

Department of Labor and Industry

Financial Audit

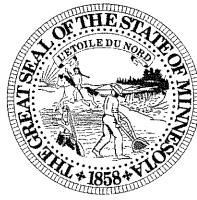
Fiscal Year Ended June 30, 1997

February 1998

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Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

98-5



STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Deanna Wiener, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Gretchen Maglich, Commissioner
Department of Labor and Industry

We have audited selected areas of the Department of Labor and Industry for the fiscal year ended June 30, 1997, as further explained in the Introduction. The work conducted in the department is part of our Statewide Audit of the state of Minnesota's fiscal year 1997 financial statements. The Comprehensive Annual Financial Report for the year ended June 30, 1997, includes our report, issued thereon dated December 8, 1997. The following summary highlights the audit objectives and conclusions.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards also require that we design the audit to provide reasonable assurance that the Department of Labor and Industry complied with provisions of laws, regulations, and contracts that are significant to the audit. Management of the Department of Labor and Industry is responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, and contracts.

This report is intended for the information 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 February 12, 1998.

A handwritten signature in black ink, reading "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in black ink, reading "Claudia Gudvangen".

Claudia Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 5, 1997

Report Signed On: February 6, 1998

SUMMARY

State of Minnesota
Office of the Legislative Auditor
1st Floor Centennial Building
658 Cedar Street • St. Paul, MN 55155
612/296-4708 • FAX 612/296/4712
TDD Relay: 1-800-627-3529
email: auditor@state.mn.us
URL: <http://www.auditor.leg.state.mn.us>

Department of Labor and Industry

Financial Audit For the Fiscal Year Ended June 30, 1997

Public Release Date: February 12, 1998

No. 98-5

Background

The Department of Labor and Industry is responsible for processing and paying over \$100 million of workers' compensation claims each year. The department's liability for these claims results from supplemental benefits, second injury responsibilities, and uninsured employers. The claims are paid from the Special Compensation Fund that is financed by assessments made on employers. The department also collected receipts for various purposes and activities, such as issuing licenses. Ms. Gretchen Maglich was appointed Commissioner of Labor and Industry in December 1997. Mr. Gary Bastian served as the commissioner from April 12, 1995, until November 21, 1997.

Selected Audit Areas and Conclusions

Our audit scope focused on workers' compensation claims paid and assessments collected by the Special Compensation Fund for fiscal year 1997. The fund's financial activities were material to the state's financial statements and examined as part of our annual Statewide Audit. We also examined the department's information system security access controls during fiscal year 1997.

We concluded that Special Compensation Fund claims and assessments were fairly presented on the state's fiscal year 1997 financial statements in compliance with generally accepted accounting principles. However, we found that department staff need to improve consistency in their calculations of the reserve for general long-term obligation.

Also, we concluded that the department adequately limited access to sensitive computer resources and data. Restricted access to the department's computerized systems effectively separated staff capabilities. Special Compensation Fund security clearances appear reasonable based on job responsibilities.

The department agreed with the audit report finding and recommendation. They are currently implementing a new claims management system, which should consistently calculate the estimated future liability for claims.

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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
Dale Ogren, CPA, CISA	Auditor-in-Charge
Susan Kong	Auditor

Exit Conference

We discussed the findings and recommendations with the following staff of the Department of Labor and Industry on January 29, 1998:

Gretchen Maglich	Commissioner
Michael Houliston	Deputy Commissioner
Gail Blackstone	Assistant Commissioner, Workplace Services Division
Brandon Miller	Director, Special Compensation Fund Section
John Kufus	Accounting Officer, Special Compensation Fund Section
Cindy Farrell	Chief Financial Officer
Cindy Valentine	Chief Information Officer

Department of Labor and Industry

Chapter 1. Introduction

The Department of Labor and Industry consists of the following divisions: Workers' Compensation Division, Workplace Services Division, and General Support Division. Minn. Stat. Chapters 175 to 178, 181 to 184, and 326 govern the department. These chapters create the agency and establish the general purposes for its financial transactions. Specifically, Minn. Stat. Chapter 176 provides legal provisions governing the workers' compensation laws. Gary Bastian became commissioner of the Department of Labor and Industry on April 12, 1995, and resigned from the position on November 21, 1997. Gretchen Maglich was appointed commissioner of the department in December 1997.

