

Management Letter**Department of Economic Security**
Fiscal Year Ended June 30, 2002

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 fifty 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 and one best practices review.

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, evaluation, or best practices review, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

Department of Economic Security

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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
Irene Hass	Auditor
Rob Litchke	Auditor
Dave Massaglia	Auditor
Ellen Sibley, CPA	Auditor
Heather White	Auditor

Exit Conference

We discussed the finding and recommendation with the following representatives of the Department of Economic Security at an exit conference on February 26, 2003:

Harry Mares	Commissioner
Erik Aamoth	Deputy Commissioner
John Stavros	Chief Financial Officer
Tim Langlie	Accounting Director
Bonnie Elsey	Assistant Commissioner, State Services to the Blind
Frank Schneider	Acting Assistant Commissioner, Workforce Service Branch
Jack Weidenbach	Director, Workforce Wage Assistance

Department of Economic Security

Report Summary

Key Findings and Recommendations

- The department used federal Workforce Investment Act (WIA) program funds to pay the total cost of a consulting contract that involved duties and responsibilities not directly related to the federal program. The department paid \$186,321 (\$138,321 in fiscal year 2002 and \$48,000 for fiscal year 2003) to the head of the transition team on Workforce and Economic Development. The transition team was to make recommendations regarding the transfer of responsibilities of the Department of Economic Security (DES) to other departments. Abolishment of the agency and reorganization of functions affects all of DES' programs, including unemployment insurance and several other federal and state programs. Due to its broader role, the federal WIA program should not have funded the full cost of the consultant contract. Federal allowable cost principles require that costs be allocated in accordance with the relative benefits received by the federal program. While reviewing this issue we also noted concerns with the Office of the Governor's processing of the consulting contract (Finding 1, page 4).
- The department made a \$31.5 million error when compiling the Unemployment Insurance (CFDA #17.225) expenses for the federal Single Audit report. An audit adjustment was made to correct the error; however, we recommended that the department compare the unemployment benefit expense reported in its financial statements to the amount reported in the federal Single Audit report (Finding 2, page 5).
- The department did not clearly define its relationship with one recipient receiving federal Employment Services Cluster (CFDA #17.207) moneys. The department entered into a grant agreement with the subrecipient that appeared to be a vendor relationship. The professional-technical contract format and terms were used and invoices were submitted. The contract did not address financial status reports typically required from subgrantees. In addition, the department did not obtain a required certification asserting the recipient had not been disqualified from receiving federal funds (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 2002 audit, our work at the Department of Economic Security 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.



OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Harry Mares, Commissioner
Department of Economic Security

We have performed certain audit procedures at the Department of Economic Security as part of our audit of the financial statements of the State of Minnesota for the year ended June 30, 2002. We also have audited certain federal financial assistance programs administered by the Department of Economic Security 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 Economic Security.

Table 1 identifies the financial activities within the Department of Economic Security that were material to the state's financial statements. 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, 2002, were free of material misstatement.

Table 1
Programs Material to the State's Financial Statements
Fiscal Year 2002
(in thousands)

<u>Unemployment Insurance Fund</u>	<u>Amount</u>
Balance Sheet Accounts:	
- Cash and Investments	\$270,988
Income Statement Accounts:	
- Unemployment Tax Revenues	\$378,531
- Federal Revenues	\$266,459
- Unemployment Benefits	\$946,562

Source: *State of Minnesota Comprehensive Annual Financial Report* for fiscal year 2002.

Table 2 identifies the State of Minnesota's major federal programs administered by the Department of Economic Security. 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 2
Major Federal Programs Administered by the
Department of Economic Security
Fiscal Year 2002
(in thousands)

<u>CFDA #</u>	<u>Program Name</u>	<u>Federal</u>
17.225	Unemployment Insurance Administration ⁽¹⁾	\$ 986,365
	<i>Employment Services Cluster:</i>	
17.207	Employment Services	\$ 23,858
17.801	Disabled Veterans Outreach	1,579
17.804	Local Veterans Employment Representative	<u>1,905</u>
	Total Employment Services Cluster	\$ 27,342
	<i>Workforce Investment Act (WIA) Cluster:</i>	
17.255	WIA-Adult & Youth	\$ 3,419
17.258	WIA-Adult	6,746
17.259	WIA-Youth	9,896
17.260	WIA-Dislocated Workers	<u>872</u>
	Total Workforce Investment Act Cluster	\$ 20,933
84.126	Vocational Rehabilitation	\$ 55,367
93.568	Low Income Home Energy Assistance ⁽²⁾	\$ 4,112

Note (1) Expenditures include \$862,616,000 of unemployment insurance grants, \$80,117,000 of federal emergency benefits, and \$43,632,000 of federal administrative reimbursements.

