OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Department of Labor and Industry
July 1, 2000, through June 30, 2004

AUGUST 11, 2005 05-45

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.

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- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

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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

Scott Brener, Commissioner
Department of Labor and Industry

We conducted an audit of selected financial activities within the Department of Labor and Industry for the period July 1, 2000, through June 30, 2004. Our audit scope included payroll, administrative expenditures, and penalties collected from employers for failure to carry workers' compensation insurance. Our objectives focused on a review of the department's internal controls over these financial activities and its compliance with applicable legal provisions. We emphasize that this has not been a comprehensive audit of the department.

The enclosed Report Summary highlights our overall audit conclusions for the areas examined. The specific audit objectives and conclusions for each area are contained in the individual chapters of this report.

We would like to thank staff from the Department of Labor and Industry for their cooperation during this audit.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

End of Fieldwork: May 27, 2005

Report Signed On: August 8, 2005

Room 140, 658 Cedar Street, St. Paul, Minnesota 55155-1603 • Tel: 651/296-4708 • Fax: 651/296-4712
E-mail: auditor@state.mn.us • TDD Relay: 651/297-5353 • Website: www.auditor.leg.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
Laura Peterson, CPA	Auditor-in-Charge
Patrick Phillips, CPA	Auditor
Kelly Olson	Auditor

Exit Conference

We discussed the results of the audit with the following representatives of the Department of Labor and Industry at an exit conference on July 29, 2005:

Scott Brener	Commissioner
Cindy Valentine	Chief Information Officer and Acting Assistant Commissioner for Workers' Compensation
James Feckey	Director of Special Compensation Fund
Cindy Farrell	Chief Financial Officer
John Kufas	Accounting Officer

Report Summary

Overall Conclusions:

The Department of Labor and Industry's internal controls over payroll and other administrative expenditures were adequate, and for the items tested, the department complied with finance-related legal provisions.

However, we identified two internal control weaknesses as discussed below.

Findings:

- The department provided incompatible accounting system access to five employees who, as a result, could both initiate purchases and process payments. (Finding 1, page 9)

- The department did not effectively monitor unpaid penalties nor control reductions of certain penalties assessed to employers for failure to carry workers' compensation insurance. (Finding 2, page 12)

The report contained two findings related to the department's internal controls. The department resolved one prior audit finding regarding payroll system security.

Audit Scope:

Audit Period:
July 1, 2000, to June 30, 2004

Selected Audit Areas:
- Payroll expenditures
- Administrative expenditures
- Penalties for failure to carry workers' compensation insurance

Agency Background:

The Department of Labor and Industry ensures a safe and equitable work environment for Minnesota employees and employers.

In fiscal year 2004, the department collected $124 million and spent $111 million, mostly for the financing of the Special Workers' Compensation Fund.

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Chapter 1. Introduction

The Office of the Legislative Auditor selected the Department of Labor and Industry for audit based on an annual assessment of state agencies and programs. We used various criteria to determine the entities to audit, including the size and type of each agency's financial operations, length of time since the last audit, changes in organizational structure and key personnel, and available audit resources.

Agency Overview

The Department of Labor and Industry's mission is to ensure a safe and equitable work environment for Minnesota employees and employers and to be a trusted resource utilized by employees and employers. The department is a regulatory agency that operates under the authority of *Minnesota Statutes*, Chapters 175 through 186, and is responsible for enforcing compliance with workplace statutes and rules. Mr. Scott Brener was appointed department commissioner in May 2003.

The Department of Labor and Industry has three divisions:

- The ***Workers' Compensation Division*** oversees and administers the workers' compensation system for the State of Minnesota.

- The ***Workplace Services Division*** assures that conditions of employment, safety standards, apprenticeship programs, and wages comply with legal requirements.

- The ***General Support Division*** provides administrative support for the overall operations of the department.

Over 90 percent of the department's spending budget comes from the Special Compensation Fund, which is financed primarily by an assessment collected from workers' compensation insurers and self-insured employers. More than 70 percent of the department's expenditures are for workers' compensation benefits paid to injured workers. In fiscal year 2004, the department collected a total of $124 million and spent $111 million. The Office of the Legislative Auditor examined the workers' compensation assessments and benefits during our annual financial statement audit of the State of Minnesota for fiscal years 2001 through 2004.

