

**Schedule of Findings and Questioned Costs
For the Fiscal Year Ended June 30, 2016**

Financial Findings Reported Under Government Auditing Standards

2016-001 The State should improve internal controls over the processing and recording of Unemployment Insurance premium payment and wage information and accounting for program activities in the Guaranteed Education Tuition program's (GET) to ensure accurate reporting.

Background

It is the responsibility of state management to design and follow internal controls that provide reasonable assurance regarding the reliability and accuracy of information used for financial reporting. We identified deficiencies in internal controls that could adversely affect the State's ability to accurately report its financial statements.

Government Auditing Standards, prescribed by the Comptroller General of the United States, require the auditor to communicate material weaknesses as defined below in the Applicable Laws and Regulations section, as a finding.

Next Generation Tax System's (NGTS)

The Employment Security Department (ESD) administers Washington State's unemployment insurance program. A new system called NGTS was implemented in March 2014 to process employer wage reports and payments.

During the previous audit, we issued a finding related to the NGTS processing of employer wage reports and payments. NGTS processed approximately \$1.1 billion in Unemployment Insurance Premium payments during fiscal year 2016.

Guaranteed Education Tuition Program (GET)

The State of Washington administers a Guaranteed Education Tuition (GET) program. GET is Washington's prepaid college tuition plan that helps families with young children save for future higher education expenses. GET is a qualified tuition program under Section 529 of the Internal Revenue Code.

Engrossed Second Substitute Senate Bill (E2SSB) 5954 was signed into law by the Governor on July 6, 2015, establishing the College Affordability Program. It reduced tuition at all public institutions of higher education during the 2015-16 and 2016-17 academic years and limits tuition growth in future years. Subsequent to the passage of E2SSB 5954, the State GET Program Committee authorized account holders, upon request, to receive a refund of their contributions or a fixed payout value, whichever is greater. GET is closed to new enrollments until July 1, 2017.

Description of Condition

We identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a material weakness over financial reporting:

NGTS

System processing

- Adjustments can be entered and processed in NGTS without review and approval of a second individual.
- Detail Benefit Charges within NGTS do not consistently agree to the Summary Benefit Charges.

System report issues

- Employer Unemployment Insurance Premium payments and tax and wage reports were not consistently posting accurately to employer accounts in NGTS.
- Reports generated from NGTS were incorrect and could not be relied upon to verify the accuracy or completeness of changes made to employer accounts.
- NGTS account balance reports do not accurately reflect ending and beginning account balance from month to month. NGTS reports cannot be relied upon for use in reconciling premiums to the State's general ledger account system, AFRS.

Reconciliations

- Controls are inadequate over interfaces between internal and external systems. There are no reconciliations between systems to ensure information transmitted by interfaces is accurate and complete.
- Summary and detail wage reports filed by employers are not reconciled and are sometimes out of balance. As a result, filing errors that could cause an incorrect calculation of premiums and benefits may not be identified and resolved timely.
- Daily reconciliations between the bank and NGTS are attempted, however, due to a variety of system errors, the bank and NGTS are often out of balance.
- GUIDE reports are used to determine a portion of the accounts receivable balance. The amount reported by ESD and the amount according to the detail claimant GUIDE reports varied by \$13.3 million.

GET

- The legislative change to the GET program resulted in complicated and unique accounting for the program activities. The Office of Financial Management (OFM) and GET program staff did not have a process in place to ensure unique program activities were correctly recorded in the State's general ledger accounting system AFRS and financial statements.

Cause of Condition

NGTS

This is the second year that the Employment Security Department has used the NGTS system. Prior to implementing the system, the Department did not perform adequate testing to ensure the system could process accurate and complete Unemployment Insurance Premium payments, tax and wage reports, unemployment insurance rates, and employer receivables. In addition, the lack of some key reconciliations increase the likelihood that system errors will not be detected and corrected timely.

GET

OFM and GET program staff did not perform adequate research to ensure GET program activity was correctly accounted for in AFRS and reported correctly on the financial statements.

Effect of Condition

We identified the following errors during our audit of the financial statements:

NGTS

- The “Other Receivables” balance was overstated by a net total of \$6.6 million due primarily to the following:
 - Testing of 87 employer receivable balances found 16 instances where the employer paid amount recorded in NGTS varied from what was recognized as receivable at year-end, resulting in an understatement of \$1,278,372.
 - The Department did not apply their written criteria for the determination of uncollectible receivables consistently each period based on an aging report to ensure that the allowance for uncollectible accounts reflects historical experience. The Department wrote off accounts over 180 days as their allowance method.
- A total of \$129,025,815 of the claimant overpayment portion of the balance was written off. OFM improperly classified \$24,600,977 as a current period expense rather than a prior period adjustment.
- Testing of 87 employer tax rates found five rates that were incorrectly assessed as delinquent. This represents a 5.7% exception rate for the population. The actual misstatement is \$321,507 with a projected overstatement of \$13,006,411.

GET

- Refunds to program participants were accounted for as a reduction to revenues, which resulted in negative revenues of \$347 million in the charges for services balance on the financial statements. Rather than a reduction to revenue, this should have been reported as a “special item” on the financial statements. This error was corrected on the final financial statements.
- In fiscal year 2015, the GET program established a liability to account for refunds of \$59 million and recognized it as a reduction in revenues. In fiscal year 2016, accounting staff

continued to reduce revenue rather than reducing the established liability. This error was corrected.

