



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Department of Economic Security

Year Ended June 30, 2005



Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.



Copies of the Auditor General's reports are free.
You may request them by contacting us at:

Office of the Auditor General

2910 N. 44th Street, Suite 410 • Phoenix, AZ 85018 • (602) 553-0333

Additionally, many of our reports can be found in electronic format at:

www.azauditor.gov



DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

July 25, 2006

Tracy L. Wareing, Director
Department of Economic Security
1717 West Jefferson Street
Phoenix, AZ 85007

Dear Ms. Wareing:

In planning and conducting our single audit of the State of Arizona for the year ended June 30, 2005, we performed the following as required by *Government Auditing Standards* (GAS) and Office of Management and Budget (OMB) Circular A-133:

- Considered the Department's internal controls over financial reporting,
- Tested its internal controls over major federal programs, and
- Tested its compliance with laws and regulations that could have a direct and material effect on the State's financial statements and major federal programs.

Specifically, we performed tests of revenues, receivables, expenditures, payables, transfers, cost allocations, payroll, purchasing, bank accounts, capital assets, and financial reporting. In addition, we performed compliance test work on the Food Stamp Cluster, Unemployment Insurance, Rehabilitation Services—Vocational Rehabilitation Grants to States, Child Care and Development Fund Cluster, Temporary Assistance for Needy Families, Child Support Enforcement, Social Services Block Grant, and Adoption Assistance programs.

All audit findings that are required to be reported by GAS and OMB Circular A-133 have been included in the State of Arizona's Single Audit Reporting Package for the year ended June 30, 2005, and have been communicated to your staff. In addition, our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the Department of Economic Security and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

TABLE OF CONTENTS



Recommendation 1: The Employment Administration should improve controls over unemployment insurance tax cash receipts	1
Recommendation 2: The Employment Administration should notify employers when overpayments of unemployment insurance taxes are received	2
Recommendation 3: The Division of Aging and Community Services needs to comply with federal cash management requirements	3
Department Response	

The Employment Administration should improve controls over unemployment insurance tax cash receipts

The Unemployment Insurance (UI) Tax Section collected UI payroll tax payments totaling approximately \$262 million in fiscal year 2005 from employers. Since cash receipts can be easily lost, stolen, or misused, the Employment Administration (Administration) should ensure that the Tax Section properly controls and safeguards them. However, the Tax Section did not adequately communicate, monitor, and enforce its internal control policies and procedures to ensure that cash receipts were properly safeguarded. For example, significant cash receipts were not stored in a secure location or deposited daily, and checks were not restrictively endorsed. Also, several prenumbered cash receipt books were issued and used simultaneously. As a result, cash receipts were not issued sequentially, and therefore, cash receipts were not adequately accounted for. In addition, cash receipts were not reconciled to the amounts recorded on the Tax Employer Accounting System (System). Further, the Tax Section did not reconcile receipts recorded on the System to the UI Financial Transaction Summary ETA-2112 report, which the Administration is required to prepare and file monthly with the U.S. Department of Labor, and was also the source for UI's financial statements. As a result, during the period July 1, 2004 through June 30, 2005, there was an unreconciled difference of \$3,148,302.

Furthermore, the Tax Section's supervisor had incompatible responsibilities, such as collecting, recording, depositing, and reconciling tax payments received. In addition, this employee was able to make changes to payment information on the System without supervisory review or approval.

To help strengthen controls over UI tax cash receipts, the Administration should better communicate and enforce its written policies and procedures for collecting, recording, reconciling, and depositing cash receipts. In addition, the Administration should periodically monitor that the Tax Section is consistently following them. Further, the Administration should review its policies and procedures to ensure they include the following:

- Store undeposited cash and checks in a locked drawer or safe.
- Deposit cash receipts intact daily.

- Restrictively endorse all checks immediately upon receipt.
- Use prenumbered cash receipt books in sequential order and account for cash receipts as used, unused, or voided.
- Reconcile daily the totals from the sequence of receipts issued to the amounts recorded in the System and deposited. All differences should be investigated and corrected. In addition, a supervisor should review and approve the daily reconciliations.
- Reconcile the System's monthly reports to the monthly UI Financial Transaction Summary reports and investigate and resolve all differences. In addition, a supervisor should review and approve the monthly reconciliations.
- Separate responsibilities between employees so that the employee who collects cash receipts does not record, deposit, and reconcile the receipts.