Audit Approach

Our audit was conducted in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of the department's internal controls relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of

Sponsoring Organizations of the Treadway Commission, as our criteria to evaluate agency controls. The standards also require that we plan the audit to provide reasonable assurance that the department complied with financial-related legal provisions that are significant to the audit. In determining the department's compliance with legal provisions, we considered requirements of laws, regulations, contracts, and grant agreements.

To meet the audit objectives, we gained an understanding of the Department of Labor and Industry's financial policies and procedures. We considered the risk of errors in the accounting records and noncompliance with relevant legal provisions. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We also examined documents supporting the department's internal controls and compliance with laws, regulations, and contracts.

Chapter 2. Payroll Expenditures

Chapter Conclusions

The Department of Labor and Industry's internal controls provided reasonable assurance that it accurately compensated employees in accordance with various bargaining agreements, compensation plans, and management's authorization, and that payroll expenditures were accurately recorded in the accounting systems.

For the items tested, the department complied with significant finance-related legal provisions contained in various bargaining agreements and compensation plans.

Audit Objective

The primary objective of our audit of the Department of Labor and Industry's payroll expenditures was to answer the following questions:

- Did the department's internal controls ensure that it accurately compensated employees in accordance with various bargaining agreements, compensation plans, and management's authorization, and that payroll expenditures were accurately recorded in the accounting and payroll systems?
- For the items tested, did the department comply with significant finance-related legal provisions of the employee bargaining agreements and compensation plans?

Background Information

Payroll is the second largest expenditure category for the Department of Labor and Industry. In fiscal year 2004, the department paid over $22 million in payroll costs. As of June 2005, the department had approximately 450 employees. These employees' compensation is governed by various bargaining agreements and compensation plans, including the American Federation of State, County, and Municipal Employees; Minnesota Association of Professional Employees; Middle Management Association; Minnesota Government Engineer's Council; Commissioner's Plan; and Managerial Plan.

The department processes payroll through the state's payroll system (SEMA4) on a biweekly basis. In February 2004, the department implemented the state's new electronic timesheet feature called "Self-Service Time Entry." Self-Service Time Entry allows employees to enter their hours online and have those recorded hours forward to their supervisor for review and authorization. The electronically recorded hours then flow into SEMA4 and are the basis for the employees' compensation.

Table 2-1 shows the breakdown of the department's payroll expenditures by type of earnings for fiscal years 2001 to 2004.

Table 2-1
Payroll Expenditures by Earnings Type
Budget Fiscal Years 2001 to 2004

	2001	2002	2003	2004
Regular	$17,595,386	$17,797,964	$18,513,232	$17,863,946
Vacation	1,708,992	1,824,872	1,969,392	1,917,752
Sick	824,361	897,558	984,030	890,210
Holiday	930,558	976,888	1,002,923	958,429
Overtime	63,538	54,876	8,724	10,165
Other (Note 1)	899,615	859,613	511,800	463,250
Total	$22,022,450	$22,411,971	$22,990,101	$22,103,752

Note 1: Other includes a wide variety of other costs for training, separation, and supplemental pay.

Source: State Employee Management System (SEMA4) for fiscal years 2001 through 2004.

There were no findings as a result of our work in this area.

Chapter 3. Other Administrative Expenditures

Chapter Conclusions

The Department of Labor and Industry's internal controls provided reasonable assurance that it properly procured goods and services, accurately recorded these expenditures in the state's accounting system, and obtained appropriate management authorization. However, the department provided five employees with incompatible accounting system access to initiate procurements and make payments.

For the items tested, the department complied with the applicable Minnesota Statutes and Department of Administration policies regarding the procurement of goods and services.

Audit Objective

The primary objective of our audit of nonpayroll administrative expenditures was to answer the following questions:

- Did the department's internal controls provide reasonable assurance that it properly procured goods and services, accurately recorded the administrative expenditures in the state's accounting system, and obtained management's authorization?

