



FINANCIAL AUDIT DIVISION REPORT

**Department of Employment
and Economic Development**
Federal Compliance Audit
Year Ended June 30, 2008

March 26, 2009

Report 09-09

FINANCIAL AUDIT DIVISION

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State of Minnesota • James Nobles, Legislative Auditor

March 26, 2009

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Mr. Dan McElroy, Commissioner
Department of Employment and Economic Development

This report presents the results of our audit of certain federal programs administered by the Department of Employment and Economic Development during fiscal year 2008. We conducted this audit as part of our audit of the state's compliance with federal program requirements. We emphasize that this has not been a comprehensive audit of the Department of Employment and Economic Development.

We discussed the results of the audit with department staff at an exit conference on March 12, 2009. This audit was conducted by Brad White, CPA, CISA, CFE, (Audit Manager) and Joan Haskin, CPA, CISA, (Auditor-in-Charge), assisted by auditors Tyler Billig, Thomas Derus, Tracia Gimbut, Jason Huynh, Pat Ryan, Paul Thompson, and Zach Yzermans, CPA.

This report is intended for the information and use 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 26, 2009.

We received the full cooperation of department staff while performing this audit.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusions

The Department of Employment and Economic Development generally complied with and had controls to ensure compliance with provisions of laws, regulations, contracts, and grants applicable to the major federal programs we audited for fiscal year 2008. However, the department had several weaknesses as noted in the seven findings presented in this report.

Findings

- The department did not identify and document its internal controls ensuring compliance with federal requirements. ([Finding 1, page 5](#))
- The department did not ensure that unemployment benefit payments were always appropriately assigned to employer accounts for use in tax rate calculations. ([Finding 2, page 6](#))
- The department did not have effective internal controls to ensure that overtime hours paid to employees were reasonable and approved in advance. ([Finding 3, page 7](#))
- Prior audit issues not resolved: The department did not consistently monitor subrecipients' compliance with audit requirements and did not accurately report expenditures for the Community Development Block Grant Program to the federal government. ([Findings 4 and 5, page 9](#))
- The department entered not public data in the state's accounting system and did not amend some employment plans for Vocational Rehabilitation clients. ([Findings 6 and 7, pages 10 and 11](#))

Audit Objectives and Scope

Programs material to the State of Minnesota's financial statements and federal program compliance for fiscal year 2008, including:

- Unemployment Insurance
 - Workforce Investment Act Cluster
 - Vocational Rehabilitation
 - Community Development Block Grants
-

Department of Employment and Economic Development

Federal Program Overview

The Department of Employment and Economic Development administered federal programs that we considered major federal programs for the State of Minnesota, subject to audit under the federal Single Audit Act.¹ Table 1 identifies these major federal programs.

Table 1
Audited Federal Programs Administered by the
Department of Employment and Economic Development
Fiscal Year 2008
(in thousands)

<u>CFDA¹</u>	<u>Program Name</u>	<u>Federal Expenditures</u>
17.225	Unemployment Insurance ²	\$863,531
84.126	Vocational Rehabilitation	\$ 44,333
	<u>Workforce Investment Act Cluster:¹</u>	
17.260	Workforce Investment Act-Dislocated Worker	\$ 14,171
17.259	Workforce Investment Act-Youth	8,483
17.258	Workforce Investment Act-Adult	7,715
	Total Workforce Investment Act Cluster	\$ 30,369
14.228	Community Development Block Grant	\$ 26,094

¹The Catalog of Federal Domestic Assistance (CFDA) is a unique number assigned by the federal government to identify its programs. Some federal programs are clustered if they have similar compliance requirements. Although the programs within a cluster are administered as separate programs, they are treated as a single program for the purpose of meeting the audit requirements of the U.S. Office of Management and Budget's Circular A-133.

²Expenditures include unemployment insurance benefits and over \$47 million of federal administrative reimbursements.

Source: Department of Employment and Economic Development's accounting system for fiscal year 2008.