The department's primary funding sources are workers' compensation assessments, General Fund appropriations, and federal grants. The majority of the department's receipt collection occurs in the Special Compensation Fund of the Workers' Compensation Division. Total revenue collected by the department during fiscal year 1997 totaled \$120.4 million. Of this amount, workers' compensation assessments totaled \$105.2 million or 87 percent. The remaining \$15.2 million represents amounts collected for interest on investments, penalties, fines, federal grants, and other revenues. Fiscal year 1997 expenditures of the department are shown in Table 1-1.

Table 1-1
Summary of Expenditures by Fund
Fiscal Year 1997

	Special Compensation Fund	General Fund	Federal Fund	Other Funds	Total
Workers' Compensation Claims	\$ 91,799,211	\$ 0	\$ 0	\$ 0	\$ 91,799,211
Other	8,716,178	3,865,644	3,220,742	291,166	16,093,730
Total	<u>\$100,515,389</u>	<u>\$3,865,644</u>	<u>\$3,220,742</u>	<u>\$291,166</u>	<u>\$107,892,941</u>

Source: Workers' compensation claims as calculated by the Department of Labor and Industry for presentation in the Comprehensive Annual Financial Report published by the Department of Finance for fiscal year 1997; and the Minnesota Accounting and Procurement System for fiscal year 1997 as of September 26, 1997.

Our audit scope focused on the Special Compensation Fund assessments collected and workers' compensation claims paid. Both financial activities were material to the state's financial statements. We discuss the results of our work on workers' compensation assessments and claims in Chapter 2 and 3, respectively. We also reviewed computer access for the department's computer system, as discussed in Chapter 4.

Department of Labor and Industry

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Chapter 2. Workers' Compensation Assessments

Chapter Conclusions

Special Compensation Fund revenues are fairly presented in the state's financial statements in accordance with generally accepted accounting principles. The department designed internal controls to provide reasonable assurance that revenues are safeguarded and properly recorded in the accounting records and also comply with finance-related legal provisions.

The Department of Labor and Industry collects most of its funding through the Special Compensation Fund. Within the fund, the revenue consists mainly of assessments, interest, penalties, and fines. The department sends assessment reports to licensed insurance companies and self-insured employers. The assessment is a self-calculated tax based on the amount of benefits the company paid out to injured employees.

Workers' compensation assessments are deposited into the state treasury. Fiscal year 1997 receipts of the fund are shown in Table 2-1.

Table 2-1
Special Compensation Fund Revenues
Fiscal Year 1997

Workers' Compensation Assessments and Penalties - Note 1	\$108,113,000
Investment and Interest Income	4,294,000
Other Revenues, Penalties, and Fines	<u>3,002,000</u>
Total Fund Revenues	<u>\$115,409,000</u>

Note 1: Workers' Compensation Assessments for fiscal year 1997 totaled \$105.2 million based on Minnesota Accounting and Procurement System balances as of September 26, 1997. The remainder is other penalties and assessments.

Source: State of Minnesota Comprehensive Annual Financial Report for fiscal year 1997.

During fiscal year 1997, the department changed its method of recognizing Special Compensation Fund accounts receivables based on the modified accrual basis of accounting. The department had previously reported all outstanding accounts receivable as assets and revenue in the current period. Accounts receivables are now recognized when measurable and available by the close of the accounting period, or September 26, 1997. Receivables not collected by that date are offset by deferred revenue until funds are received. This change resulted in a decrease to fund balance by \$3.3 million as of June 30, 1997, for prior year receivables which were never collected.