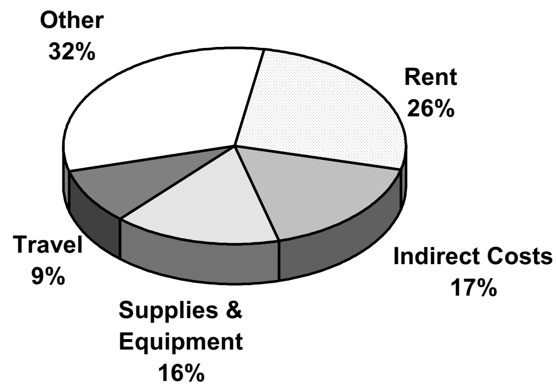
- For the items tested, did the department comply with the applicable Minnesota statutes and Department of Administration policies regarding procurement of goods and services?

Background Information

In addition to the payroll expenditures discussed in Chapter 2, the department incurred other administrative costs, which totaled $6.5 million in fiscal year 2004. Figure 3-1 shows a breakdown of those expenditures by type.

Department of Labor and Industry

Figure 3-1
Department of Labor & Industry
Nonpayroll Administrative Spending
Fiscal Year 2004



Source: Minnesota Accounting and Procurement System (MAPS) payments coded to budget fiscal year 2004.

Space Rental

Space rental is the department's largest nonpayroll administrative expenditure category, totaling approximately $1.7 million during fiscal year 2004. The department currently has eight lease agreements for office space rental. Seven of the department's agreements are for satellite offices located throughout the state of Minnesota, and one lease agreement is for the department's main office location in St. Paul. The department's satellite offices are in Duluth, Mankato, Bemidji, Fergus Falls, St. Cloud, Rochester, and Hibbing.

Agency Indirect Costs

Indirect costs are operating expenditures, such as information technology, human resources, and financial services, that benefit the department as a whole. In fiscal year 2004, the department reallocated $1.1 million of these expenditures to various programs it administers based on direct salary expenditures.

Supplies and Equipment

The department spent $483,583 on supplies and $524,487 on equipment purchases during fiscal year 2004. The department purchased supplies and equipment by using state contracts and through its local purchasing authority. Due to staff turnover, the last full physical inventory of department equipment was conducted in November 2002.

Travel

Department of Labor and Industry

In fiscal year 2004, the department incurred $493,628 for in-state travel and $105,809 for out-of-state travel. The OSHA inspectors, boiler inspectors, and work place safety consultants incurred the majority of the department's travel cost, including vehicle usage, lodging, and meals.

Finding and Recommendation

1. The department did not adequately restrict employee access to the state's accounting system.

The Department of Labor and Industry gave five employees who use the state's accounting system (MAPS) the ability to purchase and encumber funds, enter the invoice and/or receiving data, and process payments. Generally, the functions of purchasing and payment processing should be segregated to provide an appropriate level of control over expenditures. The risks of errors and improprieties diminish when employee access to incompatible functions is limited. If restricting these users' access is not feasible, the department should, at a minimum, have an independent person review the activity.

Recommendation

- *The department should eliminate incompatible access to the accounting system, or develop mitigating controls involving an independent review of the activity processed by the users with access to incompatible functions.*

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Chapter 4. Penalties for Failure to Carry Workers' Compensation Insurance

Chapter Conclusions

The Department of Labor and Industry's internal controls provided reasonable assurance that it properly assessed penalties to employers that failed to carry workers' compensation insurance, accurately recorded initial assessments and collections in the accounting system, and safeguarded penalty receipts collected. However, we found that the department did not adequately monitor unpaid penalties and did not effectively control penalty reductions or dismissals.

Audit Objective

The primary objective of our audit of failure to insure penalties was to answer the following questions:

- Did the department's internal controls provide an adequate and systematic method of assessing failure to insure penalties in compliance with applicable Minnesota statutes and rules?

- Did the department's internal controls provide assurance that it accurately recorded penalty assessments and collections in the state's accounting system and properly safeguarded penalty receipts collected?