¹ We defined a major federal program for the State of Minnesota in accordance with a formula prescribed by the federal Office of Management and Budget as a program or cluster of programs whose expenditures for fiscal year 2008 exceeded \$23.8 million.

Objective, Scope, and Methodology

The objective of our audit was to determine whether the Department of Employment and Economic Development complied with federal program requirements in its administration of these federal programs for fiscal year 2008. This audit is part of our broader federal single audit objective to obtain reasonable assurance about whether the State of Minnesota complied with the types of compliance requirements that are applicable to each of its federal programs.² In addition to specific program requirements, we examined the department's general compliance requirements related to federal assistance, including its cash management practices.

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 the *Government Auditing Standards*, issued by the Comptroller General of the United States of America and with the U.S. Office of Management and Budget's *Circular A-133 Compliance Supplement*.

Conclusions

The Department of Employment and Economic Development generally complied with and had controls to ensure compliance with certain provisions of laws, regulations, contracts, and grants applicable to its major federal programs for fiscal year 2008. However, the department had some weaknesses, as noted in the following *Findings and Recommendations* section.

We have reported these weaknesses to the federal government in the *Minnesota Financial and Compliance Report of Federally Assisted Programs*, prepared by the Department of Finance. This report provides the federal government with information about the state's use of federal funds and its compliance with federal program requirements. The report includes the results of our audit work, conclusions on the state's internal controls over and compliance with federal programs, and findings about control and compliance weaknesses.

² The State of Minnesota's single audit is an entity audit of the state that includes both the financial statements and the expenditures of federal awards by all state agencies. We issued an unqualified audit opinion, dated December 9, 2008, on the State of Minnesota's basic financial statements for the year ended June 30, 2008. In accordance with *Government Auditing Standards*, we also issued our report, dated December 9, 2008, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants. (Office of the Legislative Auditor's Financial Audit Division Report 09-03, *Report on Internal Control Over Financial Reporting*, issued February 13, 2009.) This report included control deficiencies related to the Department of Employment and Economic Development.

Findings and Recommendations

The Department of Employment and Economic Development did not identify and document its internal controls ensuring compliance with federal requirements.³

Finding 1

The department did not document its entity's risk assessment for internal controls over compliance with federal single audit requirements, specific internal controls over program compliance requirements, and its monitoring process that assesses the quality of internal control performance over time. An increased likelihood of noncompliance exists if the risk, control activity, and monitoring policies and procedures are not clearly communicated to all staff.

State policy details that each agency head has the responsibility to identify, analyze, and manage business risks that impact an entity's ability to maintain its financial strength and the overall quality of its products and government services.⁴ This policy also requires communication of the internal control policies and procedures to all staff so they understand what is expected of them and the scope of their freedom to act. Follow-up procedures, at a minimum, should include mechanisms for monitoring results and reporting significant control deficiencies to individuals responsible for the process or activity involved, including executive management and those individuals in a position to take corrective action, are also required per this policy. A new audit standard⁵ reinforced management's responsibility to have effective internal controls over its financial operations. The federal government expects that those controls also ensure compliance with federal program requirements.

The Department of Employment and Economic Development is aware of certain risks, has control activities in place, and performs selected internal control monitoring functions; however, the department has not documented these processes for compliance with federal single audit requirements.

Findings 2 through 7 identify specific deficiencies in the agency's internal control procedures that resulted in noncompliance with federal requirements. These deficiencies created an unacceptable risk of noncompliance or did not detect or prevent noncompliance from occurring. The department had some specific control deficiencies and instances of noncompliance, including unemployment benefits that were not assigned to an employer account for accurate tax rate calculations, concerns with approval and documentation supporting overtime, and

³ The finding applies to all federal programs listed in Table 1 to the report.

⁴ Department of Finance Policy 0102-01.

⁵ Statement on Auditing Standards #109.

noncompliance with monitoring of subrecipient audits and inaccurate cutoff for reporting of federal community development block grants.

