



FINANCIAL AUDIT DIVISION REPORT

**Department of Labor and
Industry**

**Construction Codes and Licensing
Division**

Internal Controls and Compliance Audit

July 1, 2009, through February 29, 2012

June 14, 2012

Report 12-13

FINANCIAL AUDIT DIVISION

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

June 14, 2012

Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ken Peterson, Commissioner
Department of Labor and Industry

This report presents the results of our selected-scope internal controls and compliance audit of the Department of Labor and Industry, Construction Codes and Licensing Division, for the period July 1, 2009, through February 29, 2012.

We discussed the results of the audit with the Department of Labor and Industry's staff on June 4, 2012. This audit was conducted by Brad White, CPA, CISA, CFE (Audit Manager) and Joan Haskin, CPA, CISA (Auditor-in-Charge), assisted by auditors Reidar Gullicksrud, CPA, and Daly Miskowicz.

This report is intended for the information and use of the Legislative Audit Commission and the management of the Department of Labor and Industry. This restriction is not intended to limit the distribution of this report, which was released as a public document on June 14, 2012.

We received the full cooperation of the Department of Labor and Industry's staff while performing this audit.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusion

The internal controls reviewed at the Department of Labor and Industry's Construction Codes and Licensing Division were generally adequate to ensure that it safeguarded its financial resources, accurately paid claimants in accordance with management's authorization, created reliable financial data, and complied with significant finance-related legal requirements. However, the department had some control weaknesses related to its receipts in the Construction Code and Licensing Division. For the items tested, the department complied with significant finance-related legal requirements.

Findings

- The Department of Labor and Industry did not perform effective monthly receipt reconciliations between its subsystems and the state's accounting system. ([Finding 1, page 7](#))
- The Department of Labor and Industry inappropriately allowed Construction Code and Licensing Division staff access to receipts collected for construction plan reviews. ([Finding 2, page 8](#))

Audit Objectives and Scope

Objectives

- Internal Controls
- Legal Compliance

Period Audited

July 1, 2009, through February 29, 2012

Programs Audited

- Construction Code Fund Revenue
 - Residential Contractor Recovery Fund
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Department of Labor and Industry

Agency Overview

The Department of Labor and Industry's mission is to ensure Minnesota's work and living environments are equitable, healthy and safe. The department accomplishes this mission by regulating workplaces through education and enforcement. The Department of Labor and Industry has four primary divisions:

- **Safety and Workers' Compensation** - oversees and administers the workers' compensation system for the State of Minnesota.
- **Construction Codes and Licensing** - assures conditions of employment, wages, safety standards, construction codes and licensing, and apprenticeship programs comply with legal requirements.
- **Apprenticeship and Labor Standards** - enforces various employment laws and regulates and promotes apprenticeship programs.
- **General Support and Research** - provides support for the overall operations of the department, including financial services, policy development, research, and statistics.

In July 2007, Governor Tim Pawlenty appointed Steve Sviggum as commissioner of the Department of Labor and Industry. He served as the commissioner until Governor Mark Dayton appointed Ken Peterson as the department's commissioner in January 2011.

Our audit focused on selected financial activities of the Construction Codes and Licensing Division. The division develops construction code standards and administers programs for plan review, permitting, inspections, professional licensing, education, and enforcement activities for all aspects of the building construction industry.

Table 1 summarizes Construction Code Fund receipts by type for fiscal years 2010 and 2011.

Table 1
Department of Labor and Industry
Construction Code Fund Receipts
July 1, 2009, through June 30, 2011

	<u>Fiscal Years</u>	
	<u>2010</u>	<u>2011</u>
<u>Receipts by Type:</u>		
Inspections	\$11,254,766	\$10,524,194
Licensing	5,775,049	4,789,894
Surcharges	2,576,320	3,837,847
Plan Review	2,086,405	2,595,569
Permits	1,438,308	2,983,181
Boiler Registrations	704,058	754,555
Other	460,713	411,418
Total Receipts	<u>\$24,295,619</u>	<u>\$25,896,658</u>

Note: From July 1, 2011, to February 29, 2012, the Construction Codes and Licensing Division collected approximately \$15 million.

Source: Minnesota Accounting and Procurement System.