Background Information

According to the provisions of *Minnesota Statute* 176.181, all employers that are covered by Minnesota workers' compensation laws must obtain insurance through an insurance company or become self-insured. *Minnesota Statute* 176.181 gives the Department of Labor and Industry the authority to assess penalties to employers who do not carry the required workers' compensation insurance. The special compensation fund unit of the department's Workers' Compensation Division is responsible for investigating any employer suspected of operating without workers' compensation insurance. The department receives this information from one of three sources:

- information from the *First Report of Injury,* which employers must file when a workplace injury occurs,
- matching employers' unemployment insurance records against their workers' compensation insurance records, and
- tips received from the public.

Department of Labor and Industry

When assessing penalties, the department considers the company size, number of employees, nature of business, and length of time an employer has not had insurance coverage to calculate the amount of penalty. *Minnesota Rule* 5220.2865 provides guidance for determining penalties for failure to carry workers' compensation insurance. An employer may object to a penalty, which could result in a settlement of the penalty or a hearing before an administrative law judge. If an employer fails to respond to an order to comply and notice of penalty assessment within ten working days, the department may seek judgment in Ramsey County District Court.

The department deposits Failure to Insure penalties in the Assigned Risk Safety Account which was created by the 1992 Minnesota Legislature. Table 4-1 shows the Failure to Insure penalty assessments and collections during fiscal years 2002 through 2004.

Table 4-1
Failure to Insure Penalties
Fiscal Years 2002 to 2004

	2002	2003	2004
July 1 Beginning Accounts Receivable	$1,895,333	$2,121,118	$2,907,298
Initial Assessments (Note 1)	$2,217,275	$2,361,299	$2,551,298
Dismissals/Reductions (Note 1)	1,082,794	1,085,721	620,696
Final Assessments	$1,134,481	$1,275,578	$1,930,602
Collections	$ 510,370	$ 450,663	$ 529,585
Write-Offs (Note 2)	398,326	38,735	906,290
Total Collections & Write-Offs	908,696	489,398	1,435,875
June 30 Ending Accounts Receivable	$2,121,118	$2,907,298	$3,402,025

Note 1: Fiscal year 2002 initial assessments and dismissals/reductions reflected in the accounting system were both increased by $827,380 for items netted by the department. An additional $287,573 of failure to insure penalties were dismissed or reduced but not reflected in the accounting system, as discussed in Finding 2.

Note 2: The department refers old, unpaid accounts receivable to the Collection Division of the Department of Revenue for recovery. Write-offs are recorded after all collection efforts are unsuccessful and do not correspond to the fiscal year in which the initial assessment was made.

Source: Minnesota Accounting and Procurement System (MAPS) as of May 11, 2005.

Finding and Recommendations

2. The department did not adequately monitor unpaid penalties or effectively control reductions of certain penalties assessed.

The department did not sufficiently monitor its unpaid penalties recorded as accounts receivable in the state's accounting system. We identified the following errors and weaknesses:

- The Workers' Compensation Division did not consistently communicate penalty reductions to the General Support Division for input into the accounting system. For 6 of 35 penalties we reviewed, the department did not decrease accounts receivable balances for penalty reductions it approved. As a result, the department's accounts receivable balance was overstated by $287,573. All six of these employers had the amounts listed as overdue balances exceeding 365 days. Department follow up on these overdue balances would have revealed that it had not reduced the balances owed. A formal list or document to authorize reductions should be approved by management and forwarded to the accounting unit for input into the accounting system.

- The department did not take timely action on three additional employers with unpaid balances. In one case, the department had been waiting for a pending legal opinion from department staff since May 2004. In another case, the department had been waiting for an employer's attorney response since April 2004. Finally, for a third case, the department should have sought a judgment against the employer in January 2005 but had not yet proceeded. The department should improve methods for monitoring open cases.

- The department did not adequately document resolution of a January 2003 penalty of $170,424 that possibly was dismissed in error. Typically, before the department dismisses or reduces a penalty, the employer must first submit a written objection to the commissioner stating its basis for the objection. We did not find evidence that the employer submitted an objection to the department. The only department evidence supporting the rationale for the dismissal was a notation that the employer was going out of business. However, employee wage detail records filed by the employer with the Department of Employment and Economic Development revealed that it did not go out of business; it had changed its business name but continued to operate. We questioned various staff from the department's Workers' Compensation Division, and they agreed the penalty should not have been dismissed. Due to the inadequate documentation and untimely detection of the error, the department is unable to pursue collection of the $170,424 penalty it dismissed. The department should ensure that all penalty reductions are sufficiently documented and approved to minimize the likelihood of errors or improprieties.