If the department had a comprehensive internal control structure, it should have identified these deficiencies, assessed the degree of risk of these deficiencies, designed control procedures to address significant risks, and monitored whether controls were working as designed and effective in reducing the risks to an acceptably low level. It is likely that the department will continue to have noncompliance and weaknesses in internal controls over compliance until it operates within a comprehensive internal control structure.

Recommendation

- *The department should frequently review and clearly document its risks, control activities, and internal control monitoring functions for its key business processes.*

Finding 2

The department did not ensure that unemployment benefit payments were always appropriately assigned to employer accounts for use in tax rate calculations.

Department staff did not always accurately update eligibility determinations in the unemployment insurance system causing certain unemployment benefits to not be assigned to the respective employer's account. Staff was not familiar with how to use aspects of the new unemployment benefits system that began in October 2007. As a result, staff did not correctly update the eligibility determination in the system for five of ten nonassigned benefits we tested – they should have assigned the benefits to an employer. Because statutes base employers' unemployment tax rates, in part, on the amount of benefits assigned to the employer's account, these errors could result in an understatement of an employer's future unemployment tax rate, reducing the amount the employer pays into the state's Unemployment Insurance Fund during subsequent periods.

The process for determining unemployment benefit eligibility involved multiple levels of interaction between the unemployment system and benefit recipients, employers, and department staff. Department employees make benefit eligibility determinations and update the unemployment system to cause benefits to be either assigned or not assigned to an employer's accounts in accordance with reasons cited in statutes.⁶ Nonassigned benefit payments for fiscal year 2008 totaled \$86 million, increasing 48 percent from fiscal year 2007.

⁶ [*Minnesota Statutes*](#) 2008, 268.047.

Recommendations

- *The department should ensure staff is adequately trained on system processes that assign unemployment benefits to employer accounts.*
- *The department should review and correct nonassigned benefits entered incorrectly in the system and develop a process to monitor unemployment benefit payments that are not assigned to employer accounts.*

The department did not have effective internal controls to ensure that overtime hours paid to employees were reasonable and approved in advance.

Finding 3

The department's controls did not ensure that overtime hours were documented and approved in advance by management. The department delegates to supervisors the determination of whether overtime was a reasonable and necessary expense for the program. The supervisors do authorize the overtime subsequently reported by the employee on their biweekly timesheet but do not always document the need and prior approval of those overtime hours. As shown on the following table, the department's federally-funded overtime paid to its employees tripled from fiscal year 2007 to 2008.

Table 3
Federal Overtime Costs by Fiscal Year

	<u>2007</u>	<u>2008</u>
Overtime Pay	\$378,723	\$1,113,230
Related Employer Taxes and Benefits	<u>44,049</u>	<u>129,973</u>
Total	<u>\$422,772</u>	<u>\$1,243,203</u>

Note: A large portion of the overtime was paid to information technology staff involved in a new unemployment insurance computerized system. The department includes payroll and overtime costs for some information technology staff in its indirect costs that it allocates to all federal programs.

Source: State Employee Management System.

The department had the following weaknesses related to overtime payments:

- The department's policy is not consistent with state policy. It does not require that an employee document advance approval of overtime and leaves it to the supervisor's discretion whether to document the need for overtime to be worked and the approval. However, state payroll policies require a documented overtime request that indicates why the overtime was needed, the amount of overtime hours, and approval by the appointing

authority.⁷ The policy states that the department should not pay for overtime hours without prior approval unless it involves an emergency situation. The policy also requires that the department retain the overtime request and approval documents for three years.