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Our review of workers' compensation assessments was part of our audit of the state's Comprehensive Annual Financial Report for fiscal year 1997. Specifically, we addressed the following questions:

- Did the Department of Labor and Industry, in conjunction with the Department of Finance, measure workers' compensation assessments through the Special Compensation Fund in accordance with generally accepted accounting principles?
- Did the Department of Labor and Industry design internal controls to provide reasonable assurance that revenue was adequately safeguarded and properly recorded in the accounting records and comply with finance-related legal provisions?

In addressing our objectives, we examined the department's internal control structure and its compliance with finance-related legal provisions. We interviewed department employees, reviewed its policies and procedures, observed controls, and tested samples of financial transactions.

Conclusions

We found that the Department of Labor and Industry properly processed and deposited assessment receipts for workers' compensation. Special Compensation Fund financial statement revenues were fairly presented, in all material respects. The department designed internal controls to provide reasonable assurance that revenues were safeguarded and properly recorded in the accounting records. For the items tested, the department materially complied with finance-related legal provisions.

Chapter 3. Workers' Compensation Claims

Chapter Conclusions

Generally, we found that the department designed internal controls to provide reasonable assurance that staff authorized and properly recorded disbursements in the accounting system and complied with finance-related legal provisions for items we tested. The workers' compensation claims were fairly presented in the state's financial statements in accordance with generally accepted accounting principles. However, the department's claim specialists do not follow the policy developed to calculate the long-term liability for ongoing claims. Each specialist calculates the reserve differently.

The Department of Labor and Industry processes workers' compensation claims under a variety of circumstances. Supplemental benefits are reimbursed to insurers for injured workers who have been disabled for at least 208 weeks. Second injury reimbursements are made for injured workers who have an existing disability which has been registered by the employer with the department. The department directly pays workers' compensation for uninsured employers and bankrupt self-insurers and it attempts to recover from the employer. All workers' compensation claim payments are made from the Special Compensation Fund.

Table 3-1 shows a breakdown of types of claims incurred for fiscal year 1997.

Table 3-1
Special Compensation Fund
Workers' Compensation Claims
Fiscal Year 1997

Supplemental benefit reimbursements	\$63,153,631
Second injury benefit reimbursements	20,983,997
Uninsured benefits - Note 1	7,022,753
Other costs	<u>638,830</u>
Total workers' compensation claims	<u>\$91,799,211</u>

Note 1: In accordance with generally accepted accounting principles, the department also recognized a long-term liability of \$41,344,841 for uninsured employees. This liability is presented in the General Long-Term Debt Account Group for the state's fiscal year 1997 financial statements.

Source: Workers' compensation claims as calculated by the Department of Labor and Industry for presentation in the Comprehensive Annual Financial Report published by the Department of Finance for fiscal year 1997.

Our review of workers' compensation claims was part of our audit of the state's financial statements for fiscal year 1997. Specifically, we addressed the following questions:

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- Did the Department of Labor and Industry, in conjunction with the Department of Finance, measure workers' compensation claims payable from the Special Compensation Fund in accordance with generally accepted accounting principles?
- Did the Department of Labor and Industry design internal controls to provide reasonable assurance that claims are authorized, comply with finance-related legal provisions, and are properly recorded in the accounting records?

To address these objectives, we examined certain aspects of the department's internal control structure and its compliance with finance-related legal provisions. We interviewed department employees, reviewed its policies and procedures, tested samples of financial transactions, and recalculated reserve estimates.

Conclusion

Generally, we found that the Department of Labor and Industry designed internal controls to provide reasonable assurance that staff authorized and properly recorded disbursements in the Minnesota Accounting and Procurement System and complied with finance-related legal provisions for items tested. Workers' compensation claims were fairly presented in the state's fiscal year 1997 annual financial statements for the Special Compensation Fund. As discussed in Finding 1, however, department staff inconsistently calculate the general long-term obligation.

