SPECIAL REPORT: DELAWARE UNEMPLOYMENT COMPENSATION FUND

FINANCIAL MANAGEMENT WITHIN
THE DELAWARE DEPARTMENT OF LABOR
DIVISION OF UNEMPLOYMENT INSURANCE

Dear members of the Delaware public,

One of the primary audit engagements overseen by the Office of Auditor of Accounts is the Annual Comprehensive Financial Report (ACFR) – financial statements on all State of Delaware funds, departments, organizations, bureaus, boards commissions, elected offices, and legal entities. The ACFR is important not only for transparency about the use of public money, but as a tool used to analyze our state's financial position for bond financing and to maintain our credibility with creditors and federal oversight agencies. Every detail published in the ACFR has far-reaching consequences for our State. My office released the ACFR for fiscal year 2023 on March 26, 2024, with this accompanying special report.

This year, the Independent Auditors' Report includes an unprecedented disclaimer of opinion related to the Delaware Unemployment Compensation Fund (DUCF). To my office's knowledge, the Delaware ACFR has never before included a disclaimer opinion.

The DUCF is managed by the Delaware Department of Labor Division of Unemployment Insurance (DOLUI). As of June 30, 2023, the DUCF reported cash assets of approximately $390 million consisting of contributions from the federal government and businesses of all sizes who hire Delawareans. The firm hired to prepare the Independent Auditors' Report, CliftonLarsonAllen LLP (CLA), has determined that this fund is **not auditable for fiscal year 2023**. Simply put, DOLUI was unable to provide detailed accounting records of any kind to allow CLA to reach an opinion. **The enclosed special report provides details on AOA's inquiry into how this happened, and our suggestions for a path forward.**

Our inquiry revealed several factors contributing to this result. DOLUI management failed to ensure accounting work was performed in a timely manner. State agencies, like Division of Accounting, were slow to respond when the scope of the problems within DOLUI became clear. These failures represent not only an **unacceptable lack of adherence to the State's established accounting policies**, but more importantly demonstrate an **absence of accountability** in a program that Delaware employers fund, and Delawareans rely on.

The breadth of the consequences to our State from publishing a disclaimer of opinion within the ACFR are not yet known. What I hope is made clear in the special report is that **this was an avoidable outcome.** The large increase in benefits and beneficiaries throughout the Covid-19 pandemic strained the resources of Delaware's unemployment system, as it did unemployment programs across the country. Regardless, this does not excuse the failures of management that followed.

I truly believe that here in Delaware**, we are small enough to get this right**. When AOA was presented with evidence of problems, we acted. I believe this report offers a clear direction forward. DOLUI must immediately put itself on a path to rectify the problems with fiscal year 2023, but also ensure that it is never in a similar position again. This will require changes with not only the way DOLUI operates, but also all oversight of state accounting practices.

Our office will continue to monitor this situation and keep you informed as efforts to solve these problems are underway. I want to thank the Department of Labor for their cooperation and assistance in this inquiry, and thank our highly qualified, nonpartisan auditors, who do this important work every day to keep our government transparent.

Thank you,

Lydia E. York

Lydia E. York
Delaware State Auditor of Accounts

OVERVIEW

On March 20, 2024, CliftonLarsonAllen, LLP (CLA) issued its opinions on the State of Delaware Annual Comprehensive Financial Report (ACFR)* as of and for the year ended June 30, 2023. CLA included a disclaimer of opinion* in its Independent Auditors' Report on the ACFR and the basis for the disclaimer:

> ***Basis for Disclaimer of Opinions on Business-type Activities and Unemployment Fund***
>
> *The State's Department of Labor was unable to provide sufficient appropriate audit evidence for the balances and financial activity of the account balances of the unemployment fund. The State's records do not permit us, nor is it practical to extend or apply other auditing procedures, to obtain sufficient appropriate audit evidence to conclude that the account balances and related cash flows in the business-type activities and unemployment fund were free from material misstatement. As a result of these matters we were unable to determine whether further audit adjustments may have been necessary in respect to the unemployment fund account balances, and the elements making up the statement of activities and cash flows.*

In context, CLA determined the Delaware Unemployment Compensation Fund (DUCF) to be unauditable, even though its financial statements are presented. The Department of Labor, Division of Unemployment Insurance (DOLUI) was unable to provide detailed accounting records for the financial statement captions of the DUCF in the Statements of Net Position, Activities, and Cash Flows*, for the fiscal year ended June 30, 2023.

Prior to this opinion being issued, the Delaware Office of Auditor of Accounts (AOA) was made aware of significant deficiencies in internal controls within DOLUI. We began our inquiry on January 9, 2024.

This report outlines AOA's observations of circumstances and identifies correlations about contributing factors that led up to the disclaimer event. The report presents our observations in the course of inquiry and recommendations for a path forward.

**Defined in definitions page at the conclusion of this document.*

Delaware Unemployment Compensation Fund - Background

The DUCF is a proprietary fund* managed by DOLUI containing employer and grant contributions to Delaware's unemployment insurance program. Thousands of Delaware employers contribute to this fund, which pays out unemployment benefits to Delawareans every week. As of June 30, 2023, this fund had cash assets of approximately $390 million.

The DOLUI DUCF is audited at the ACFR Proprietary Fund level by CLA. Unlike the financial statements for the Delaware State Lottery and the Delaware Department of Transportation, which are both proprietary funds, DOLUI DUCF does not produce basic audited financial statements with note disclosures in accordance with Government Auditing Standards*.

Since at least fiscal year 2020, Department of Labor leadership has enlisted the Delaware Department of Finance (DOF) and Division of Accounting (DOA) to compile a trial balance* in accordance with United States Generally Accepted Accounting Principles*. This includes creating accrual basis* entries for the DOLUI provided cash basis* trial balance.

