NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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December 19, 2014

John Albin, Interim Commissioner
Nebraska Department of Labor
550 South 16th Street
Lincoln, Nebraska 68509-4600

Dear Mr. Albin:

We have audited the basic financial statements of the State of Nebraska (State) as of and for the year ended June 30, 2014, in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and have issued our report thereon dated December 16, 2014. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures for the purpose of expressing our opinions on the basic financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Department of Labor (Agency) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of the Agency's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations (if applicable) have been satisfactorily resolved.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

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 and correct misstatements on a timely basis. A material weakness is a deficiency, or a 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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

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. We consider Comment Number 1 (Errors in Financial Information) to be a significant deficiency.

This comment will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

Draft copies of this letter were furnished to the Agency to provide management with an opportunity to review and to respond to the comments and recommendations contained herein. All formal responses received have been incorporated into this letter. Responses have been objectively evaluated and recognized, as appropriate, in the letter. Responses that indicate corrective action has been taken were not verified at this time, but will be verified in the next audit.

The following are our comments and recommendations for the year ended June 30, 2014.

1. <u>Errors in Financial Information</u>

A good internal control plan and sound business practices require procedures to ensure information used to compile financial statements is complete and accurate. Furthermore, good internal controls require accounting records to be reconciled timely to the bank and variances identified and explained.

We noted several instances where financial information was incomplete or inaccurately recorded in the accounting system used to generate the State's financial statements. Consequently, audit adjustments were necessary to ensure the financial statements were materially correct.

The Agency used four separate bank accounts for the Unemployment Compensation (UC) program. Two were used primarily to receipt taxes; the third was used to disburse benefits, and the fourth was the trust fund held with the Federal government. Prior to July 1, 2013, the Agency utilized QuickBooks to record UC activity. During June 2014, the Agency started entering UC activity into the State's accounting system for the fiscal year. During testing of the financial activity entered into the accounting system, we noted the following issues:

- The Agency did not record a receivable for amounts due for April, May, and June 2014 from non-profits and governmental entities that participated in the UC reimbursable option. This resulted in an understatement of charges for services and receivables, net of allowance, for $1,775,402.

- The Agency entered UC contribution activity into the accounting system using a journal entry template that it developed. The Agency used daily reports from the Tax Management System (TMS), a system that tracked the receipt of UC funds from employers. However, the Agency's accounting area did not have an understanding of the activity being reported from the TMS system in order to make the proper journal entries.

  The APA reviewed the fiscal year activity and determined the following:

  - Investment income was overstated by $918,889.
  - Charges for services were understated by $488,545.
  - Operating expenses were overstated by $317,815.
  - Other operating revenues were understated by $90,280.
  - Unemployment claims were overstated by $22,249.

- State Unemployment Insurance Tax (SUIT) received was recorded in the UC fund as revenues. Neb. Rev. Stat. § 48-622.01(1) (Cum. Supp. 2012) requires SUIT monies to be transferred quarterly to the State Unemployment Insurance Trust Fund. When the Agency recorded the monies to the State Unemployment Insurance Trust Fund, they were recorded as revenues again. This caused a doubling of revenues between the two funds, resulting in an overstatement of $3,093,357 in charges for services.

- Penalties and interest monies collected were recorded initially to the UC fund, on the State's accounting system as revenues. Neb. Rev. Stat. § 48-621 (Cum. Supp. 2012) and Neb. Rev. Stat. § 48-656 (Reissue 2010) require the penalties and interest collected to be moved to the Employment Security Special Contingent Cash Fund. When the Agency recorded the monies to the Employment Security Contingent Cash Fund, they were recorded as revenues again. This caused a doubling of revenues between the two funds, resulting in an overstatement of $511,226 in Other Operating Revenues.

- The Agency received Reed Act funds from the Federal government and recorded the funds as revenue in the UC trust account. When the Agency expended the funds in the Reed Act fund, the monies were transferred to the Reed Act fund and recorded as revenue again. This resulted in the Federal grants and contracts revenue being overstated by $273,532.

- The Agency's calculation of claims liability was not complete, causing the claims, judgments, and compensated absences liability and the unemployment claims expense to be understated by $191,451.