A similar recommendation was previously provided in our Management Letter to the Department of Economic Security dated June 17, 2005.

The Employment Administration should notify employers when overpayments of unemployment insurance taxes are received

The Employment Administration (Administration) collects UI payroll tax payments on a quarterly basis from employers. Each quarter, employers are required to submit to the Administration a UI Tax and Wage Report (UC-018) along with its quarterly tax payment. Once the Administration processes and posts the quarterly payments to the Tax Employer Accounting System, the System recalculates the employers' balances. For employers owing UI taxes, the Administration sent out notification letters requesting payment. However, the Administration did not always notify employers or issue a refund for overpayments. At June 30, 2005, the Department recorded \$15.4 million as accrued liabilities on their financial statements that were related to overpayments.

To ensure that overpayments are properly reported and returned to employers, the Administration should establish written policies and procedures for processing employer overpayments. These procedures should include establishing a process for notifying employers of overpayments and preparing and sending out refunds.

The Division of Aging and Community Services needs to comply with federal cash management requirements

The Department receives federal funding on a reimbursement basis from the U.S. Department of Health and Human Services when eligible expenditures are incurred for the Temporary Assistance for Needy Families (TANF) program. When a program is funded on a reimbursement basis, the Department must pay program costs before requesting reimbursement from the federal government. In addition, the Department must monitor federal monies it passes through to subrecipients to ensure that the subrecipients are also funded on the reimbursement basis. However, the Division of Aging and Community Services advanced federal TANF monies to its subrecipients for administrative and programmatic expenses. In some cases, the subrecipients did not spend advanced monies for several months after receiving the advances. In addition, these advances were not included in the State's federal interest liability calculation. An estimated \$8,300 of interest would have been earned from these advances.

To comply with 45 Code of Federal Regulations §§92.20(b)(7) and 92.21(c), the Department must follow the cash management procedures outlined in the Cash Management Improvement Act Agreement between the State of Arizona and the U.S. Department of Treasury for the TANF program and only disburse monies to subrecipients on a reimbursement basis.

A similar recommendation was previously provided in our Management Letter to the Department of Economic Security dated June 17, 2005.



ARIZONA DEPARTMENT OF ECONOMIC SECURITY

1717 W. Jefferson • P.O. Box 6123 • Phoenix, AZ 85005

Janet Napolitano
Governor

Tracy L. Wareing
Director

Debra K. Davenport
Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

Thank you for the opportunity to respond to the Department of Economic Security (Department) Management Letter audit findings for the fiscal year 2004-05 financial statement and single audits of the Department. It is understood that the Department's responses will be included in the published Management Letter.

The Department wishes to express its appreciation to you and your staff for the time and effort invested in these audits.

If you have any questions, please contact James Hillyard, Assistant Director for the Division of Business and Finance at (602)542-7166, or me at (602) 542-5678.

Sincerely,

Tracy L. Wareing

Enclosure

**DEPARTMENT OF ECONOMIC SECURITY
RESPONSE TO THE FISCAL YEAR 2004-05
MANAGEMENT LETTER**

The Employment Administration should improve controls over Unemployment Insurance tax cash receipts

To help ensure that Unemployment Insurance (UI) Tax Section's written procedures for collecting, recording, reconciling and depositing cash receipts are communicated and properly followed for all Remittance Processing Unit (RPU) cash handling, bank corrections, and check processing, in March 2006, the Department developed a computer based training module on Cash and Check Handling, and all UI Tax Section accounting and RPU personnel have completed this training course. The training module, which is based on the cash receipts procedures in *Section II-Q* of the *State of Arizona Accounting Manual*, provides instruction and reinforcement on cash receipts guidelines and procedures and covers five elements of a strong internal control system, including separation of duties; safeguarding assets; authorization; documentation; and reconciliation.

The Department will monitor and enforce adherence to the following written policies and procedures for UI tax cash receipts, effective fiscal year 2006.