Note (2) Expenditures include amounts spent by the Department of Economic Security through September 30, 2001. Beginning October 1, 2001, the program was transferred to the Department of Commerce.

Source: *State of Minnesota Financial and Compliance Report on Federally Assisted Programs* for fiscal year 2002.

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 6, 2002, report included an unqualified opinion on the State of Minnesota's basic financial statements for fiscal year 2002. In accordance with *Government Auditing Standards*, we also issued our report, dated December 6, 2002, 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 Economic Security.

Department of Economic Security

- 1. The department used federal Workforce Investment Act (WIA) program funds to pay the total cost of a consulting contract that involved duties and responsibilities not directly related to the federal program.**

The Department of Economic Security (DES) paid \$186,321 (\$138,321 in fiscal year 2002 and \$48,000 in fiscal year 2003) from the federal WIA program for consulting costs relating to the transition team on Workforce and Economic Development. However, the contractual arrangements and statutory directive involved a broader role for the consultant than federal WIA (CFDA #17.258, #17.259, #17.260) program administration and service delivery. Laws of Minnesota (2001), 1st Special Session, Chapter 4, Article 3 established a transition team to make recommendations regarding abolishment of the Department of Economic Security (DES) and the transfer of duties and responsibilities to the Department of Trade and Economic Development (DTED), as well as other departments. The transfer originally was to occur on July 1, 2002, but was delayed by the 2002 Legislature until July 1, 2003.

Legal provisions provided that the head of the transition team would be in the unclassified service of the state. However, the Legislature did not appropriate additional funding for the position. Rather than hire an unclassified state employee, the Office of the Governor entered into a sole source contractual agreement with the former Chancellor of the Minnesota State Colleges and Universities System. The original contract, which was executed on September 6, 2001, provided compensation of \$110,000 for the period August 2001 through June 30, 2002. On October 20, 2001, the contract amount was increased by \$35,000, although the duties and responsibilities and contract period were not changed. (The amendment did provide that \$5,000 of the increase was for travel expenses.) The Office of the Governor negotiated and executed the contractual agreements; however, DES encumbered the funds and processed payments to the contractor. DES charged the total cost of the contract to the WIA program.

We noted some concerns with the contractual arrangement entered into by the Office of the Governor. The contractor began work on the project approximately one month before the contract was executed. A sole source letter, draft contract, and contract encumbrance were made prior to August 22, 2001, the date that DOER finalized its employment posting required by Minn. Stat. Section 16C.07. The contract expired on June 30, 2002; however, a second amendment was executed on July 30, 2002, to increase the contract amount by \$48,000 and extend the contract to December 31, 2002. Once again, the contract extension was not finalized until one month after its effective date. In addition, we found that DES did not receive the monthly progress reports called for in the contract; they were filed with the Office of the Governor. The Office of the Governor could locate only four of the seventeen required monthly progress reports. The reports available were for the months of February, October, November and December 2002. We were able to obtain all but two of the remaining monthly progress reports directly from the contractor.

The consulting contract provided that the contractor would:

“Provide leadership, policy management, and direction in placement and realignment of personnel and functions currently performed by the Department of Economic Security with other functions in the executive branch or with units of local government.”

Department of Economic Security

The contract goes on to identify a number of specific duties and activities to be performed by the contractor. The contract amendments, in addition to DES transition responsibilities, included regional organization planning and recommendations.

We discussed the broad role of the contract with the contractor and reviewed the monthly progress reports. The reports discussed various issues relating to the reorganization of DES and DTED, such as monitoring the progress of legislation authorizing the merger, consolidation of the commissioners' offices and central service functions, and resolving issues that had arisen such as the appropriate organizational structure for the State Services for the Blind. The later reports also discuss the coordination of regional partnerships, including funding to counties from the federal School To Work program managed by the Department of Children, Families & Learning (CFL).

The Department of Economic Security administers many federal and state programs in addition to WIA, such as unemployment insurance, employment services, vocational rehabilitation, social security disability, and blind services programs. Abolishment of the agency and reorganization of functions affects all of DES' programs, as well as activities in other state agencies. Therefore, we do not think it was appropriate to charge the full cost of this contract to the WIA program. OMB Circular A-87, which defines allowable cost principles for federal programs, requires cost allocation in accordance with the relative benefits received by individual programs.

Recommendation

- *The Department of Economic Security should reimburse \$186,321 to the federal WIA program for the cost of the consulting contract, or work with the federal Department of Labor to determine an appropriate cost allocation methodology.*

2. The department made a significant error when compiling the Unemployment Insurance (CFDA #17.225) expenditure schedule for the federal Single Audit report.