1. PRIOR FINDING NOT IMPLEMENTED: The Department of Labor and Industry staff each calculate the general long-term obligation differently.

The department estimates the long-term liability for the costs of ongoing claims of an uninsured or bankrupt employer. The Department of Finance includes this obligation in the financial statements for the General Long-Term Obligation Account Group. The department has five claim specialists preparing the estimates. For temporary partial disability, medical, and rehabilitation benefits, specialists based their calculations on judgment and past history. However, for temporary and permanent total disability benefits, each specialist calculated the general long-term obligation differently. The department had developed a formula each specialist was to use when calculating the reserve. Despite this policy, specialists did not consistently use the formula to determine estimated amounts.

We noted the following specific concerns:

- workers' compensation specialists used three different life expectancy tables;
- inconsistent annual escalator factors were used, some specialists used two percent while others used four percent; and
- some specialists rounded benefits to 52 weeks per year rather than using the precise number of 52.2 weeks designated in the policy.

In order to provide consistency in the presentation of the financial statements, the specialists need to calculate the reserve in accordance with department policy. During our audit, the department began development of a new workers' compensation claims system which should improve the calculation of the reserve for general long-term obligation.

Recommendation

- *The department's Special Compensation Fund specialists should follow the policy established to calculate the reserve for the general long-term obligation.*

Chapter 4. The Computing Environment

Chapter Conclusions

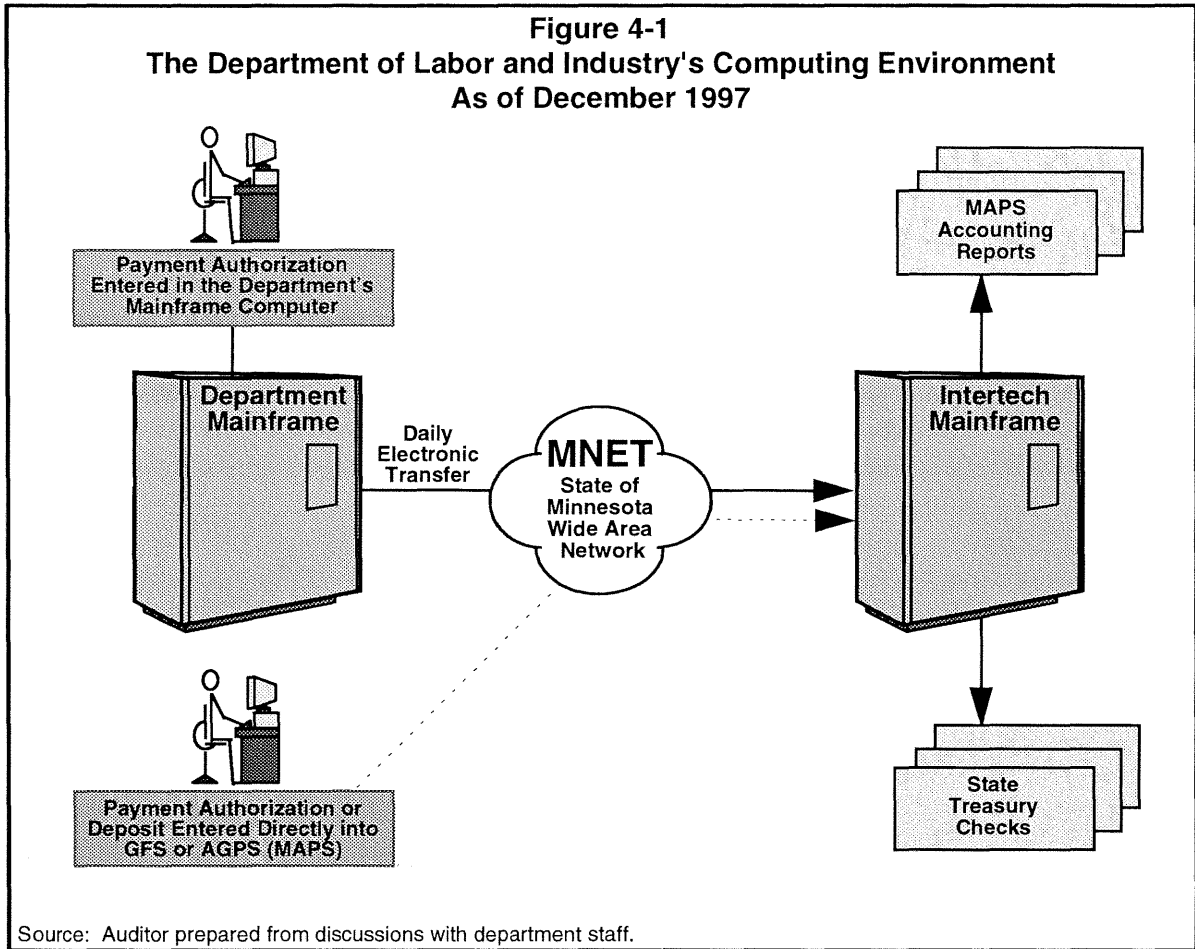
We found that the Department of Labor and Industry has improved the design of its computer access controls. Access to sensitive computer resources and data is being restricted and is based on functional separation of duties. Special Compensation Fund employee security clearances appear reasonable based on their job responsibilities.

