Audit Results From
CAFR and Single Audit Procedures

Department of Labor and Workforce Development

For the Year Ended
June 30, 2005

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

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Department of Labor and Workforce Development
For the Year Ended June 30, 2005

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Department of Labor and Workforce Development
For the Year Ended June 30, 2005

EXECUTIVE SUMMARY

Findings

FINDING 1 The Director of Information Services approved the purchase of over $2 million of computer equipment using an unreliable inventory system and failed to report the resulting error to his supervisor. At June 30, 2005, 228 computers costing $352,210 were not being used in the Unemployment Insurance program that funded the purchase.

FINDING 2 The Assistant Director of Unemployment Benefit Operations and Technical Services failed to establish controls to provide for monitoring the preparation of the federal reports for the Trade Adjustment Assistance program. The performance reports on program participants were not reviewed for accuracy by someone other than the preparer and because of significant errors, federal employees requested that the department resubmit Trade Act Participant Report files for the last three quarters of fiscal year ending June 30, 2005.

This report addresses reportable conditions in internal control and noncompliance issues found at the Department of Labor and Workforce Development during our annual audit of the state's financial statements and major federal programs. For the complete results of our audit of Tennessee, please see the State of Tennessee *Comprehensive Annual Financial Report* for the Year Ended June 30, 2005, and the State of Tennessee *Single Audit Report* for the year Ended June 30, 2005. The scope of our audit procedures at the Department of Labor and Workforce Development was limited. During the audit for the year ended June 30, 2005, our work at the Department of Labor and Workforce Development focused on the Employment Security Trust Fund, a major fund in the *Comprehensive Annual Financial Report* of the State of Tennessee. Our audit of the fund included determining whether the department had an adequate system of internal control over financial reporting. We also performed certain audit procedures to obtain reasonable assurance about whether the State of Tennessee's financial statements were fairly presented. In addition, our work at the Department of Labor and Workforce Development focused on three major federal programs: Workforce Investment Act Cluster, Unemployment Insurance, and Trade Adjustment Assistance_Workers. We audited these federally funded programs to determine whether the department complied with certain federal requirements and whether the department had an adequate system of internal control over the programs to ensure compliance. Management's response is included following each finding.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

April 18, 2006

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable James G. Neeley, Commissioner
Department of Labor and Workforce Development
Andrew Johnson Tower, 8th Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith are the results of certain limited procedures performed at the Department of Labor and Workforce Development as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2005, and our audit of compliance with the requirements described in the U.S. Office of Management and Budget Circular A-133 Compliance Supplement.

Our review of management's controls and compliance with laws, regulations, and the provisions of contracts and grants resulted in certain findings which are detailed in the Findings and Recommendations section.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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December 20, 2005

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have performed certain audit procedures at the Department of Labor and Workforce Development as part of our audit of the financial statements of the State of Tennessee as of and for the year ended June 30, 2005. The scope of our work included the Employment Security Trust Fund, a major fund in the *Comprehensive Annual Financial Report* of the State of Tennessee. Our objective was to obtain reasonable assurance about whether the State of Tennessee's financial statements were free of material misstatement. We emphasize that this has not been a comprehensive audit of the Department of Labor and Workforce Development.

We also have audited certain federal financial assistance programs as part of our audit of the state's compliance with the requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement. The following table identifies the State of Tennessee's major federal programs administered by the Department of Labor and Workforce Development. We performed certain audit procedures on this program as part of our objective to obtain reasonable assurance about whether the State of Tennessee complied with the types of requirements that are applicable to each of its major federal programs.

**Major Federal Program Administered by the
Department of Labor and Workforce Development
For the Year Ended June 30, 2005
(in thousands)**

CFDA Number	Program Name	Federal Disbursements
17.225	Unemployment Insurance	$490,477
17.245	Trade Adjustment Assistance_Workers	$23,475
17.258 17.259 17.260	Workforce Investment Act Cluster	$51,672

Source: State of Tennessee's Schedule of Federal Financial Assistance for the year ended June 30, 2005.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards contained in Government Auditing Standards, issued by the Comptroller General of the United States.

We have issued an unqualified opinion, dated December 20, 2005, on the State of Tennessee's financial statements for the year ended June 30, 2005. We will issue, at a later date, the State of Tennessee *Single Audit Report* for the same period. In accordance with Government Auditing Standards, we will report on our consideration of the State of Tennessee's internal control over financial reporting and our tests of its compliance with certain laws, regulations, and provisions of contracts and grants in the *Single Audit Report*. That report will also contain our report on the State of Tennessee's compliance with requirements applicable to each major federal program and internal control over compliance in accordance with OMB Circular A-133.