In addition, the Construction Codes and Licensing Division also administers the Residential Contractor Recovery Fund. The fund compensates owners or lessees of residential property in Minnesota who have suffered an actual and direct out-of-pocket loss due to a licensed contractor's fraudulent, deceptive, or dishonest practices, conversion of funds, or failure of performance. The Residential Contractor Recovery Fund is funded by an additional fee on licenses for residential contractors, which totaled \$3.5 million and \$2.9 million in fiscal years 2010 and 2011, respectively.¹ Contractor Recovery Fund claims totaled \$2.7 million in fiscal year 2010 and \$2.9 million in fiscal year 2011.

Objectives, Scope, and Methodology

Our audit of the Department of Labor and Industry's Construction Code Fund revenue and Residential Contractor Recovery Fund focused on the following audit objectives for the period July 1, 2009, through February 29, 2012:

- Were the department's internal controls over Construction Code and Residential Contractor Recovery Fund's financial cycles adequate to ensure that it safeguarded its financial resources, accurately paid claimants in accordance with management's authorizations, complied with finance-related legal provisions, and created reliable financial data?

¹ Contractor Recovery Fund fees are established pursuant to *Minnesota Statutes* 2011, 326B.89, subd. 3, based on a contractor's gross annual receipts and paid in addition to the residential contractor's license application or renewal fee. Contractor Recovery Fund revenues decreased due to declining contractor receipts and a department change to a two-year license renewal period.

- Did the department comply with significant finance-related legal requirements for the Construction Code Fund and Residential Contractor Recovery Fund?

To meet the audit objectives, we gained an understanding of the department's financial policies and procedures. We considered the risk of errors in the accounting records and potential noncompliance with relevant legal requirements. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined samples of financial transactions and reviewed supporting documentation to test whether the agency's controls were effective and if the transactions complied with laws, regulations, policies, and grant and contract provisions.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

We used various criteria to evaluate internal control and compliance. We used, as our criteria to evaluate agency controls, the guidance contained in the *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.² We used state and federal laws, regulations, and contracts, as well as policies and procedures established by the departments of Management and Budget and Administration and the department's internal policies and procedures as evaluation criteria over compliance.

Conclusion

The internal controls reviewed at the Department of Labor and Industry's Construction Codes and Licensing Division were generally adequate to ensure that it safeguarded its financial resources, accurately paid claimants in accordance with management's authorization, created reliable financial data, and complied with significant finance-related legal requirements. However, the department had some control weaknesses related to its receipts in the Construction Code and Licensing Division. For the items tested, the department complied with significant finance-related legal requirements.

The following *Findings and Recommendations* provide further explanation about certain internal control weaknesses over revenues.

² The Treadway Commission and its Committee of Sponsoring Organizations were established in 1985 by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity. The resulting *Internal Control-Integrated Framework* is the accepted accounting and auditing standard for internal control design and assessment.

Findings and Recommendations

The Department of Labor and Industry did not perform effective monthly receipt reconciliations between its subsystems and the state's accounting system.

Finding 1

From July 2011 through February 2012, the department did not reconcile monthly receipts recorded on its various construction and licensing subsystems to the state's accounting system. The department used the subsystems to record specific information about licenses issued and fees paid. Reconciling the detailed receipt transactions to the state's accounting system ensures the integrity of the subsystem's data and could detect licenses issued without a corresponding deposit. Since July 2011, when the state implemented a new statewide accounting system, the department had not been able to generate the monthly revenue reports from the accounting system it needed to perform the reconciliations. The lack of a monthly reconciliation increased the risk that errors and irregularities could occur without detection, correction, and communication to department management.

During fiscal years 2010 and 2011, when the department did perform monthly reconciliations between its subsystems and the previous statewide accounting system, staff adjusted certain subsystem amounts on the reconciliations to make them agree with the accounting system. The adjustments hid the existence of reconciling items and the need to further investigate the reasons for the differences. Without further investigation, department management would not know whether the discrepancies occurred because of legitimate transaction timing differences or were an indication of uncorrected errors or fraud. In addition, the employee who reconciled the Construction Codes and Licensing Division's subsystem to the state's accounting system also had access to the receipts and could enter transactions into the subsystem. These incompatible duties provided an opportunity for theft or fraud without detection.

Recommendations

- The Department of Labor and Industry should work with the Department of Management and Budget to obtain the monthly financial reports necessary to reconcile accounting system revenues to the receipts recorded in its construction and licensing subsystems.*
 - The department should review the monthly reconciliations to ensure staff investigate the reasons for discrepancies, resolve errors, and report any indication of fraud.*
-

- *The department should assign the reconciliation responsibility to someone who does not have access to receipts or subsystem transactions; if it cannot separate these incompatible duties, it should design other controls, such as supervisory oversight, to reduce the risk of error, theft, and fraud.*

Finding 2

The Department of Labor and Industry inappropriately allowed Construction Codes and Licensing Division staff access to receipts collected for construction plan reviews.