- During the year, monies in the UC trust account were transferred to the UC benefit account in order to make payments to claimants from the benefit fund. After performing entries for the entire fiscal year, the Agency determined the transfers recorded in the accounting system did not agree between the funds. To correct the error, the Agency made an adjustment for $5,068,709. However, the APA determined the Agency's adjustment did not properly account for timing differences, resulting in an understatement of transfers in and unemployment claims expense of $963,312.

- The Agency entered activity through daily journal entries for interest receivable due from employers during the fiscal year. The Agency did not know the correct beginning balance for the receivable and, therefore, it could not determine the correct ending balance at June 30, 2014. Therefore, the Agency decided to remove the activity entered during the year and report no balance. For the fiscal year ended June 30, 2014, the net decrease was $21,187.

The following issues were noted regarding the Agency's reconciliation process between the accounting records and the bank:

- The Agency did not complete monthly reconciliations to ensure the activity recorded in the accounting system was accurate. In September 2014, after all activity had been entered into the system for the fiscal year, the Agency reconciled the bank to the accounting system and performed adjusting entries to balance.

- The benefits account reconciliation was not accurate. Payments totaling $595 were included as outstanding items at June 30, 2014; however, they were not outstanding. Additionally, $17,318 in payments issued prior to June 30, 2014, which had not cleared the bank, were not included as outstanding items. Due to the inaccurate reconciling items, cash was overstated by $16,723 in the accounting system at June 30, 2014.

- Prior to adjustments being made by the Agency to reconcile the trust account, the APA noted a variance of $1,955. The Agency was unsure what the variance consisted of and did not research the variance. Instead, the Agency adjusted the accounting system to agree to the bank balance. It is unknown if cash reflected in the accounting system for the trust account was accurate since reconciling items were not researched.

When adequate procedures are not in place to ensure the accuracy of financial information used to compile the financial statements, there is a greater risk that material misstatements may occur and remain undetected.

> We recommend the Agency implement procedures to ensure that all financial information is complete and accurate. We also recommend the Agency perform reconciliations timely and ensure any variances identified are investigated.

Agency Response: Agency agrees that procedures need to be updated to match the new system which was being converted from QuickBooks during this time period. Agency will research, develop and document procedures to ensure that financial information is complete and accurate. Bank reconciliations are now done on a monthly basis. A new template has been implemented for transfers to eliminate the double booking of revenues. Supporting documentation is being brought current.

2. Lack of Adequate Collateral for Deposits

Neb. Rev. Stat. § 77-2395(1) (Reissue 2009) states, in relevant part:

> *[T]he custodial official shall not have on deposit in such depository any public money or public funds in excess of the amount insured or guaranteed by the Federal Deposit Insurance Corporation, unless and until the depository has furnished to the custodial official securities, the market value of which are in an amount not less than one hundred two percent of the amount on deposit which is in excess of the amount so insured or guaranteed.*

A good internal control plan requires policies and procedures for the review of depository fund balances in excess of the Federal Deposit Insurance Corporation (FDIC) limit to ensure they are properly collateralized.

We requested documentation that the Agency's depository accounts were adequately collateralized for balances in excess of the FDIC limit of $250,000. The Agency did not have monthly collateral reports on file for July 2013 through April 1, 2014. Following our request for monthly collateral reports, the Agency obtained the reports from the depository bank. It is unknown if the Agency monitored the balances during this same time period to ensure the ongoing sufficiency of the collateral.

We reviewed collateral for two months during the fiscal year, July 2013 and June 2014. The Agency had inadequate collateral coverage for one day during July 2013. The bank balance on July 31, 2013, exceeded FDIC coverage by $20,650,973 and, according to State statute, 102% of this amount, or $21,063,992, must be collateralized. For July 31, 2013, the market value of pledged collateral was only $10,251,638, or 48.67% collateralized. Additional pledged collateral was obtained the following business day.

A similar finding was noted during the prior audit.

When deposits are not adequately collateralized, there is an increased risk for loss of funds, and the Agency is not in compliance with State statute.

> We recommend the Agency establish policies and procedures for the regular monitoring of bank balances to ensure adequate pledged collateral is in place to protect the Agency's funds in accordance with State statute.

Agency Response: Agency now has a Letter of Credit in place from US Bank, in lieu of pledged collateral. The Letter of Credit is based on historical aggregate balances of the three deposit accounts, and internal monitoring is ongoing. This letter is reviewed every six months with US Bank to ensure adequacy. During peak deposit times, a second short-term letter of credit can be added to ensure adequate collateral coverage.

