



STATE OF NORTH CAROLINA

EMPLOYMENT SECURITY COMMISSION

STATEWIDE FEDERAL COMPLIANCE AUDIT PROCEDURES

FOR THE YEAR ENDED JUNE 30, 2009

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

EMPLOYMENT SECURITY COMMISSION

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AUDITOR'S TRANSMITTAL

The Honorable Beverly Eaves Perdue, Governor
Members of the North Carolina General Assembly
Ms. Lynn 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 *Single Audit Report* for the year ended June 30, 2009. Our audit was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes*.

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 major federal programs. Our audit procedures were conducted in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, issued by the Comptroller General of the United States and the Single Audit Act.

Our audit objective was to render an opinion on the State of North Carolina's administration of major federal programs and not the Commission's administration of major federal programs. 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* or the Single Audit Act, 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
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**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH
MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE
IN ACCORDANCE WITH OMB CIRCULAR A-133**

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

Compliance

As part of our audit of the State of North Carolina's compliance with the types of requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs for the year ended June 30, 2009, we have performed audit procedures at the Employment Security Commission. Our report on the State of North Carolina's compliance with requirements applicable to each major program and on internal control over compliance in accordance with OMB Circular A-133 is included in the State's *Single Audit Report*. Our federal compliance audit scope at the Employment Security Commission included the following:

- CFDA 17.225 – Unemployment Insurance
- Employment Service Cluster
 - CFDA 17.207 – Employment Service / Wagner-Peyser Funded Activities
 - CFDA 17.801 – Disabled Veterans' Outreach Program (DVOP)
 - CFDA 17.804 – Local Veterans' Employment Representative (LVER) Program
- Workforce Investment Act (WIA) Cluster
 - CFDA 17.258 – WIA Adult Program
 - CFDA 17.259 – WIA Youth Activities
 - CFDA 17.260 – WIA Dislocated Workers

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 of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the

**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH
MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE
IN ACCORDANCE WITH OMB CIRCULAR A-133 (CONTINUED)**

United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of compliance with those requirements.

The results of our audit procedures at the Commission disclosed instances of noncompliance that are required to be reported in accordance with OMB Circular A-133 and which are described in findings 1, 2, and 5 in the Audit Findings and Responses section of this report.

Internal Control Over Compliance

Management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A control deficiency in an entity's internal control over compliance 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 noncompliance with a type of compliance requirement of a federal program on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in all of the findings in the Audit Findings and Responses section of this report to be significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of

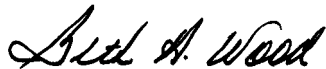
**REPORT ON COMPLIANCE WITH REQUIREMENTS APPLICABLE TO EACH
MAJOR PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE
IN ACCORDANCE WITH OMB CIRCULAR A-133 (CONCLUDED)**

compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the Audit Findings and Responses section of this report, we consider findings 1 and 5 to be material weaknesses.

We noted certain other matters related to compliance with federal requirements or internal control over compliance that we reported to management of the Commission in a separate letter dated March 3, 2010.

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, and 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

March 17, 2010

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AUDIT FINDINGS AND RESPONSES

Matters Related to Federal Compliance Objectives

1. ERRORS NOTED IN THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

The Commission failed to prepare the Schedule of Expenditures of Federal Awards (SEFA) in compliance with guidelines prescribed by OMB Circular A-133, which resulted in several errors. Errors on the SEFA reduce the usefulness of the report to the users.

The OMB Circular A-133 requires the reporting of all actual expenditures for the year and the specific identification of expenditures by federal program. Additionally, OMB guidance requires recipients of federal awards under the American Recovery and Reinvestment Act (ARRA) to separately identify the expenditures of ARRA awards on the SEFA. Our tests identified the following errors:

- a. The emergency unemployment compensation benefit payments authorized under the ARRA were not reported separately for CFDA 17.225 - Unemployment Insurance. The Commission estimates that these expenditures totaled \$162.7 million through June 30, 2009.
- b. Errors in the accounting records caused the unemployment insurance federal additional compensation (FAC) expenditures under ARRA to be overstated by \$4.2 million.
- c. The Commission failed to include \$211,738 of direct expenditures of WIA - Dislocated Worker - National Reserve - Technical Assistance and Training, which understated total expenditures for CFDA 17.260.
- d. The Trade Assistance Program (TAP) expenditures were incorrectly included in the expenditures reported for CFDA 17.804 - Local Veterans' Employment Representative Program (LVER). The \$86,568 in TAP expenditures should have been reported as CFDA 17.807, as directed by the federal compliance supplement.
- e. Expenditures were misallocated, which resulted in a \$47,209 understatement for the Employment Service Cluster and an equal overstatement for the Workforce Investment Act Cluster.
- f. Incentive Grants expenditures for \$2,097 were improperly classified as part of the Workforce Investment Act (WIA) Cluster. According to the federal compliance supplement, these expenditures are not part of the WIA Cluster and should be classified as CFDA 17.267 expenditures.