As a result of our procedures, we identified certain internal control and/or compliance issues related to the major federal programs at the Department of Labor and Workforce Development. Those issues, along with management's response, are described immediately following this letter. We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Labor and Workforce Development's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

FINDINGS AND RECOMMENDATIONS

1. <u>The Director of Information Services approved the purchase of over $2 million of computer equipment using an unreliable inventory system and failed to report the resulting error to his supervisor; thereby, failing to mitigate the risk that an improper number of computers would be ordered</u>

Finding

The Director of Information Services approved the purchase of 1,638 computers, operating software for the computers, and 227 printers for the Employment Security Division in the fall of 2003, without properly determining the number actually needed. The total cost of the equipment and software amounted to $2,781,392.83. As a result of the inadequate analysis, the department ended up reassigning 230 computers and 77 printers to other divisions in the department beginning in July 2004. Seventeen of the 230 were reassigned after June 30, 2005; and there were still 210 computers at December 31, 2005, that had not been reassigned because they were not needed in any division in the department. The director did not report the error to his supervisor, the Deputy Commissioner. Instead, one of the Commissioner's assistants discovered the error in May 2005, approximately one and a half years later. The assistant reported the matter to the Commissioner and the Deputy Commissioner, who in turn instructed the Director of Internal Audit to begin an investigation.

The investigation found that in calendar year 2003, the Director of Information Services had concluded that the department needed to replace a significant number of computers because a new job service program was about to be started and the state's Office for Information Resources was no longer going to provide maintenance for older versions of the Windows operating system. The director's staff calculated the number of computers needing replacement using an in-house inventory system that the staff knew had not been kept up to date. The system listed as active a number of older computers that had recently been replaced. The principal equipment database used by the state is the Property of the State of Tennessee (POST) system. The director relied on the in-house system because he did not feel that POST contained enough information about the computers.

The computers and printers were received between December 2003 and June 2004. By July 2004, the Information Systems Manager, who was responsible for distributing the computers, realized that the department had ordered too many computers and printers. The manager then began reallocating the computers to other divisions in the department. The cost of the computers was funded mainly by the federal Unemployment Insurance program. When the equipment was transferred to another program, the cost of the equipment should have been deducted from current Unemployment Insurance program expenditures. This was not done timely and properly. The Information Systems Manager sent e-mails to the program directors that would be using the computers and the property officer who would update the information in the POST system, but the Fiscal Services staff was not always notified. The fiscal services staff is responsible for preparing the reallocation journal vouchers which reduce the Unemployment Insurance program expenditures and determining the amount of federal funds to be requested based on federal program expenditures. Allocations between programs should be reflected in adjustments to the requests.

During June 2005, the internal auditors identified 97 computers that were not being used in the Employment Security Division but were still assigned to that division. By June 30, 2005, 79 had been reassigned. The other 18 were not reassigned until November 2005. This means that at June 30, 2005, a total of 228 computers were not being used in the Unemployment Insurance program but were still shown as being assigned to the Unemployment Insurance program. The questioned costs associated with this overpurchase amount to $352,210.

Recommendation

Management should ensure that risks noted in this finding are adequately identified and assessed in the documented risk-assessment activities. Those responsible for the design and implementation of internal controls should ensure that these controls adequately mitigate those risks and prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur. All controls and control activities, including monitoring, should be adequately documented.

The Commissioner should carefully review the assessments and the proposed controls, and if he considers them appropriate protection for the department's operations, he should approve them. These controls should include discreet methods for upper management to regularly monitor the controls to ensure that they are operating as designed. When the controls reveal problems, such as departures from required procedures, prompt corrective action should be taken. Any such problems and the corrective action should be documented contemporaneously with the activities in question.

The Commissioner should direct the Administrator of the Information Technology Division to immediately begin a physical inventory of all computers assigned to the Department of Labor and Workforce Development. The in-house system should be updated and reconciled to POST. The Administrator of the Information Technology Division should send to the Administrator of Fiscal and Administrative Services a list of those computers and printers, purchased with Unemployment Insurance and Employment Service funds, that are not being used in these programs, so that the Administrator of Fiscal and Administrative Services can begin reimbursing these federal programs. The Administrator of the Information Technology Division should also contact the state's Office for Information Resources and seek their advice about the proper disposition of these additional computers.