- Eight of ten employees whose overtime we examined were missing some documentation supporting the overtime they were paid during the year. One employee received \$19,320 of overtime pay (excluding benefits) without any documentation to show that the overtime work was necessary or approved by management in advance. For some information technology staff, the department generally approved several employees to work overtime over several months when implementing a new unemployment insurance system, but did not limit the number of hours authorized. In addition, for three employees whose supervisors did specify and approve overtime hours in advance, the department paid more overtime than the supervisors had authorized.
- One employee received over \$24,000 as overtime, but the supporting schedules showed that some of the compensation was for on-call hours. On-call hours are paid when a supervisor requests that the employee be available to report to work when requested. On-call hours are paid at one quarter of the employee's regular hourly rate; overtime is paid at the full regular hourly rate. Instead of coding the hours as on-call on the timesheet, the employee converted the hours to overtime hours (four hours of on-call equals one hour of overtime). Because compensation for on-call hours could not be distinguished from compensation for overtime, the department would have difficulty determining the validity of the payments. The payroll system should reflect the true nature of the compensation.

Recommendations

- *The department should improve internal control over federally-funded overtime pay by:*
 - *Revising the department's overtime policy to conform with overtime requirements contained in state payroll policies.*
 - *Requiring that documentation contain the reason for overtime and the approved amount of overtime hours be specified in advance.*
 - *Ensuring overtime is paid at the correct rate and properly coded in the state's payroll system.*
- *The department should review overtime pay for the exceptions noted in our testing and pursue recovery of any overpayments.*

⁷ Department of Finance Policy – PAY0012.

Finding 4

Prior Finding Not Resolved:⁸ The department did not consistently monitor audits of subrecipient expenditures for the federal Community Development Block Grant Program (CFDA 14.228).

Department staff assigned to monitor subrecipient compliance with Community Development Block Grant Program requirements did not ensure that all subrecipients had an acceptable federal compliance audit. The department had not obtained an audit report for five of the fourteen subrecipients we tested. (One audit report was due on June 30, 2008, and four of the audits were due on September 30, 2008.) In addition, one city submitted an audit report that was not acceptable because the scope of the audit did not include federal compliance objectives. However, as reported in our three previous annual audits, the department's program monitors were not consistent in their monitoring practices.

Federal guidelines require that organizations who receive over \$500,000 annually submit an independent *Office of Management and Budget's Circular A-133* audit report within nine months of their year end. Subrecipient audits are a key way that the state and federal governments assure that funds are used in accordance with program requirements. Without effective monitoring and oversight of audits completed, ineligible costs and noncompliance with federal regulations could occur without detection.

The department has an effective subrecipient grant monitoring function for its other major federal programs, but it has not incorporated subrecipient monitoring for the Community Development Block Grants into this function.

Recommendation

- *The department should comply with federal Community Development Block Grant Program requirements and ensure that subrecipients submit audit reports that comply with single audit requirements.*

Prior Finding Not Resolved:⁹ The department did not accurately report project expenditures for the federal Community Development Block Grant Program (CFDA 14.228).

Finding 5

As reported in three prior audits, the department continued to have problems with accurately completing the Community Development Block Grant's key federal financial report submitted to the federal government. The department again

⁸ Office of the Legislative Auditor's Financial Audit Division Report [08-11, Department of Employment and Economic Development](#), issued March 28, 2008, Finding 2.

⁹ Office of the Legislative Auditor's Financial Audit Division Report [08-11, Department of Employment and Economic Development](#), issued March 28, 2008, Finding 3.

submitted inaccurate data on its Community Development Block Grant 2008 *Performance and Evaluation Report* to the federal Housing and Urban Development Agency. On the report for the fiscal year ending September 30, 2008, the department inadvertently included approximately \$3 million of expenditures that the department paid from October 2008 through December 23, 2008, for program obligations after September 30, 2008; these expenditures should have been included in the 2009 federal reporting period.

The department did not review or verify the report was accurate before sending it to the federal Housing and Urban Development Agency. Upon notification of the error by our auditors, the department submitted a revised report in February 2009.

Recommendation

- *The department should comply with federal Community Development Block Grant Program requirements by submitting an accurate Performance and Evaluation Report to the federal government.*

Finding 6

The department entered not public data in the state's accounting system.