The Department of Labor and Industry supports its business operations with a complex computing environment. The department has its own computer and information systems support staff. The primary function of the mainframe system is to manage the various aspects of the state's Workers' Compensation Program.

The department uses the Minnesota Accounting and Procurement System (MAPS) to account for most of its financial activities. MAPS resides on the state's central mainframe computer center, commonly referred to as InterTech. MAPS consists of two separate computerized applications; the Government Financial System (GFS) for accounting and the Advanced Government Purchasing System (AGPS) for purchasing. These two systems work both interactively and independently to account for most of the state's financial activities. The department enters many transactions directly in GFS and AGPS. However, it also electronically interfaces a substantial amount of payment data from its mainframe to MAPS. Figure 4-1 illustrates how MAPS interacts with the department's mainframe.

Controlling access to computer resources and sensitive data is difficult in complex computing environments. To make effective access decisions, the department must determine the data and computer resources necessary for employees to satisfy their job responsibilities. The department must also be familiar with the various security software packages that control access to those computer resources and data. For example, the department runs Unisys MAPPER (Maintain and Prepare Executive Reports) software on its mainframe computer. Unisys MAPPER has its own security module which controls access to the system. The state's central mainframe computers are protected by a different security software package named ACF2. Finally, the GFS and AGPS components of MAPS are each controlled by a software package called CORE. It is necessary for the department to understand all of its security options within these software packages.

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The department has developed procedures to address other important aspects of its computing environment. Periodic backup processes and application software change controls have been designed. The department recently completed a business impact analysis in coordination with the Department of Administration. Management contracted with the Department of Administration to develop a disaster recovery plan for its critical systems and operations.

Audit Scope and Objectives

We reviewed computer access controls as part of our annual financial audit of the Department of Labor and Industry. We focused our work on the business processes of the Special Compensation Fund. Specifically, we attempted to answer the following questions:

- Was the department adequately separating duties through computer access controls for both MAPPER and MAPS transactions?
- Was the department limiting access to computer resources and data to only those employees who need that access to fulfill their job responsibilities?

To answer these questions, we interviewed the department's MAPPER system coordinator and users. The department's chief information officer completed a questionnaire describing applications, processing, and access controls. We also reviewed various MAPPER, MAPS, and

Department of Labor and Industry

ACF2 security reports. Individual units within the Department of Labor and Industry are responsible for making their own MAPPER security decisions. The department's accounting director assigns security clearances for the GFS and AGPS components of MAPS.