Management's Comment

We concur. With the appointment of an Administrator of Information Technology in September 2005, the former Employment Security Information Technology and the TDLWD Information Systems Management divisions have been unified into one division, the Information Technology Division. With this re-organization, there are no longer partial and inaccurate computer inventory systems maintained in separate IT divisions, but data on agency computers, including computers awaiting pickup by State Surplus, will be maintained in a single system with one IT staff as the assigned coordinator.

The Commissioner has directed the Administrator of Information Technology to implement new inventory and fiscal policies to ensure accurate replacement of agency computers in future mass deployments of computers. These policies include utilizing project management principles and controls to mitigate risk in future deployments, implementing network software to aid in identifying all computers connected to the agency network, reconciling of agency inventory against POST prior to any purchase of computers, and requiring that the appropriate program area administrator, the Administrator of Fiscal and Administrative Services, and the Administrator of Information Technology all review and approve future purchases of any new computers.

The Administrator of Information Technology has provided the Administrator of Fiscal and Administrative Services with complete lists of those computers and printers purchased with Employment Security funds that are not being used in that program area, so that the Administrator of Fiscal and Administrative Services can reimburse funds to Employment Security. The Administrator of Information Technology has contacted the Office for Information Resources to ask for their advice and assistance in disposing of the remaining additional computers. Following the internal agency audit of this large purchase of computers, the former Director of Information Systems Management retired and the IT project manager for the computer deployment was terminated.

2. <u>The Assistant Director of Unemployment Benefit Operations and Technical Services failed to establish controls to provide for monitoring the preparation of the federal reports for the Trade Adjustment Assistance program and therefore did not mitigate the risk that the reports would contain incorrect information</u>

Finding

The Assistant Director of Unemployment Benefit Operations and Technical Services permitted an Unemployment Insurance Specialist to submit the quarterly Trade Act Participant Report (TAPR) files to the U.S. Department of Labor for four quarters without any review by someone other than the preparer. The Trade Adjustment Assistance (TAA) program was created to provide assistance to individuals who become unemployed due to the effects of foreign competition. This program provides participants either with training to enable them to enter a new trade or business, or additional unemployment benefits if training is deemed to not be practicable. To accomplish this, participants receive payments of a weekly trade readjustment allowance (TRA) and job skills training from local educational institutions, if available. Eligible individuals may also receive a job search allowance, a relocation allowance, and a transportation and/or subsistence allowance so that they can attend approved training if it is not available within a normal commuting distance.

The U.S. Department of Labor requires the department to report quarterly on the program's performance. According to the U.S. Department of Labor, Employment and Training Administration (ETA), Trade Act Participant Report (TAPR) general instructions:

> States are required to maintain standardized individual records containing characteristics, activities and outcomes information for all individuals who receive services or benefits financially assisted by the Trade Adjustment Assistance (TAA) program. These individual records are collectively known as the Trade Act Participant Report (TAPR). The primary purposes of the TAPR are to:
>
> 1. Establish a standardized set of data elements, definitions, and specifications that can be used to describe the characteristics, activities, and outcomes of individuals served by the TAA program;
>
> 2. Facilitate the collection and reporting of valid, consistent, and complete information on an individual in order to support the overall management, evaluation, and continuous improvement of the programs at the local, state, and federal levels; and
>
> 3. Share program performance results with consumers, taxpayers, Congress and others with an interest in the TAA program.
>
> The TAPR establishes a core set of data that must be collected and maintained by states. These records are comprised of client information that is matched to outcome information obtained from Unemployment Insurance (UI) and other administrative wage records, or from other supplemental data sources as appropriate. Electronic TAPR files are due to ETA no later than 45 calendar days after the end of each quarter of reporting. Each TAPR file must consist of individual records for all TAA participants who have exited [the program] during a particular quarter.

During the fiscal year ending June 30, 2005, the department permitted one of its staff to prepare, review, and submit, with no supervisory review, quarterly TAPR files on participants that exited the TAA program between January 1, 2003, and December 31, 2003.

The U.S. Department of Labor ETA Program Analyst with the Division of Trade Adjustment Assistance noticed that the TAPR files submitted by the department for fiscal year ending June 30, 2005, were not consistent. The ETA Program Analyst discovered that the computer program used to compile the information for this report had serious computer programming errors. As a result, the ETA Program Analyst with the Division of Trade Adjustment Assistance, the ETA Regional Trade Coordinator, and an ETA Regional Information

System representative met with department management September 6, 2005, through September 8, 2005, to help management correct the computer programming errors.