If the department had developed a formalized process for review and monitoring of past due penalties, it may have identified the errors and inefficiencies noted above.

Recommendations

- *The Department of Labor and Industry should routinely review unpaid penalties assessed for failure to carry workers' compensation insurance and develop a method for tracking and monitoring pending actions.*

- *The department should develop control procedures to ensure it adequately documents the basis for penalty reductions and provides management authorization for decreasing the amounts owed.*

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Status of Prior Audit Issues
As of May 27, 2005

Most Recent Financial Audit Reports

Legislative Audit Report 01-06, issued on March 1, 2001, examined the Department of Labor and Industry's activities and programs material to the State of Minnesota's *Comprehensive Annual Financial Report* or the Single Audit for the year ended June 30, 2000. The scope included the Special (Workers') Compensation Fund taxes and benefits, the claims payable, and federal OHSA program (CDFA #17.503). The report contained one finding involving the calculation of the general long-term obligation for injured workers, and the department resolved this finding.

Legislative Audit Report 00-47, issued on September 28, 2000, examined the department's financial activities and programs for the three and one-half year period ending December 31, 1999. The scope included various fee and fine revenues, payroll and administrative expenditures, and grants. The report contained two findings involving the need for review of payroll reports and establishing reasonable timeframes for state safety grants. The department resolved these audit findings.

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 metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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443 Lafayette Road North
St. Paul, Minnesota 55155
www.doli.state.mn.us

Minnesota Department of Labor and Industry

651-284-5000
TTY: 651-297-4198
1-800-DIAL-DLI

August 5, 2005

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Centennial Office Building
658 Cedar Street
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the opportunity to review and comment on the findings addressed in your audit for the four years ending June 30, 2004 for our department. This report accurately reflects the material that your staff discussed with us at the exit conference on July 29, 2005.

You made recommendations for improvement in the areas of system security and monitoring of penalties. We believe that these findings are reasonable and will take action to address them by October 31, 2005. Enclosed is a summary of your recommendations with our action response for each item.

I would like to thank you and your staff for your review of our operations. We view the audit of our department as an opportunity for improving our financial processes.

Sincerely,

M. Scott Brener

M. Scott Brener
Commissioner

Enclosure

SUMMARY OF FINDINGS, RECOMMENDATIONS, AND ACTION RESPONSES

Finding 1 – The department did not adequately restrict employee access to the state's accounting system.

Recommendation:

The department should eliminate incompatible access to the accounting system, or develop mitigating controls involving an independent review of the activity processed by the users with access to incompatible functions.

Action Response:

The audit identified five employees in the Financial Services unit with access to incompatible functions in the state's accounting system. The unit is currently under reorganization, due to the recent transfer of construction regulation activities from five state agencies to DLI. The addition of staff to the unit will better enable the department to separate incompatible duties of primary and back-up staff for various financial functions. Once the reorganization is complete, the Chief Financial Officer will make the necessary modifications to security clearances in the accounting system.

Finding 2 – The department did not adequately monitor unpaid penalties or effectively control reductions of certain penalties assessed.

Recommendations:

The Department of Labor & Industry should routinely review unpaid penalties assessed for failure to carry workers' compensation insurance and develop a method for tracking and monitoring pending actions.

The department should develop control procedures to ensure it adequately documents the basis for penalty reductions and provides management authorization for decreasing the amounts owed.

Action Response:

The Special Compensation Fund (SCF) Director and the Chief Financial Officer will develop a process for reconciling penalty information between the unit's database and the state's accounting system. This reconciliation will ensure that all penalty actions are properly recorded in each system.

The Penalty Administrator will begin to note on his calendar a future point in time to review and follow-up on penalties with unresolved legal issues. All outstanding penalties will be reviewed on a quarterly basis to ensure that collection actions are initiated timely.

The Penalty Administrator will develop a new form for documenting all penalty reductions and the reason for reduction. The Penalty Supervisor and the Special Compensation Fund Director will approve each reduction. The form will be submitted to the Financial Services unit for entry into the accounting system.