It is essential that effective internal control over the preparation of the SEFA be established to provide reasonable assurance that expenditures are accurate and presented in accordance with federal guidelines.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

Federal Award Information: CFDA 17.207 - award # ES-17573-08-55-A-37; CFDA 17.804 - award # E-9-5-9-5060; CFDA 17.225 - unemployment insurance funding from the Federal Unemployment Trust Fund; CFDA 17.260 - award # MI-17470-08-60-A-37 and MI-16959-07-60-A-37. This finding affects funds administered under the American Recovery and Reinvestment Act.

Recommendation: The Commission should strengthen internal controls over the preparation of the Schedule of Expenditures of Federal Awards to ensure that federal expenditures are properly identified and reported in accordance with federal guidelines.

Agency Response: The Commission will strengthen its review of the Federal Awards documentation to insure that the proper CFDA #'s are recorded on the Schedule of Expenditures of Federal Awards.

2. CHANGES TO UNEMPLOYMENT INSURANCE BENEFITS PAYMENT SYSTEM NOT PROPERLY IMPLEMENTED

The Commission failed to implement all changes required by the American Recovery and Reinvestment Act (ARRA) in the unemployment insurance benefit payment program. Failure to implement the required changes causes the Commission to be out of compliance with federal requirements. In addition, other program changes were not fully tested prior to placing them into production, resulting in overpayments, payments to ineligible claimants, and incorrect denials.

The Commission did not implement programming changes to identify overpayments for federal additional compensation (FAC) payments. As such, no attempts have been made to recover overpayments for FAC as required by the ARRA. The Commission estimated that FAC overpayments may be in excess of \$689,000 for fiscal year 2009.

An analysis of benefit payments from March until June 2009 identified 49 instances of duplicate payments. These duplicate payments consisted of unemployment benefits of \$10,445 plus \$1,225 in federal additional compensation. The federal government implemented several changes to the benefit payment structure that ultimately allowed benefit payments to exceed the normal 52-week benefit-year. This allowed multiple benefit-years to be established for unemployed individuals. The benefit payment system did not have an edit check to prevent the system from making multiple payments for the same benefit week in different benefit years. We are questioning the \$11,670 in duplicate payments.

In addition to the above noted deficiencies, several changes to the system to implement new or enhanced benefit payments caused monetary redeterminations that erroneously identified benefit payments as overpayments and improperly paid recipients for the waiting period week. Additionally, the extension of benefits was improperly programmed for 20.8 weeks and should have been 20 weeks. These implementation problems were evidenced by spikes in the overpayment counts ranging from 3,000 to 20,000 instances.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

The Commission was under pressure from the federal agency and unemployed citizens to quickly implement and make payments to eligible claimants. Additionally, the Commission has indicated that there are only two programmers experienced enough with the unemployment insurance benefit system to develop these types of changes.

Federal Award Information: Unemployment Insurance – funding from the Federal Unemployment Trust Fund. This finding affects funds administered under the American Recovery and Reinvestment Act.

Recommendation: The Commission should implement procedures to ensure that changes to the unemployment insurance benefit program are thoroughly evaluated, properly developed, and tested prior to implementation to prevent erroneous payments. The Commission should implement appropriate edit checks in the benefit payment system to prevent duplicate payments. Also, programming should be implemented to identify federal additional compensation overpayments and begin recovering those overpayments.

Agency Response: The Commission currently employs procedures to ensure that changes to the unemployment insurance benefit program are evaluated, properly developed and tested prior to implementation. The Commission will work to further strengthen these procedures to minimize erroneous payments.

The Commission will strengthen employee training in the use of the benefits payment system to prevent duplicate payments.

Programming is under development to identify federal additional compensation overpayment and begin recovery of such overpayments.

3. WEAKNESSES IN GENERAL PROGRAM CHANGE CONTROLS

The Commission does not have adequate standardized program change control policies and procedures nor formal naming conventions in place for programmers. This increases the risk of improper, incomplete, untested, or undocumented changes being made and the inability to identify changes or datasets of a particular system.

The Commission has a draft document to be used by programmers as guidance for initiating, documenting, and gaining approval for program changes, but it is incomplete and has not been implemented. Programmers use program change utilities to a certain extent to track and document program changes. However, there are no set standards for the level and type of detailed information to be included in the change utilities, which leads to inconsistencies in how program changes are documented and processed. Additionally, the Commission does not fully utilize the existing program change and approval tracking functionality of the utilities, but instead relies on a hard copy paper form to track requests from beginning to end. The form is routed through various areas of the user and information system sections and may not always reflect the timeframe a change occurs.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

Additionally, the Commission has not adopted a formal naming convention to be used by programmers and other information system staff in naming critical program files, related changes, and data files throughout the organization. Inconsistent application of naming conventions makes it difficult, or nearly impossible, to implement data classification such that only authorized access is assigned to data with sensitive information such as social security numbers. Also, auditors were unable to obtain a listing of all program changes made during fiscal year 2009 because inconsistent naming conventions made it impossible to be certain which changes were associated with an individual system.