Our prior audit highlighted critical risk exposures in access to the department's systems and data. As a result, the department made substantial changes to staff security clearances. Our current audit focused on changes made to security clearances for Special Compensation Fund employees. In the next section of this chapter, we discuss our work done and conclusions reached on MAPPER security administration.

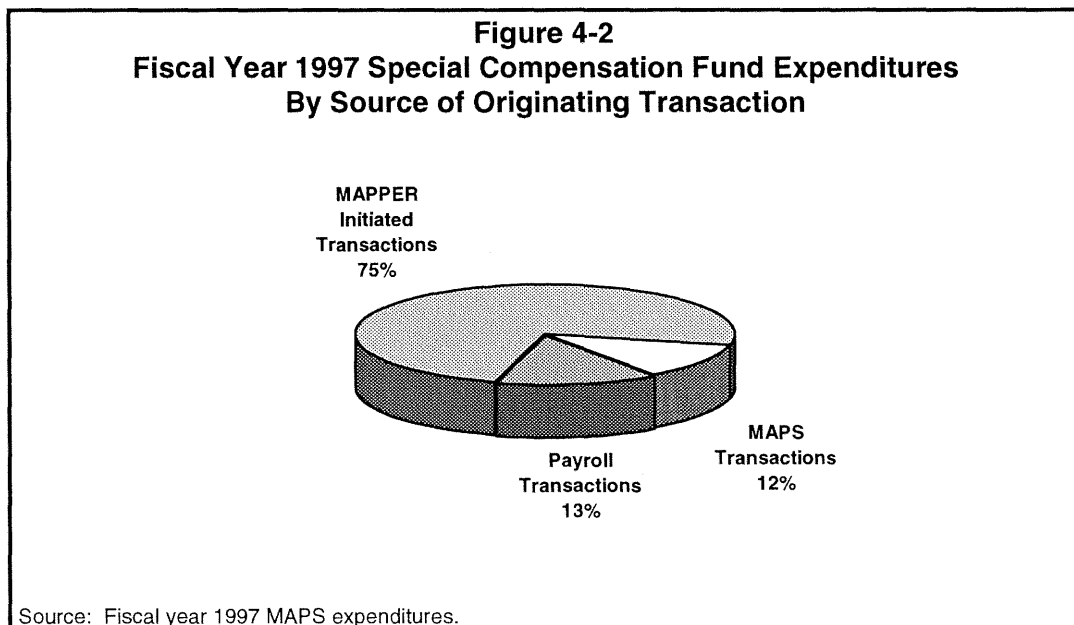
Controlling Access to Computerized Resources and Data

The Department of Labor and Industry must control access to electronic resources and data originating in various computerized systems. Special Compensation Fund revenue comes from a variety of sources, including insurance companies, self-insurance companies, and uninsured companies. This revenue totaled approximately \$114.7 million in fiscal year 1997. The department records detailed receipt transactions in MAPPER and deposits all funds in the state treasury. The department also records the total amount of each deposit in MAPS. Chapter 2 discusses our financial objectives and conclusions on workers' compensation assessments.

Special Compensation Fund expenditures consist primarily of annual reimbursements to insurance companies, benefit payments to claimants, and agency payroll costs. Fund expenditures totaled approximately \$100.5 million in fiscal year 1997. Staff initiate most benefit payment and insurance company reimbursement transactions in MAPPER. The department then electronically transfers these transactions to MAPS, where warrants are generated. For certain transactions, the department must enter benefit payment and insurance company reimbursement transactions directly into both MAPPER and MAPS. The state's central payroll system generates checks for employees and posts payroll expenditures to the fund accounting records in MAPS.

As

Figure 4-2 illustrates, transactions originating in MAPPER accounted for approximately 75 percent of the Special Compensation Fund expenditures in fiscal year 1997.



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Conclusion

We found that the Department of Labor and Industry has restricted access to sensitive computer resources and data based on job responsibilities. Functional separation of duties is being achieved by limiting access for incompatible duties. We determined security clearances were reasonable for employees who access and process Special Compensation Fund transactions and data for the department.