The Department of Economic Security underreported unemployment benefit expenses in its federal financial schedule provided to the Department of Finance for inclusion in the state's federal Single Audit report. Typically, those benefit expenses equal the amount reported in the Unemployment Insurance Fund reported in the state's Comprehensive Annual Financial Report, minus small amounts included in two other related federal programs. However, we noted a \$31.5 million difference and submitted an audit adjustment to the Department of Finance. Differences resulted from a large accounting reversal posted in the wrong direction and two other accounting entries for the wrong amount.

A comparison of benefits expense between the Unemployment Insurance Fund financial statements and the Single Audit schedules would provide the department with assurance that it had accurately prepared the schedules.

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Recommendation

- *The Department of Economic Security should reconcile unemployment benefits reported in its Unemployment Insurance Fund financial statements to the amounts reported in the Unemployment Insurance (CFDA #17.225) Single Audit schedule.*

3. The department did not consistently define the nature of its relationship with one recipient of federal moneys from the Employment Services Cluster (CFDA #17.207).

The department did not clearly define its relationship for a contract paid from federal Employment Services Cluster (CFDA #17.207) moneys. Federal regulations provide guidance for distinguishing between a subrecipient and vendor. For example, a subrecipient would have responsibility for program decision-making while a vendor simply provides an operational service. The department entered into a contract and two contract amendments accumulating to \$1,040,000. We noticed the department used the professional-technical contract format and terms but included grant language and called for invoices. The contract did not require the grantee to provide financial status reports typically required of federal grant subrecipients. It appeared to us that the recipient was acting in a vendor capacity in performing services for the department and was not a subrecipient of federal program funds. In addition, the department did not have a federally required suspension and debarment certification from this subrecipient asserting the organization had not been disqualified from receiving federal funds.

Recommendations

- *The department should ensure that relationships with contractors and grantees are clearly defined in contracts and comply with federal definitions.*
- *The suspension and debarment certification should be obtained from all recipients, and grant agreements should require periodic financial status reports to oversee how moneys were used.*

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Economic Security. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 13, 2003.

/s/ James R. Nobles

/s/ Claudia J. Gudvangen

James R. Nobles
Legislative Auditor

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: January 6, 2003

Report Signed On: March 11, 2003

Department of Economic Security

Status of Prior Audit Issues As of January 6, 2003

Fiscal Year 2001 Statewide/Single Audit

We examined the department's activities and programs material to the *State of Minnesota's Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2001. The purpose of the audit was to render an opinion on the State of Minnesota's financial statements for fiscal year 2001. We issued an unqualified opinion on the *State of Minnesota's Comprehensive Annual Financial Report* for the year ended June 30, 2001. We did not identify any reportable weaknesses as a result of our audit work.

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.



State of Minnesota

Department of Economic Security

390 North Robert Street
Saint Paul, Minnesota 55101

Office of the Commissioner

March 6, 2003

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, 2002.

Finding 1

- **The department used federal Workforce Investment Act (WIA) program funds to pay the total cost of a consulting contract that involved duties and responsibilities not directly related to the federal program.**

We disagree. The WIA “10%” funds that were used are allowable for numerous system-wide activities, *i.e.* “*...assisting in the establishment and operation of one-stop delivery systems....*” The consultant and the transition duties that he performed were toward that end. Because those activities would be an entirely allowable expenditure of these Grant funds, there is no requirement to allocate those costs to other benefiting programs. (OMB Circular A-87, Allocable costs item c. states that: “*Any cost allocable to a particular Federal award or cost objective under principles provided for in this Circular may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of the Federal awards, or for other reasons. However, this prohibition would not preclude governmental units from shifting costs that are allowable under two or more awards in accordance with existing program agreements.*”

We have confirmed this interpretation with the USDOL Office of Financial and Administrative Services, and received correspondence from Mr. Barry Dale, CPA, Regional Financial Manager that states that the types of activities outlined in the contract are not inconsistent with what is defined by the federal government as a legitimate use of Workforce Investment Act (WIA) funds.

Mr. James R. Nobles
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Finding 2

- **The department made a significant error when compiling the Unemployment Insurance (CFDA#17.225) expenditure schedule for the federal Single Audit report.**

We agree. When we prepare the two reports next year, we will ensure that they are in agreement.

Finding 3

- **The department did not properly define the nature of its relationship with one recipient of federal monies from the Employment Services Cluster (CFDA 17.207).**

We agree. Although the proper contractual relationship with this vendor/grantee (which has ended) was subject to varying interpretations, we will treat subsequent agreements in a manner consistent with federal guidelines.

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

Sincerely,

/s/ Erik Aamoth

Erik Aamoth
Deputy Commissioner

AA/JS/jc