The Statewide Information System Security Manual requires state agencies to develop and enforce formal change control procedures which would include naming conventions. Without proper procedures, there is an increased risk that improper, incomplete, untested, undocumented, or unauthorized changes could be made to critical systems. This weakness was potentially a factor in the numerous errors and overpayments in unemployment benefits noted during the year.

This finding was also reported in the November 2008 Information Systems General Controls audit.

Federal Award Information: Unemployment Insurance – funding from the Federal Unemployment Trust Fund. This finding affects funds administered under the American Recovery and Reinvestment Act.

Recommendation: The Commission should adopt formal program change control policies and procedures, including standardized naming conventions, to ensure that changes are properly documented, tested, and approved. Additionally, the Commission should evaluate functionality of the program change utilities to ensure they are used effectively and consistently.

Agency Response: The IS Director has met with the Deputy Chairman to request the resources necessary to finalize and implement the draft Change Control Policies and Procedures document in accordance with the availability of funds and staff resources. The request has been approved.

4. EXTENDED BENEFITS PAYMENTS DRAWN FROM IMPROPER FUNDING SOURCE

The Commission did not draw down the federal funds that it was entitled to for extended benefit payments. There is increased cost to the State when federal funds are not drawn down for allowable expenditures. When controls are not in place to ensure that funds are drawn from the proper source, the risk of drawing down federal funds improperly increases.

The American Recovery and Reinvestment Act changed extended benefits from being 50% federally funded to 100% federally funded in February 2009. The change was implemented in the benefits payments system; however, the report used to determine the amount to be drawn from the federal unemployment trust fund did not reflect the new

AUDIT FINDINGS AND RESPONSES (CONTINUED)

funding source correctly. Therefore, funds to cover extended benefit payments in the amount of \$6.3 million were incorrectly drawn from the state's unemployment trust fund rather than the federal trust fund from March until June 2009.

After the auditors brought this to the Commission's attention, adjustments were made to draw the federal funds to reimburse the State's trust fund.

Federal Award Information: Unemployment Insurance – funding from the State and Federal Unemployment Trust Funds. This finding affects funds administered under the American Recovery and Reinvestment Act.

Recommendation: The Commission should strengthen internal controls to ensure funds are drawn from the proper funding source to pay unemployment insurance benefits.

Agency Response: The Commission drew down funds against the funding source that was indicated on the check register. A programming review resulted in a redistribution of charging which switched the funding sources. Efforts will be made to ensure that programming reviews are made on a timely basis.

5. NONCOMPLIANCE IN UNEMPLOYMENT INSURANCE REPORTING

Errors and omissions were noted on the Commission's unemployment insurance financial reports. Errors in these reports reduce the usefulness of the data to the users. The following issues were noted:

- The Commission failed to report emergency unemployment compensation funded through the American Recovery and Reinvestment Act (ARRA) separately in the comments section of the ETA 2112 *UI Financial Summary* report as prescribed by instructions from the federal agency. This occurred on the April, May, and June 2009 monthly reports with an estimated \$162.7 million not being reported as ARRA expenditures.
- An accounting error overstated expenditures associated with the federal additional compensation payments. This caused expenditures on the April, May, and June 2009 monthly ETA 2112 *UI Financial Summary* reports to be overstated by a total of \$4.2 million.
- According to the federal ETA Unemployment Insurance Reporting handbook, the quarterly ETA 227 *Overpayment Detection and Recovery Activities* reports are due by the first day of the second month following quarter-end. We noted that all quarters during 2009 were filed late and the June 2009 report still had not been filed as of February 2010.

Federal Award Information: CFDA 17.225 – Unemployment Insurance - award # UI-18032-09-55-A-37; Unemployment Insurance – funding from the Federal Unemployment Trust Fund. This finding affects funds administered under the American Recovery and Reinvestment Act.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

Recommendation: The Commission should enhance internal controls over reporting to ensure expenditures are properly reported and reports are filed timely in accordance with federal guidelines.

Agency Response: The Commission will conduct a review of reporting requirements and monitor changes to those requirements so that the appropriate information is being reported on a timely basis and in accordance with federal guidelines.