Status of Prior Audit Issues As of December 5, 1997

Most Recent Audits

The March 14, 1997, Legislative Audit Report 97-13 and the February 16, 1996, Legislative Audit Report 96-8 identified many audit issues related to separation of duties and information system access. Separation of duties issues were associated with both the disbursement and receipt processing procedures within the department. The reports identified instances where the department did not separate incompatible accounting functions within each financial cycle. Also, the reports identified instances where the department did not control access to sensitive computer resources and data.

The most recent audit has found the department has resolved these critical control issues. Incompatible accounting functions within disbursement and receipt procedures have been separated. Also, access to sensitive computer resources and data is now controlled.

One unresolved issue concerns the inconsistent calculation of the general long-term obligation estimates. This issue is discussed in Finding 1 of the current report.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the Metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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443 Lafayette Road
St. Paul, Minnesota 55155
612-296-6107
612-297-4198 (TTY)
1-800-DIAL-DLI



World Wide Web address:
www.doli.state.mn.us
E-mail address:
DLI.Commissioner@state.mn.us

February 4, 1998

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

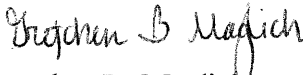
Dear Mr. Nobles:

Thank you for the opportunity to review and comment on the finding addressed in the draft of your audit of Labor and Industry for the fiscal year ending June 30, 1997. This draft report accurately reflects the material that your staff discussed with us at the exit conference on January 28, 1998.

The fiscal year 1997 audit has one finding and recommendation for action. The finding is reasonable and we concur with the recommendation. Enclosed is a summary of your recommendation with our action response.

I would like to thank you and your staff for your review of our operations. The annual audit of our department is an opportunity for operation improvements, and we view it as a healthy learning experience.

Sincerely,


Gretchen B. Maglich
Commissioner

GBM/cf/jk

Enclosure

Prior finding not implemented: The Department of Labor and Industry staff each calculates the general long-term obligation differently.

Recommendation:

- *The department's Special Compensation Fund specialists should follow the policy established to calculate the reserve for the general long-term obligation.*

Action Response: In response to the FY 1996 Legislative Auditor's report all of the Special Compensation Fund claims administrators were instructed to utilize the reserve worksheet which had been developed in January 1995. The worksheet specifically instructed staff to use a set formula of 52.2 weeks multiplied by the weekly compensation rate and the employee's life expectancy, multiplied by a 4% escalator representing the annual cost-of-living increase. The formula was modified for the following year's reserves to accommodate the 1995 statutory limitation to 2% annual increases. Other factors of the formula remained the same. This change was implemented via internal e-mail. No hard copy of the formula was distributed.

The department does not distribute life expectancy tables to all units. Typically the Special Compensation Fund staff has used the U.S. Life Expectancy Table. The source of this table is the U.S. Public Health Service based on a compilation of data from surveys. The table is distributed by the Minnesota Department of Commerce. Some claims administrators, however, had been relying on a life expectancy table provided by a former employee of the department.

Under the direction of Brandon Miller, Director, the Special Compensation Fund is currently installing a claims management software program which will require files to have monies reserved prior to payment of benefits. The standard formula for calculating the reserves cannot be modified by department staff. The formula program incorporates statutory changes to limits on benefits and annual increases, is based on 52 weeks per year and utilizes one life expectancy table. It will keep a cumulative total on remaining reserves and future liability for claims. It will automatically assign one amount to all "medical-only" claims. All increases in reserves beyond a specified limit will require the approval of the claims supervisor. Upon implementation of the software program, reserves must be set immediately to allow for payment of benefits. Reserves must also be set upon acceptance of a claim. Payments will not be permitted by the system unless sufficient reserves are on file. This system will be implemented by March 1, 1998, and used to determine the long-term obligation beginning with the fiscal year 1998 annual financial statements.