The department entered vocational rehabilitation (CFDA 84.126) client names in the vendor invoice field in the state's accounting system. While this allowed the service providers being paid to identify the client that the payment is for, it also allowed anyone with access to this table in the state's information warehouse to have access to this not public data. *Minnesota Statutes* state that vocational rehabilitation data is not public.¹⁰ Not public data includes any government data which is classified by statute, federal law, or temporary classification as confidential, private, nonpublic, or protected nonpublic. In addition, state policy categorizes accounting system data as public and specifically instructs state agencies that names and certain information on individuals should not be included.¹¹

Recommendation

- *The department should work with the Department of Finance to restrict access to client names, or avoid including program client names in the accounting system when making vendor payments. In addition, the departments should remove or protect client names previously included in the state's accounting system in prior years.*

¹⁰ [Minnesota Statutes](#) 13.791, 268A.05.

¹¹ Department of Finance Policy 0803-01.

The department did not amend employment plans for two vocational rehabilitation (CFDA 84.126) clients.**Finding 7**

For two (out of ten) clients we tested, the department did not revise or amend their Individual Plan for Employment (employment plan) for changes in vocational rehabilitation services that it provided. The State Services for the Blind paid a client for housing and meal costs, but the client's employment plan did not include or authorize these expenditures. In addition, the State Services for the Blind paid a client for services that exceeded the employment plan's authorized amount of \$16,500, and included paid day care expenses for the period beyond the end date of the employment plan. The department did not document and amend the employment plan for these costs.

According to federal regulations, vocational rehabilitation services are to be provided in accordance with the provisions in the individual's employment plan. The plan must state the specific vocational rehabilitation services needed and an estimate of the cost. The plan should be amended as necessary when there are substantial changes in the services to be provided. Amendments are not effective until agreed to and signed by the client and the counselor.

Recommendations

- *The department should review clients' employment plans prior to approving payments to ensure the expenditures are authorized by the plan and that payment limits are not exceeded.*
 - *The department should amend employment plans for changes in services, service dates, and amounts.*
-

March 19, 2009

Mr. James R. Nobles
Legislative Auditor
First Floor, Centennial Office Building
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles:

Thank you for the opportunity to respond to the findings and recommendations related to the audit work on selected federal programs awarded to the Department of Employment and Economic Development (DEED) for the year ended June 30, 2008.

Audit Finding 1: The Department of Employment and Economic Development did not identify and document its internal controls ensuring compliance with federal requirements.

Recommendation:

- *The department should frequently review and clearly document its risks, control activities, and internal control monitoring functions for its key business processes.*

Response: The department agrees with the finding and recommendation. While DEED does maintain internal controls over compliance with federal requirements, those controls are not well documented and monitored. Cindy Farrell, Chief Financial Officer, will oversee the establishment of an internal control structure over compliance with federal requirements to be completed by March 31, 2010.

Audit Finding 2: The department did not ensure that unemployment benefit payments were always appropriately assigned to employer accounts for use in tax rate calculations.

Recommendations:

- *The department should ensure staff is adequately trained on system processes that assign unemployment benefits to employer accounts.*
- *The department should review and correct non-assigned benefits entered incorrectly in the system and develop a process to monitor unemployment benefit payments that are not assigned to employer accounts.*

Response: The department agrees with the finding and recommendations. The auditor's report suggests that the source of the incorrect non-assignment of charges is attributable primarily to staff error. Training has been completed for those areas where staff errors may have affected the proper assignment of charges. While staff error does explain a small percentage of incorrect non-assignment of charges, nearly all errors the auditor detected were attributable to a known system defect in the "charge" module of the new system. That defect is scheduled to be corrected in the April 2009 system update. Following that update, all non-assignment of charge errors will be corrected and employer experience rates will be recalculated where necessary. In addition, DEED will periodically validate that assignment and non-assignment of charges is working properly. Kathy Nelson, Unemployment Insurance Director, will implement these changes by July 31, 2009.

Audit Finding 3: The department did not have effective internal controls to ensure that overtime hours paid to employees were reasonable and approved in advance.