The department did not route all receipts directly to the Financial Services section for safekeeping and deposit. Instead, it routed checks received for construction plan reviews to the Construction Codes and Licensing Division. After division staff verified the plan review payment was appropriate and recorded it in the licensing subsystem, they delivered the checks to the Financial Services section for deposit. From July 2009 through February 2012, revenue from construction plan reviews exceeded \$6 million.

In assessing its internal controls designed to mitigate risks related to its receipts, the department stated that the Financial Services section should collect and deposit all incoming receipts. The department increased the risk of loss or theft by not routing checks directly to the Financial Services section.

Recommendation

- *The Department of Labor and Industry should route all receipts directly to the Financial Services section for safekeeping and deposit.*
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June 11, 2012

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

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to the selected scope internal controls and compliance audit of the Department of Labor and Industry, Construction Codes and Licensing Division for the period July 1, 2009, through February 29, 2012. This letter is the Minnesota Department of Labor and Industry (DLI) response to the draft report issued May 30, 2012.

Finding 1: DLI did not perform effective monthly receipt reconciliations between its subsystems and the state's accounting system.

Recommendations:

- *The Department of Labor and Industry should work with the Department of Management and Budget to obtain the monthly financial reports necessary to reconcile accounting system revenues to the receipts recorded in its construction and licensing subsystems.*
- *The department should review the monthly reconciliations to ensure staff investigates the reasons for discrepancies, resolve errors, and report any indications of fraud.*
- *The department should assign the reconciliation responsibility to someone who does not have access to receipts or subsystem transactions; if it cannot separate these incompatible duties, it should design other controls, such as supervisory oversight, to reduce the risk of error, theft, and fraud.*

Response: DLI agrees that reconciliation between the agency sub-systems and the state's accounting system is a critical risk control. DLI has been working with the Office of Minnesota Management and Budget (MMB) to obtain the necessary reports to perform the reconciliation. MMB launched the report on Thursday, June 7, 2012. DLI is testing the report to ensure it meets our needs. If successful, DLI will start to reconcile its receipts with the MMB report. DLI has been reconciling its receipts with US Bank and the Minnesota Treasury. DLI will improve its reconciliation process by ensuring employees reconciling provide documentation as adjustments are made. With the MMB reconciliation report, DLI will restore internal controls for the reconciliation of receipts.

Responsible Staff: Cecelia Jackson, Chief Financial Officer

Implementation Date: Dependent on when SWIFT system's capabilities are available.

Finding 2: The Department of Labor and Industry inappropriately allowed Construction Codes and Licensing Division staff access to receipts collected for construction plan reviews.

Recommendation: The Department of Labor and Industry should route all receipts directly to the Financial Services Section for safekeeping and deposit.

Response: Construction plan review materials were forwarded to unit staff for review and determination as to whether the materials were properly forwarded to DLI or whether they should have been filed with another jurisdiction. DLI allowed this review as a service to the construction industry as complaints were received from contractors that DLI was delaying construction projects as funds were deposited where materials had mistakenly been filed with DLI, and it took time to process refunds. DLI has now revised its process and all construction plan checks are held by Financial Services for 24 hours to allow time for the Construction Code and Licensing Division staff to review the materials to confirm that the plans were properly filed with DLI.

In addition, DLI has launched a “Local Code Lookup” on DLI’s Internet site where a city’s name is entered and the appropriate municipality and/or building official is identified. We anticipate that this website will reduce the number of misdirected plan reviews.

<http://workplace.doli.state.mn.us/jurisdiction/>

Responsible Staff: Cecelia Jackson, Chief Financial Officer

Implementation Date: Completed May 1, 2012 (website was launched June 5, 2012)

Thank you for the opportunity to respond to your findings and recommendations. DLI will monitor and ensure successful resolution of these findings. Please contact Cecelia Jackson, Chief Financial Officer, at 651-284-5528 with any follow-up questions or information.

Sincerely,

A handwritten signature in dark ink, appearing to read "LB PT", is written over a light gray circular stamp.

Ken Peterson
Commissioner of Labor and Industry