6. DEFICIENCIES NOTED IN THE BENEFIT PAYMENT QUALITY CONTROL PROCESS

Controls were not in place to ensure that all cases referred to the benefit payment quality control unit were properly investigated or completed within the required time. These deficiencies increase the risk that potential overpayments due to errors or fraud will go undetected. The following deficiencies were noted:

- There is no evidence of a second or supervisory review of cases to ensure the cases were properly investigated and appropriate action was taken to close the case.
- Documentation is not maintained for all cases by investigators. Documentation is only maintained for cases resulting in prosecution for fraud.
- The Benefits Audit Reporting Tracking System (BARTS) was implemented in April 2009 to replace the existing system. However, the BARTS does not provide the necessary aging and tracking reports to sufficiently monitor that cases are assigned, processed, and completed in 90 days in accordance with the Commission's internal policy.

In addition to limited reporting capabilities, there are deficiencies in the data being obtained from the BARTS:

- In a listing of 1,777 cases for the time period of April – June 2009, 118 duplicate cases were noted.
- Seven cases were listed as being assigned to a P.O. Box rather than an investigator. It was unclear whether these cases were routed to an investigator and properly investigated.
- The system was queried to return a report listing all cases worked by a particular individual for the three-month period. The results showed no cases for the individual when in fact the individual was known to have worked several cases during the period.

Federal Award Information: Unemployment Insurance – funding from the State and Federal Unemployment Trust Funds. This finding affects funds administered under the American Recovery and Reinvestment Act.

AUDIT FINDINGS AND RESPONSES (CONTINUED)

Recommendation: The Commission should implement controls to ensure the benefit overpayment cases are assigned, monitored, and completed appropriately and in a timely manner. Additionally, enhancements to the new tracking system should be made to ensure the necessary reports are available for management to monitor case processing.

Agency Response: The Commission will implement controls to ensure proper benefit overpayment case monitoring is conducted in a timely manner and enhance our new tracking system to ensure management reports are available for monitoring case processing.

7. CONTROL WEAKNESSES OVER EQUIPMENT INVENTORY

Deficiencies were noted in the Commission's control procedures over equipment purchased with Wagner-Peyser grant funds, resulting in an increased risk that assets will not be properly maintained or safeguarded.

Tests of the physical inventory records revealed two missing assets, and there were no records to support that the assets were transferred to surplus or another location. The notification of property transfer forms were not properly completed and maintained to evidence that the asset was picked up by support services for surplus in accordance with Commission policy. Additionally, missing asset forms were not completed as prescribed by statewide physical inventory policy.

Findings for weaknesses related to equipment have been reported for seven consecutive years.

Federal Award Information: Employment Services Cluster - CFDA 17.207 - Employment Service/Wagner-Peyser Funded Activities - award number ES-17573-08-55-A-37.

Recommendation: The Commission should enhance its procedures related to the accounting for equipment inventory items to ensure that assets are safeguarded and proper documentation should be maintained to support the transfer of assets.

Agency Response: The Commission will continue with its efforts to improve and strengthen its accounting for equipment inventory items. While a great amount of effort and improvement has been made in this area, we will continue our resolve to properly safeguard and document the transfer of our assets.

8. INSUFFICIENT DOCUMENTATION NOTED IN WORKFORCE INVESTMENT ACT CASE FILES

The Workforce Investment Act (WIA) case files did not contain sufficient documentation to provide evidence of eligibility or support the increased training costs for participants. This condition increases the risk that services will be provided to ineligible individuals.

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

Our tests of 60 participants' case files revealed the following:

- Three participants' case files did not have sufficient documentation to clearly support the participant's eligibility status. Documents that were not in the files included (1) the initial eligibility approval, (2) verification of the participant's underemployment, and (3) proof of a participant's dislocated worker status. By reviewing information outside the case file, we determined that the participants were eligible for WIA services. The WIA Application Guide requires that documentation be obtained and maintained that provides proof of the eligibility status.
- The case file for one dislocated worker did not have evidence of the approval for additional training costs. The authorization was in the Workforce Program Entitlement System, but not in the case file. The increase must be approved and signed by both the case manager and participant and included in the case file in accordance with the Commission's policies and procedures.

Federal Award Information: Workforce Investment Act Cluster pass-through funding from Local Workforce Investment Boards through contracts with local employment security offices. Specifically, Local Board contract numbers: 08-2020-54-9900 with Regional Consolidated Partnership; 07-2020-45-9900 with Mid-Carolina; 07-2030-36-9900 with Centralina; and 07-2030-40-9900 with Eastern Carolina. This finding affects funds administered under the American Recovery and Reinvestment Act.

Recommendation: The Commission should implement policies and procedures to ensure proper documentation is obtained and maintained in participants' case files to support eligibility and allowance for service costs.

Agency Response: The Commission will review policies, procedures and program issuances with employees to ensure proper documentation is obtained and maintained in participants' case files to support eligibility and allowances for service costs.

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