Recommendations:

- *The department should improve internal control over federally-funded overtime pay by:*
 - *Revising the department's overtime policy to conform with overtime requirements contained in state payroll policies.*
 - *Requiring that documentation contain the reason for overtime and the approved amount of overtime hours be specified in advance.*
 - *Ensuring overtime is paid at the correct rate and properly coded in the state's payroll system.*
- *The department should review overtime pay for the exceptions noted in our testing and pursue recovery of any overpayments.*

Response: The department agrees with the finding and recommendations. The department's overtime policy will be updated to require documentation of advance approval in order to conform to state policy. DEED will also review the exceptions noted by the auditor and will determine if any overtime was erroneously paid and pursue recovery if necessary. Mary Oman, Human Resources Director will oversee the resolution of this finding by April 30, 2009.

Audit Finding 4: The department did not consistently monitor audits of subrecipient expenditures for the federal Community Development Block Grant Program (CFDA 14.228).

Recommendation:

- *The department should comply with federal Community Development Block Grant Program requirements and ensure that subrecipients submit audit reports that comply with single audit requirements.*

Response: The department agrees with the finding and recommendation. The Business and Community Development Division (BCD) will implement a new process to identify those sub-recipients that require the federal compliance audit and assign the staff person responsible for obtaining and reviewing the audit reports. BCD management will actively monitor to ensure these assignments are completed by the established deadlines. Meredith Udoibok, Assistant Division Director of Business and Community Development Division, will implement the new process by April 30, 2009.

Audit Finding 5: The department did not accurately report project expenditures for the federal Community Development Block Grant Program (CFDA 14.228).

Recommendation:

- *The department should comply with federal Community Development Block Grant Program requirements by submitting an accurate Performance and Evaluation Report to the federal government.*

Response: The department agrees with the finding and recommendation. In the future, BCD staff will be required to more closely review the data extract prior to submitting the annual report. Mark Loftus, Business and Community Development Director, will implement this change with the next annual report that is due by December 31, 2009.

Audit Finding 6: The department entered not public data in the state's accounting system.

Recommendation:

- *The department should work with the Department of Finance to restrict access to client names, or avoid including program client names in the accounting system when making vendor payments. In addition, the departments should remove or protect client names previously included in the state's accounting system in prior years.*

Response: The department agrees with the finding and recommendation. The Minnesota Management and Budget (MMB) department is currently working on an enhancement to its information warehouse security that would restrict access to accounting system data by agency. This enhancement would apply to current and prior year accounting data and is expected to be in place by June 30, 2009. In addition, DEED will review the access of its own employees to data contained in the information warehouse and reinforce with these employees their responsibilities for protecting any private data. Cindy Farrell, Chief Financial Officer, will oversee the implementation of these changes by June 30, 2009.

Audit Finding 7: The department did not amend employment plans for two vocational rehabilitation (CFDA 84.126) clients.

Recommendations:

- *The department should review clients' employment plans prior to approving payments to ensure the expenditures are authorized by the plan and that payment limits are not exceeded.*
- *The department should amend employment plans for changes in services, service dates, and amounts.*

Response: The department partially agrees with the finding and recommendations. DEED agrees with the recommendation that employment plans should be amended for changes in services and service dates prior to the authorization of amounts for specific services. State Services for the Blind provided the necessary training to its vocational rehabilitation staff on February 24, 2009. State Services for the Blind's Workforce Development Director, Pam Brown, will monitor the effect of the staff training that was provided and ensure that new employees are appropriately trained.

DEED does not agree that employment plans need to be amended for changes in amounts for planned services since that is not a legal requirement pursuant to 34 CFR 361.46 - Content of the individualized plan for employment. Instead, DEED controls the costs for vocational rehabilitation services through the use of authorization transactions. These transactions authorize a specific amount to a specific vendor and provide the necessary control of expenditures.

If you have any questions or need additional information please contact Cindy Farrell at Cindy.Farrell@state.mn.us or 651-259-7085.

Sincerely,



Dan McElroy
Commissioner