts to cash recorded in the accounting records.**

February 10, 2022

Judy Randall, Legislative Auditor
Office of the Legislative Auditor (OLA)
Room 140 Centennial Building
658 Cedar Street
Saint Paul, MN 55155-1603

Dear Legislative Auditor Randall:

Thank you for the opportunity to submit a written response to the findings and recommendations of your financial statement audit of the Unemployment Insurance Fund for the period from July 1, 2020, through June 30, 2021.

The audit reported internal control weaknesses to ensure it properly classified receipts from the federal government and accurately reported the cash balance in the Unemployment Insurance Fund financial statements. The audit report summary contains the specific audit finding and recommendation listed in the following page.

This letter responds to the written findings and recommendations identified in the audit report.

Finding Number 1

Prior Finding Not Resolved: The Department of Employment and Economic Development did not have adequate internal controls to ensure it properly classified receipts from the federal government and accurately reported the cash balance in the Unemployment Insurance Fund financial statements.

The Department of Employment and Economic Development (DEED) made four accounting errors that resulted in misstatements in the Unemployment Insurance Fund financial statements. Two of the errors misclassified federal receipts between revenue and unearned revenue. Under generally accepted accounting principles, receipts should be classified as unearned revenue until the unemployment benefit obligations are incurred. Once those obligations are incurred, the receipts should be classified as revenue.[1] The net effect of the errors was an overstatement of revenue and understatement of unearned revenue by $115.75 million, as follows:

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- DEED misclassified $144.09 million in federal receipts that it applied as credits to reimbursing employer accounts as unearned revenue instead of revenue. Since obligations were incurred when DEED applied the credits, the receipts should be classified as revenue.

The other two errors understated the cash balance as of June 30, 2021, by a total of $65.80 million, as follows:

- DEED incorrectly reduced cash by $54.15 million for some of the credits posted to reimbursing employer accounts. Since those credits offset insurance premiums owed by the employers, no cash was disbursed.
- In its accounting records for Fiscal Year 2020, DEED properly recorded a cash-in-transit adjustment to reduce cash by $21.63 million for federal receipts recorded but not yet received as of June 30, 2020. In its accounting records for Fiscal Year 2021, the amount of the corresponding adjustment to record that cash was only $9.98 million.

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Minnesota Department of Employment and Economic Development
Administrative and Financial Services
332 Minnesota Street, Suite E200, St. Paul, Minnesota 55101
Phone 651/259-7161 or 1-800-657-3858
mn.gov/deed

DEED's secondary review of the Unemployment Insurance Fund financial statements and underlying accounting records was not sufficient to identify and correct the errors. In addition, DEED did not reconcile the actual cash in Unemployment Insurance Fund bank accounts to the cash recorded in the accounting records during Fiscal Year 2021. As of December 2021, the last completed monthly cash reconciliation was for June 2020. If completed, those reconciliations would have identified the cash misstatements in the accounting records.

The Department of Management and Budget posted the proposed audit adjustments to reclassify $115.75 million from revenue to unearned revenue, and to recognize an additional $65.80 million in cash. As a result, the total net position reported for the Unemployment Insurance Fund decreased from negative $725.23 million to negative $775.18 million.

Recommendations

- **The Department of Employment and Economic Development should strengthen internal controls to ensure any accounting errors are identified and corrected.**

- **The Department of Employment and Economic Development should complete timely reconciliations of cash in Unemployment Insurance Fund bank accounts to cash recorded in the accounting records.**

DEED's Response

The Department of Employment and Economic Development agrees with the audit finding related to the misclassification of revenue but reiterates that this was an accounting error only of classification and not one which had any cash impact to the State. During fiscal year 2020 and 2021, DEED received $7.37 billion as an advance from the federal government under the Coronavirus Aid, Relief, and Economic Security (CARES) Act for anticipated unemployment benefit obligations. To meet this unprecedented emergency, the federal government advanced funds to the states to address immediate needs due to the COVID pandemic. This misclassification as revenue was self-identified by DEED after initial submittal of financial statement and the adjusting entries were provided to the OLA. DEED did include unearned revenue adjustment in the FY21 ACFR, but upon further review we discovered that we didn't calculate prior period unearned revenue balances into the adjusting entry.

