



STATE OF NORTH CAROLINA

EMPLOYMENT SECURITY COMMISSION

STATEWIDE FINANCIAL STATEMENT AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2010

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

EMPLOYMENT SECURITY COMMISSION

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State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Beverly Eaves Perdue, Governor
Members of the North Carolina General Assembly
Mrs. Lynn R. Holmes, Chairman
Employment Security Commission

We have completed certain audit procedures at the Employment Security Commission related to the State of North Carolina reporting entity as presented in the *Comprehensive Annual Financial Report (CAFR)* and *Single Audit Report* for the year ended June 30, 2010. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

In the *CAFR*, the State Auditor expresses an opinion on the State's financial statements. In the *Single Audit Report*, the State Auditor presents the results of tests of internal control and compliance with laws, regulations, contracts, and grants applicable to the State's financial statements. Our audit procedures were conducted in accordance with 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.

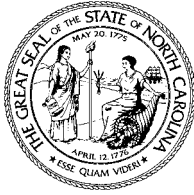
Our audit objective was to render an opinion on the State of North Carolina's financial statements and not the Commission's financial statements. However, the report included herein is in relation to our audit scope at the Commission and not to the State of North Carolina as a whole.

The audit findings referenced in the report are also evaluated to determine their impact on the State's internal control and the State's compliance with rules, regulations, contracts and grants. If determined necessary in accordance with *Government Auditing Standards*, these findings are reported in the State's *Single Audit Report*.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor



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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Mrs. Lynn R. Holmes, Chairman
and Management of the Employment Security Commission

As part of our audit of the State of North Carolina's financial statements, we have audited selected elements of the Employment Security Commission's financial statements, as of and for the year ended June 30, 2010. Our report on the State of North Carolina's financial statements is included in the State's *Comprehensive Annual Financial Report*. Our financial statement audit scope at the Employment Security Commission included the following:

- Enterprise Fund - Unemployment Compensation Fund

The audit results described below are in relation to our audit scope at the Commission and not to the State of North Carolina as a whole.

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 *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Commission's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the State's financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Commission's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Commission's internal control over financial reporting.

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 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or 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.

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS (CONCLUDED)**

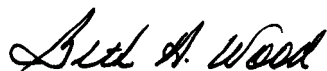
Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses, and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, we consider the deficiency described in finding 3 in the Audit Findings and Responses section of this report to be a material weakness in internal control over financial reporting, as defined above. Furthermore, we consider the deficiencies described in findings 1 and 2 in the Audit Findings and Responses section of this report to be significant deficiencies in internal control over financial reporting, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State's financial statements are free of 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 an instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in finding 3 in the Audit Findings and Responses section of this report.

Management's responses to the findings identified in our audit are included in the Audit Findings and Responses section of this report. We did not audit the responses, and accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, Commission Chairman Holmes, others within the entity, the Governor, the General Assembly, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.



Beth A. Wood, CPA
State Auditor

December 8, 2010

AUDIT FINDINGS AND RESPONSES

Matters Related to Financial Reporting

The following findings and recommendations were identified during the current audit and discuss conditions that represent deficiencies in internal control and/or noncompliance with laws, regulations, contracts, or grants.

1. INAPPROPRIATE INFORMATION SYSTEM ACCESS

The Employment Security Commission allowed employees to have system access rights that were not necessary for their assigned job functions. As a result, there is an increased risk of errors and fraudulent transactions. We noted the following access deficiencies:

- In the prior year audit, we identified employees with one or more instances of inappropriate update access rights to the unemployment insurance tax and/or unemployment insurance benefits systems. Of the over 4,000 instances found, most remained uncorrected as of the end of the 2010 fiscal year. These improper access rights allowed various users the ability to manipulate data impacting employer contribution rates and amount of benefits paid, as well as access to confidential information.
- We identified 18 instances where users were assigned multiple user names in error by the Commission's information systems help desk.

Additionally, the Commission did not have a designated information technology security officer that would be responsible for defining and enforcing information technology security policies and procedures, including ensuring proper reviews of system access rights. The Commission designated someone to this position after the end of the fiscal year.

Maintaining proper access controls over computer systems helps protect the confidentiality and integrity of information by preventing alteration, unauthorized use, or loss of data. Statewide information technology standards specify that system access be controlled and prescribe procedures such as documented reviews of users' rights.

Significant aspects of this finding were reported in the prior year.

Federal Award Information: Unemployment Insurance - funding from the State and Federal Unemployment Trust Funds.

Recommendation: The Commission should continue to improve internal controls and emphasize security policies to ensure periodic security reviews are conducted and personnel are granted only the necessary system access to perform their job duties.

Agency Response: The Commission has implemented corrective action and will continue to improve internal controls over information system access. Corrective action was completed December 1, 2010.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

The ESC Help Desk distributes a RACF access listing on a quarterly basis. Managers and supervisors are required to review this report and certify that the employees under their supervision require the stated clearances to perform their job duties. Unneeded clearances may be deleted by so indicating on the report. Any additional clearances must be requested by the manager via the Network User Request (NUR) process.

