Independent Auditor's Report on
Internal Control over Financial Reporting and on Compliance
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, 2020, and have issued our report thereon dated December 15, 2020. 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, 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 15, 2020
Saint Paul, Minnesota

Enclosures

Finding and Recommendation

FINDING 1

The Department of Employment and Economic Development did not have adequate internal controls to ensure it properly classified receipts from the federal government in the Unemployment Insurance Fund financial statements.

The Department of Employment and Economic Development (DEED) misclassified $1.12 billion in federal receipts as revenue instead of unearned revenue in the Unemployment Insurance Fund financial statements. During fiscal year 2020, DEED received $4.71 billion from the federal government as advances under the Coronavirus Aid, Relief, and Economic Security (CARES) Act for anticipated unemployment benefit obligations.[1] 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.[2] As of June 30, 2020, DEED had $1.12 billion remaining from the federal advances for unemployment benefit obligations not yet incurred.

DEED does not typically receive advances from the federal government for unemployment benefits. Instead, DEED collects federal funds as reimbursements for unemployment benefits paid. DEED classifies those receipts as revenue because the corresponding obligations have already been incurred. Since DEED did not identify the different classification required for advances by generally accepted accounting principles, it classified the advances in the same way it classified reimbursements.

Minnesota Management and Budget posted the proposed audit adjustment to reclassify the $1.12 billion from revenue to unearned revenue. As a result, the total net position reported for the Unemployment Insurance Fund decreased from $1.58 billion to $461 million.[3]

RECOMMENDATION

The Department of Employment and Economic Development should strengthen internal controls to ensure all staff involved in the preparation and review of the Unemployment Insurance Fund financial statements have an adequate understanding of relevant generally accepted accounting principles.

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[1] 15 *U.S. Code*, secs. 9023-4 (2020); and 42 *U.S. Code*, sec. 1103 (2020).

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

[3] The misclassification of revenue did not affect the Unemployment Insurance Fund's cash position.

January 27, 2021

Mr. James R. Nobles, Legislative Auditor
Office of the Legislative Auditor (OLA)
Room 140 Centennial Building
658 Cedar Street
Saint Paul, MN 55155-1603

Dear Mr. Nobles:

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, 2019 through June 30, 2020.

The audit reported internal control weaknesses to ensure it properly classified receipts from the federal government 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.

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

Finding Number 1

The Department of Employment and Economic Development did not have adequate internal controls to ensure it properly classified receipts from the federal government in the Unemployment Insurance Fund financial statements.

The Department of Employment and Economic Development (DEED) misclassified $1.12 billion in federal receipts as revenue instead of unearned revenue in the Unemployment Insurance Fund financial statements. During fiscal year 2020, DEED received $4.7 billion from the federal government as advances under the Coronavirus Aid, Relief, and Economic Security (CARES) Act for anticipated unemployment benefit obligations.[1] Under generally accepted accounting principles, the federal advanced receipts should be classified as unearned revenue until the unemployment benefit obligations are incurred.[2] Once those obligations are incurred, the receipts should be classified as revenue. As of June 30, 2020, DEED had $1.12 billion remaining from the federal advances for unemployment benefit obligations not yet incurred.

DEED does not typically receive advances from the federal government for unemployment benefits. Instead, DEED collects federal funds as reimbursements for unemployment benefits paid. DEED classifies those receipts as revenue because the corresponding obligations have already been incurred. Since DEED did not identify the different classification required for advances by generally accepted accounting principles, it classified the advances in the same way it classified reimbursements.

Minnesota Management and Budget posted the proposed audit adjustment to reclassify the $1.12 billion from revenue to unearned revenue. As a result, the total net position reported for the Unemployment Insurance Fund decreased from $1.58 billion to $461 million.

Recommendation

The Department of Employment and Economic Development should strengthen internal controls to ensure all staff involved in the preparation and review of the Unemployment Insurance Fund financial statements have an adequate understanding of relevant generally accepted accounting principles.

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, DEED received $4.7 billion in advance funds 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.

Ordinarily, unemployment funding from the federal government is received on a reimbursement basis, where it is immediately classified as revenue at the point of cash drawdown, as the obligation to pay unemployment benefits has already been incurred. By contrast, under the CARES Act, the cash advances should have been classified as unearned revenue, with the unearned revenue recognized as revenue when the federal benefits were paid. Instead, the advanced federal revenue was recognized as revenue, as would have done under the normal reimbursement/cash drawdown process. As of June 30, 2020, of the original $4.7 billion in federal advance funds, DEED had $1.12 billion remaining for unemployment benefit obligations not yet incurred. As part of the audit, DEED worked with the OLA to identify the federal programs and amounts that were misclassified as federal revenue in the June 30, 2020 Unemployment Insurance CAFR statement originally submitted, OLA prepared an audit adjustment to reclassify the $1.12 billion from revenue to unearned revenue, and MMB posted the adjustment before publication of the CAFR. This adjustment did not have an actual cash impact on the UI Trust Fund or state funds, nor did it have any impact on administration of the UI program.

From a day-to-day managerial perspective, the COVID pandemic placed an unprecedented set of demands on the UI Program and related accounting staff as DEED managed the exponential surge in claims. Initial claims volumes were over 20x monthly the previous year's level, and over 10x the peaks seen during the 2008 financial crisis. To meet these needs, UI and accounting staff's top priority was to ensure proper cash management to safeguard prompt payments to benefits recipients. This focus ensured that out-of-work Minnesotans were paid promptly at a time when many states struggled with the unprecedented surge in claims. Additionally, the major increase in workload led to unexpected staffing challenges due to leaves and turnover. Finally, the advancement form of federal support, coupled with these factors above, challenged not just agency staff; the initial proposed audit adjustment from OLA would have recognized an additional $237 million in federal grant receivables, which would have been similarly misclassified. Regardless, the impact of the above were, or would have been, solely in classification and not in cash impact or program administration.

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. Nevertheless, 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 will also enhance its written business process documentation to include more formal evidence of review and sign-off/approval of the financial statement and other financial reporting.

Finally, DEED plans to augment 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. This would include those CARES Act federal funding received through this UI Program.

Person responsible for corrective action: Julie Freeman, Chief Financial Officer

Anticipated completion date for corrective action: 12/31/2021

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