Because the information on the TAPR files that were submitted contained significant errors, the federal employees requested that the TAPR files for the last three quarters of fiscal year ending June 30, 2005, be resubmitted. The Administrator of the Employment Security Division approved the decision to resubmit the quarterly TAPR files covering the period from the quarter ended December 31, 2003, through June 30, 2005. The ETA Program Analyst, Division of Trade Adjustment Assistance, confirmed that the department resubmitted the seven prior quarterly TAPR files on November 23, 2005. Had management established controls requiring the review of these files before they were submitted, these errors would likely have been discovered earlier.

States are required to review the accuracy of their TAPR records through data validation software provided by the ETA. This validation is performed annually. The *Employment and Training Administration (ETA) TAA Data Validation Handbook* states, "Data validation confirms the accuracy of selected data elements by examining a sample of participant records to assess whether the data in the sampled records are correct. When a record is selected for validation, state staff compares it against the case documentation for that participant." The most recent federally mandated annual data validation on the data reported in the quarterly TAPR files for the year ended June 30, 2003, evaluated 159 participant cases, selected at random, that exited the program from July 1, 2001, to June 30, 2002, to determine the accuracy of the data used to complete the TAPR. Seventeen performance measurements were tested. The error rates ranged from 0% to 74.6%. Two performance measurements had a 0% overall error rate, and the remaining 15 had error rates ranging from .4% to 74.6%. Because of the large error rate on the annual data validation and the computer programming errors, the accuracy of the data compiled for the quarterly TAPR files for fiscal year ending June 30, 2005, could not be determined.

The department is required to submit two other status reports. The Administrator of Fiscal and Administrative Services oversees the submission of Standard Form (SF) 269, *Financial Status Report*, and the Assistant Director of Unemployment Benefit Operations and Technical Services oversees the submission of the *Employment and Training Administration* (ETA) 563, *Quarterly Determinations, Allowance Activities and Reemployment Services Under the Trade Act* report. Although testwork did not reveal any problems with these two reports, there was no documentation to show that any of these reports, including the TAPR, were reviewed by someone other than the preparer before being submitted to the grantor. An Accounting Manager stated that there was an undocumented review of the SF 269. The lack of effective controls over TAA reporting increases the risk that the department will submit reports with inaccurate information.

Recommendation

The Administrator of the Employment Security Division should ensure that risks such as those noted in this finding are adequately identified and assessed and that effective mitigating controls are designed and implemented. These controls should include ongoing monitoring for compliance with all pertinent requirements. The Administrator of the Employment Security

Division should instruct his staff to assign review responsibilities to supervisory personnel which will ensure that the federal reports for this program receive a documented review before they are submitted to the grantor. All controls and control activities, including monitoring, should be adequately documented.

The Commissioner should carefully review the assessments and the proposed controls, and if he considers them appropriate protection for the department's operations, he should approve them. These controls should include discreet methods for upper management to regularly monitor the controls to ensure that they are operating as designed. When the controls reveal problems, such as departures from required procedures, prompt corrective action should be taken. Any such problems and the corrective action should be documented contemporaneously with the activities in question.

Management's Comment

We concur. The responsibility for preparing the TAPR has been transferred to our Job Service Program Support section. Future TAPRs will be prepared by a staff person and reviewed by the Acting Director of Job Service Program Support, prior to submission to the United States Department of Labor. Procedures used to generate the TAPR will be monitored on a continuous basis to assure report accuracy. Results of annual TAA data validation will be used as alerts to correct report deficiencies. EMILE is projected to be implemented in June 2006. That should facilitate increased report accuracy. Then all of the data for the TAPR will be obtained from a single database, rather than from three separate ones, which do not currently interface.

STATUS OF PRIOR AUDIT FINDINGS

State of Tennessee *Single Audit Report* for the year ended June 30, 2004

The *Single Audit Report* contained five findings pertaining to the Department of Labor and Workforce Development. The updated status of these findings as determined by our audit procedures is described below:

Resolved Audit Findings

The prior audit findings dealing with inadequate monitoring of Workforce Investment Act subrecipients; controls over the Unemployment Insurance Program; improper preparation and submission of federal reports for the Unemployment Insurance program; inadequate procedures for requesting federal funds to cover administrative costs for the Trade Adjustment Assistance_Workers program; and inadequate procedures for requesting federal funds to cover administrative costs for the Unemployment Insurance program have been resolved.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls.

Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.