The ESC Help Desk distributes a RACF access listing to data owners on a semi-annual basis. Data owners are required to review this report and confirm that the employees listed require the stated clearances to perform their job duties. Unneeded clearances are to be deleted in accordance with the "Revision to RACF Data Access Policy and Procedure" issued on October 8, 2010. When coupled with the quarterly RACF review, this process provides an access cross check and verification process.

The instances of inappropriate access identified by the auditors have been corrected. The ESC Help Desk will run additional checks prior to the issuance of new user IDs to preclude the erroneous assignment of multiple user IDs to the same employee. The Help Desk also will conduct periodic reviews to assure the process is working as designed.

2. WEAKNESSES NOTED IN CASH RECONCILIATION PROCESS

The Employment Security Commission did not fully reconcile the cash balance in its accounting records to the balance in the bank. Failure to properly reconcile accounts and resolve outstanding items may lead to unrecorded or improperly recorded transactions, resulting in financial reporting errors and possibly misappropriations that go undetected.

The Commission's reconciliation for the State Treasurer account begins with the bank balance but only reconciles to a daily recap spreadsheet of checks written, cancelled, cleared, and voided. It does not clearly reconcile to the balance in the accounting records.

The reconciliations have several reconciling items that have been outstanding for months and even years. In addition the State Treasurer account reconciliation as of June has unspecified reconciling variances for each month of the fiscal year, with the highest difference exceeding \$54,000. Also, the U.S. Treasury account reconciliation as of June had a \$166,000 amount that could not be reconciled and a \$319,000 reconciling item that had not cleared since October 2008.

Additionally, the Commission maintains numerous manual spreadsheets on a daily basis to track the flow of cash, support the monthly entries to the accounting records, and to reflect the cash balance for the monthly reconciliations. We identified multiple occasions where the underlying spreadsheets did not clearly support the entries posted to the accounting records. In these cases, agency personnel had identified revisions that were necessary before the amounts were posted; however, the supporting spreadsheets were not updated to clearly explain why the changes were necessary. The inconsistencies

AUDIT FINDINGS AND RESPONSES (CONTINUED)

noted impact the cash balance and potentially contribute to the numerous reconciling items in the month-end reconciliations.

Aspects of this finding were reported in the prior year.

Federal Award Information: Unemployment Insurance - funding from the State and Federal Unemployment Trust Funds.

Recommendation: The Commission should implement internal controls to ensure that complete and proper reconciliations are performed. Management should also implement a workflow that allows for consistent recording and maintenance of source documentation. Management should dedicate the necessary resources to ensure that balances in the accounting records are clearly reconciled to the bank balances and that reconciling items are properly investigated and resolved.

Agency Response: Management is reviewing internal controls to ensure complete and proper reconciliations are performed and adjustments are made timely.

The Commission is developing an automated workflow process which will be more efficient, eliminate errors, and provide consistent recording and maintenance of source documentation.

3. COMPUTER PROGRAMMING RESULTED IN PAYMENTS FROM INCORRECT FUNDING SOURCE

The unemployment benefits system was not programmed to ensure second year unemployment benefits were appropriately determined and expended from the proper funding source. This resulted in \$147 million of new unemployment insurance claims being paid from the State unemployment trust fund when the recipient should have continued to receive benefits under previous benefit programs paid with federal unemployment trust funds or federal recovery funds.

The problem was identified in late December 2009 by federal reviewers; however, the Commission did not implement changes in the benefits system until May 2010. Reports to determine the amount of improper payments paid from January through May 2010 were not generated until September 2010, after fiscal year-end closing. As a result, the year-end financial information prepared by the Commission and submitted to the Office of the State Controller contained a material misstatement that was corrected as a result of our audit adjustment.

Since the State unemployment trust fund had been depleted and the State was in a borrowing status to pay benefits, the problem caused the revolving line of credit liability to be overstated by \$147 million with a corresponding understatement in federal intergovernmental receivables. This adjustment also impacted several notes to the financial statements as well as the cash flow statement. Additionally, the presentation of federal expenditures on the Schedule of Expenditure of Federal Awards and notes thereto were impacted by the change in funding source.

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

The Commission is responsible for compliance with program payment requirements and the fair presentation of its financial statements; therefore, it is essential that effective internal control over program changes be established to provide reasonable assurance regarding the reliability of financial data and the preparation of financial statements.

Federal Award Information: Unemployment Insurance - funding from the State and Federal Unemployment Trust Funds.

Recommendation: The Commission should enhance internal controls to ensure that programming changes are in accordance with regulations. Future system corrections should be made timely to ensure amounts are correct for presentation in the financial statements.

Agency Response: The Commission will review and develop additional internal controls over the process for implementing changes/revisions of benefit payment requirements to ensure programming changes are made timely and in accordance with regulations so that benefit payments are paid from the correct funding source.

The Unemployment Insurance (UI) Division submitted a Service Request on January 13, 2010, to Information Systems to provide assistance in identifying and implementing additional programming verification(s) to ensure federal compliance. These changes were implemented in phases from May to September 2010. The UI Division is in agreement and supports recommendations made in the findings.

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