3. <u>Unemployment Insurance Benefit Overpayments</u>

A good internal control plan requires procedures to identify and correct variances noted during reconciliation procedures. Furthermore, when such variances are due to system errors, good internal controls require procedures to correct the system errors to prevent further variances.

During testing of UC benefit payments, we noted variances between two daily reports generated from the Benefit Payment System (BPS), the system used by the Agency to process and pay UC benefits. The BPS Accounting Journal (Journal) provided summarized activity for the daily benefit payments and was used by the Agency to record UC activity into the State's accounting system. The second report, the BPS Daily Benefit Transaction Register (Register), detailed the benefit payments made to claimants for the day. The totals between the two reports should agree, as they are generated from the same system; however, variances were identified for 2 of 24 days tested, July 29, 2013, and October 28, 2013.

The Agency did not have documentation that it had researched the variances to determine if the variances were isolated or if there was a larger system issue. After we brought the variances to the Agency's attention, it was determined that two individuals received an overpayment of their UC benefits in the amount of $174 and $354.

Per discussion, the Agency was aware of one other occurrence – at which time a system fix was performed in October 2013. However, the Agency believed it was an isolated incident and did not attempt to identify other potential overpayments. According to the Agency, the cause of the overpayments was due to a disqualification of the individual's original wait week. The system looked for an eligible week to assign the waiting week credit. When the original disqualification was removed, the new waiting week stayed, causing a double payment. The Agency began procedures to identify further overpayments after the issues were identified during the audit.

When reconciliation procedures reveal variances in accounting records, and neither the cause is identified nor appropriate corrective measures are implemented, there is an increased risk that individuals will not receive proper payments. Additionally, UC overpayments are a misuse of funds.

> We recommend the Agency implement procedures to ensure that variances in accounting records are researched and corrected. We also recommend the Agency identify all overpayments that resulted from the system issue and take appropriate action to correct the overpayments.

Agency Response: The Agency performed an audit of overpayment records to ensure that the corrective action taken in October 2013 addressed the issue. No additional overpayments were found, and the Agency has determined that the system fix applied in October 2013 has resolved the issue.

4. BPS Segregation of Duties

NITC Standards & Guidelines, Information Security Policy 8-101, Section 4.3.2.3, Separation of Duties, states, in part:

> *To reduce the risk of accidental or deliberate system misuse, separation of duties must be implemented where practical. Whenever separation of duties is impractical, other compensatory controls such as monitoring of activities, audit trails and management supervision must be implemented.*

The Agency did not monitor or review the BPS application claims that were filed and adjudicated by the same employee. A similar finding was noted during the prior audit.

When one employee can both file and adjudicate the same claim, there is an increased risk that inappropriate or fraudulent claims will be processed, resulting in a loss of State funds.

> We recommend the Agency periodically monitor and review claims that are both filed and adjudicated by the same employee to ensure the accuracy of those claims.

Agency Response: The Agency agrees with this finding and submits the following corrective action plan: in 2013 UI Benefits developed an automated BPS report of all claims filed and adjudicated by the same employee. The report, entitled "Claims Filed-Determined by NDOL Employee" was run for the entire SFY14 (July 1, 2013-June 30, 2014) and was in the process of being reviewed during the most recent audit. The report is run monthly and monitored by Internal Security personnel. Anomalies and suspicious activities are reported to the Administrator of UI Benefits.

5. BPS Password Settings

A good internal control plan includes the use of encryption when storing sensitive data, including passwords, to ensure they are not easily accessible to unauthorized users.

Multiple generations of BPS passwords were stored in plain text. A similar finding was noted during the prior audit.

Strong password settings and storage methods reduce the risk of an unauthorized user gaining access to confidential information and key financial data. Without proper password encryption, there is an increased risk for unauthorized access to the BPS application.

> We recommend the Agency implement policies and procedures to encrypt all stored passwords.

Agency Response: This issue has been resolved by the Agency implementing new procedures to encrypt all stored passwords.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Agency and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to the Agency.

This communication is intended solely for the information and use of the Agency, the Governor and State Legislature, others within the Agency, Federal awarding agencies, pass-through entities, and management of the State of Nebraska and is not intended to be, and should not be, used by anyone other than the specified parties. However, this communication is a matter of public record, and its distribution is not limited.

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