- *Storage of undeposited cash and checks in a locked drawer or safe* – All unprocessed checks are secured in the locked storage cabinet located in the RPU, and all cash continues to be locked in the safe throughout the day until the vendor pickup at 2:30 p.m. daily.
- *Deposit of cash receipts intact daily* – All cash is deposited on a daily basis, and no cash payments are accepted after the 2:00 p.m. deadline for daily pickup for deposit.
- *Restrictive endorsement of all checks immediately upon receipt* – Currently, checks are endorsed by the remittance processing machine once they are assigned to an account. The current contract with Bank of America does not allow both a manual "stamped" endorsement and an electronic endorsement via the remittance processing machine. Due to the volume of checks that must be processed, a manual endorsement is not feasible and would cause problems for both the Department and the bank. To compensate for this internal control weakness, the Department has strengthened controls over access to the room in which the checks are handled, and in August 2006, the taxpayer assistance area will be moved away from the RPU to the Collections Unit.
- *Use of prenumbered cash receipt books in sequential order and accounting for receipts as used, unused, or voided* – Only one cash receipt book is utilized, which is maintained in sequential order, and a log is used to account for all of the issued, prenumbered cash receipt books.

**DEPARTMENT OF ECONOMIC SECURITY
RESPONSE TO THE FISCAL YEAR 2004-05
MANAGEMENT LETTER**

- *Daily reconciliation of the totals from the sequence of receipts used to the amounts recorded in the System and deposited. This reconciliation should be prepared daily, and all differences should be investigated and corrected. In addition, the daily reconciliations should be reviewed by a supervisor* – The Unit Supervisor accounts for and reconciles all cash receipts on a daily basis. The payments are then reconciled to the amounts deposited through the Employment Administration's Budget and Planning Office. The Budget and Planning Office works with the State Treasurer's Office to conduct the reconciliation, and any differences are then investigated and resolved.
- *Reconciliation of the System's monthly reports to the monthly ETA 2112–UI Financial Transactions Summary reports; investigation and resolution of all differences; and review and approval of the monthly reconciliations by a supervisor* – The Department has developed a new process to reconcile the System's monthly reports to the *ETA 2112–UI Financial Transactions Summary* report and has developed a new report to track information on the batch and reporting month. The new reconciliation process addresses offsite processing and timing of entry issues related to the timing of deposits and entry into the various systems used by the UI program.
- *Separation of responsibilities between employees so that the employee who collects cash receipts does not record and deposit the receipt* – Staff responsible for collecting cash and issuing receipts do not also process the cash, modify the employer records, or have any responsibility for the deposit. The Unit Supervisor processes cash payments received, and the Accounting Manager verifies any discrepancies to cash payments. With the move of the taxpayer assistance area to the Collections Unit in August 2006, the cashier function will control the issuance of receipts books and will be required to address any unaccounted for or out-of-sequence problems on a daily basis. Receipts will be prepared for all checks received by Collections Unit personnel to ensure that all payments are accounted for and processed timely.

The Employment Administration should notify employers when overpayments of Unemployment Insurance taxes are received

The Employment Administration has redesigned the Unemployment Tax and Wage Report (UC-018) to include notification to employers of an overpayment. Effective with the mailing of the first quarter 2006 report, taxpayers are notified of their credit balance, and the form instructs the preparer to reduce the current quarter's tax due by the credit amount. Refunds are made upon request in accordance with the provisions of Arizona Revised Statutes §23-742 and Rule R6-3-1718.

**DEPARTMENT OF ECONOMIC SECURITY
RESPONSE TO THE FISCAL YEAR 2004-05
MANAGEMENT LETTER**

The Division of Aging and Community Services needs to comply with federal cash management requirements

In accordance with the cash management procedures outlined in the Cash Management Improvement Act Agreement between the State of Arizona and the U.S. Treasury for the Temporary Assistance for Needy Families (TANF) program, effective July 1, 2005, all eligible administrative and programmatic expenditures incurred for the TANF program are paid for by the Department before reimbursement is requested from the Federal Government. Furthermore, all monies passed through to a subrecipient by the Division of Aging and Community Services are monitored to assure that the subrecipient is also funded on the reimbursement basis.