This unearned revenue finding involved four UI COVID programs that operated on a cash advance basis:

- The Federal Pandemic Unemployment Compensation (FPUC) – Supplemental payment program to applicants who were eligible for a week of regular UI, Pandemic Unemployment Assistance (PUA) or Pandemic Emergency Unemployment Compensation (PEUC).

- Waived Wait Week – Federal reimbursement of the costs incurred by states that waived their waiting week requirement during the pandemic.

- Mixed Earners Unemployment Compensation (MEUC) – a temporary, federal program that provides a $100 per week supplemental benefit amount to certain self-employed individuals who have earned at least $5,000 in net earnings in the most recent taxable year ending prior to the individual's application for regular unemployment compensation (UC) benefits.

- Lost Wages Assistance (LWA) – a federal program providing supplemental benefits to Americans who are unemployed or partially unemployed due to disruptions caused by the COVID-19 pandemic. Funding for this program was limited and came from the Federal Emergency Management Agency's (FEMA) Disaster Relief Fund.

The other two errors relating to understatements were questioned by OLA. DEED looked at them and discovered improper accounting transaction of $54.15 million and an improper journal entry of $11.65 million.

- The $54.15 million is related to a federal program managed by USDOL which provides reimbursement from the federal government of a portion of benefits already paid to former employees of reimbursing employers. A federal reimbursement to reimbursing employers had never occurred before and was very complicated to administer. The receipt of the funds was erroneously booked as a receipt as well as an expenditure. We did a deeper dive into the MIPS transactions and identified a bookkeeping issue where federal benefit expenses were recognized with a reduction of cash, but no actual benefit payment was made since these dollars are used to pay a percentage of the employer insurance premiums. The process was adjusted after the initial draw of this federal fund and didn't reoccur on future draws. It was a one-time bookkeeping error that wasn't corrected on ACFR presentation when initially submitted. We found the underlying transactions that caused the cash variance issue between the books and the bank statement, and we prepared the adjusting ACFR entries to correct the issue. Due to the pandemic workloads, the UI Cash Management staff were unable to maintain the normal process of daily bank reconciliations which would have identified this issue prior to ACFR presentation.

- The $11.65 million error was on ACFR preparation in modifying a journal entry to include all new COVID funding related to PEUC and PUA. DEED fully recognized the new COVID funding in the FY20 financial statement but didn't reverse the accrual entry recognized in the FY21 statement.

Once recognized, DEED prepared adjusting entries to correct these two issues identified for the ACFR statement presentation.

DEED's cash management accounting team has the technical skills, expertise and background in GAAP and Government Accounting Standards Board (GASB) requirements to adequately perform the accounting functions enumerated. Due to turnover, structure change, and unprecedented additional COVID programs and responsibilities, this team was behind with completing the standard processes and procedures and didn't have sufficient timeline to adequately complete the ACFR journal entries and validation processes.

DEED will offer ongoing training and education opportunities for staff and management responsible for financial statement reporting to refresh and ensure that they have an adequate understanding of relevant GAAP and GASB standards to easily adapt and apply their knowledge to different accounting circumstances that may present themselves through the economic recovery. DEED has enhanced its written business process documentation which includes more formal evidence of review and sign-off/approval of the financial statement and other financial reporting.

Finally, DEED is augmenting its internal audit functions over the next year to audit specific program areas and internal key business functions, processes, and cycles, with emphases on internal control and compliance, risk assessments, financial statement compliance, and financial reconciliation to ensure statutory compliance. The internal auditing function will also work with the MMB COVID-19 Response Accountability Office to monitor the COVID-related state appropriations and federal funds made available to DEED, maximize the use of these funding resources or other CRF and FEMA reimbursements, and ensure that all resources are used efficiently, effectively, equitably and on allowable expenses. To that end, DEED is in the process of enhancing its internal audit process by hiring an audit manager and one additional auditor. It's also in the process of establishing the ACFR business unit within AFS to partner with UI Cash Management staff for greater ACFR and financial statement review/oversight. An Accounting Supervisor Principal has been hired to lead this new unit.

Person responsible for corrective action: Julie Freeman, Chief Financial Officer
Jim Hegman, UI Division Director.

Anticipated completion date for corrective action: 12/31/2023

If you have any questions or need additional information, please contact me or Julie Freeman, CFO, at Julie.freeman@state.mn.us or 651-259-7085.

Regards,

Steve Grove
Commissioner
Department of Employment and Economic Development