- GET program staff did not make an adjustment to increase short-term receivables and decrease the long-term receivables by the same amount. This resulted in an understatement of “current receivables” by \$19.9 million and an overstatement of the non-current portion of receivables by the same amount. This error was not corrected.

Recommendation

We recommend the following:

NGTS

- Establish internal controls to ensure the complete and accurate processing of employer payments and tax and wage reports for Unemployment Insurance Premium payments.
- Identify and correct defects within NGTS, including inaccurate and incomplete reports.
- Perform reconciliations between systems to ensure information transmitted by interfaces is accurate and complete.

GET

- GET program staff and OFM ensure adequate research is performed to ensure for the correct accounting of unique transactions.
- GET program staff and OFM perform a thorough risk-based review during the year-end close process to detect potential accounting errors.
- OFM dedicate adequate staff time to research and prepare the annual financial report to ensure it is fairly presented, complete, and accurate in compliance with reporting requirements.

State’s Response

The State recognizes the significance and priority of internal controls over recording and reporting financial transactions.

OFM will continue to work with the Employment Security Department and the Washington Student Achievement Council to improve internal controls over the processing and reporting of financial activities.

OFM will enhance the process for reviewing unusual events or unique program activities that are material to the state’s financial reporting, and work with agencies to ensure they are properly accounted for and correctly reported on the financial statements.

Auditor’s Remarks

We appreciate the state's commitment to resolving this finding and thank the state for their cooperation and assistance. We will review the status during the next audit.

Applicable Laws and Regulations

RCW 43.88.160 Fiscal management – Powers and duties of officers and agencies, states in part:

- (4) In addition, the director of financial management, as agent of the governor, shall:
 - (a) Develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each agency that will safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies for accounting and financial controls. The system developed by the director shall include criteria for determining the scope and comprehensiveness of internal controls required by classes of agencies, depending on the level of resources at risk.

Government Auditing Standards, December 2011 Revision, paragraph 4.23 states:

4.23 When performing GAGAS financial audits, auditors should communicate in the report on internal control over financial reporting and compliance, based upon the work performed, (1) significant deficiencies and material weaknesses in internal control; (2) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and any other instances that warrant the attention of those charged with governance; (3) noncompliance with provisions of contracts or grant agreements that has a material effect on the audit; and (4) abuse that has a material effect on the audit.

The American Institute of Certified Public Accountants defines material weaknesses and significant deficiencies in its *Codification of Statements on Auditing Standards*, Section 265 as follows:

.07 For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

Material weakness. 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.

Significant deficiency. A deficiency, or a 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.

The Office of Financial Management's *State Administrative and Accounting Manual* (SAAM), states in part:

Section 20.15.30.a *Who is responsible for internal control?*

The agency head or authorized designee is ultimately responsible for identifying risks and establishing, maintaining, and reviewing the agency's system of internal control. If the agency head delegates this responsibility, the designated person should have sufficient authority to carry out these responsibilities. Normally, this person is a senior agency manager who does not serve in the internal audit function.

Section 20.15.40.c *Control Activities*

Control activities help ensure risk responses are effectively carried out and include policies and procedures, manual and automated tools, approvals, authorizations, verifications, reconciliations, security over assets, and segregation of duties. These activities occur across an agency, at all levels and in all functions, and are designed to help prevent or reduce the risk that agency objectives will not be achieved. Managers set up control activities to provide reasonable assurance that the agency and business unit objectives are met. An example of a control activity is something as simple as listing tasks assigned to staff members and then periodically checking the list to verify that assignments are completed on time. Refer to Section 20.25 for further discussion of control activities.

Section: 20.15.50.a - Annual assurance

A risk assessment and internal control review process provides management with reasonable assurance that controls are operating as expected. In addition, the process should be used to determine if internal control modifications are needed by considering events that have occurred, processes or procedures that have changed, new projects or programs that are being planned or implemented, and other changes within the agency that may have additional risks. If the review uncovers internal control weaknesses or if prior weaknesses still exist, they should be documented and addressed.

Periodically, an agency should conduct a comprehensive review of the internal control structure to determine if it is adequately addressing agency risks. This can be done agency-wide at one time or by sections of the agency over a period of time.

Agencies must maintain adequate written documentation of activities conducted in connection with risk assessments, review of internal control activities and follow-up actions. This documentation includes any checklists and methods used to complete these activities. Refer to Subsection 20.25.50 for required documentation. For sample checklists and procedures, refer to the OFM Administrative and Accounting Resources website at: <http://www.ofm.wa.gov/resources/default.asp>.

Agencies have the flexibility to assign appropriate staff to complete the risk assessments and review of internal control activities required by this policy. The internal control officer is the person appointed by the agency head who is assigned responsibility for coordinating and scheduling the agency-wide effort of evaluating and reporting on reviews and improving control activities. The internal control officer also provides assurance to the agency head that the agency has performed the required risk assessments and the necessary evaluative processes. This communication may be ongoing and informal, but at least once per year, this assurance must be made in writing to the agency head. The internal control officer is responsible for ensuring that the required documentation is maintained and available for review by agency management, the State Auditor's Office (SAO), and OFM.