We consider DOF to be an extension of DOLUI for the preparation of financial statements for the ACFR. Since DOF is part of the internal control structure for DOLUI, it has a duty to fully disclose relevant information that has a material effect on financial statements. When taken as a whole, DOLUI management shall ensure a complete reflection of any fiscal year's financial statements.

Recent ACFR History

CLA, the independent contractor hired to complete the audit of the ACFR, issued findings* on the financial reporting of DOLUI for each fiscal year since 2020. The findings are in the State of Delaware's Federal Uniform Guidance audit for each year, and are classified as either material weaknesses* or significant deficiencies* in internal controls* over financial reporting during fiscal years 2020-2022. The findings for each year include:

> ***2020-01 – Audit Adjustments – Material Weaknesses:*** *Material misstatements which required adjustment and were identified after the records were provided for audit. These included entries related to various accounts including Intergovernmental Receivables, Claims Payable, Due to Other Governments, and Federal Grant Revenue.*
>
> ***2020-02 and 2021-01 – UI Cash – Significant Deficiencies:*** *DOL's reconciled book balance on the bank reconciliation did not agree to the balance recorded in the general ledger.*
>
> ***2022-01 – Account Reconciliations – Material Weaknesses:*** *DOL did not have control properly implemented to ensure that accounts were reconciled timely, and balances were recorded accurately.*

> ***2022-02 – Allowance for Doubtful Accounts – Significant Deficiencies:*** *DOL did not have a documented methodology or understanding of the methodology used in determining the allowance for doubtful accounts for accounts receivable and taxes receivable.*

The Department of Labor, Department of Finance, and Division of Accounting were aware of these findings as they were published. In response, the Division of Accounting instituted a Corrective Action Plan* for DOLUI with a planned completion date of June 30, 2021. Through the course of our inquiry, AOA found that the Plan ultimately did not rectify the root causes of the ACFR findings.

An outside CPA firm was brought in to assist DOLUI in April 2023. AOA was notified of that firm's concerns with significant internal control deficiencies in January 2024.

Internal Systems

While most State entities use the centralized First State Financials System (FSF)* to record financial transactions, DOLUI employs several separate and disconnected systems. These include Microsoft Dynamics, which manages accounting trial balances, and Mainframe, the database for recording transactions between DOLUI and Delaware employers. Additionally, DOLUI manages activity across multiple bank accounts and a U.S. Department of Labor-held trust fund. None of these systems are integrated with each other or with FSF, leaving DOLUI solely responsible for maintaining databases outside of the State of Delaware Information Technology Network.

Furthermore, within DOLUI, internal procedures dictate that lower-level accounting staff must maintain records of daily tax collections and benefit payments in a Microsoft Excel spreadsheet. To incorporate these records, staff are expected to compile monthly proposed accounting journal entries*, which are then presented to management for review before being entered into Microsoft Dynamics.

Separately, the DOA has been responsible for generating year-end closing entries* for Accounts Payable and Accounts Receivable for DUCF since at least 2020. However, these entries were not shared with DOLUI management and therefore were not entered into Microsoft Dynamics. As a result, the trial balance of DUCF did not agree with the financial statements presented in the State's ACFR for fiscal year ending June 30, 2022. This left two independent CPA firms hired to assist DOLUI in 2023 with incomplete records from the previous year. Consequently, the beginning balances for the fiscal year starting on July 1, 2022, were inaccurately reported.

Accounting Problems Within the Unemployment Division

Serious accounting issues within the Unemployment Division had been mounting over the years as highlighted in the 2020-22 ACFRs. However, the situation worsened in 2023. Throughout the year, the DOLUI Director hired several new managers tasked with overseeing accounting activities related to the DUCF. Unfortunately, these new hires did not receive proper training in their accounting oversight job functions. Consequently, in April and June of 2023, respectively, the Santora CPA Group and Belfint, Lyons & Shuman, P.A. were contracted to provide accounting services within the Division.

During this time, accounting staff within the Division continued preparing monthly accounting journal entries. These entries outlined activities reflected in bank statements, consolidating daily transactions such as employer contributions, grants received, employee claims, and employer refunds. These transactions amounted to tens of millions of dollars monthly. According to the protocols outlined in DOLUI internal procedures, the entries required review, approval, and official entry by management, which did not occur.

AOA learned that despite management receiving the proposed journal entries, management failed to conduct the required review. Consequently, no accounting journal entries for DUCF were officially recorded in any database for the entirety of fiscal year 2023 through December 31, 2023, for fiscal year 2024.

Management contributed to a critical accounting situation in the months and years preceding the current fiscal year. Firstly, they neglected to adhere to established policies and procedures designed to govern accounting activities within DOLUI. DOLUI policies outline the necessary steps for staff to generate valid accounting entries, but AOA determined the lack of proper oversight resulted in the breakdown of control activities. Secondly, although external CPA firms were eventually enlisted to aid with accounting functions, AOA maintains that management did not adequately supervise the daily operations of these vendors. With closer monitoring, the extent of the issues within DOLUI might have been discernible earlier.

Chain of Events – ACFR Delayed

In December 2023, Santora CPA Group made DOLUI leadership aware of multiple deficiencies in the Division's internal control structure that the firm had observed in its nine months of work. This information was formalized in a letter received by DOLUI, which met with all concerned parties. DOA requested an ACFR filing extension. In addition, DOA contracted with CPA firm BDO to address the identified deficiencies and develop an auditable trial balance with a purchase order for $500,000.

AOA planned an inquiry designed to gain an understanding of DOLUI's internal controls, processes and procedures to form recommendations. AOA arrived onsite to begin the inquiry on January 9, 2024. After arriving at DOLUI, AOA auditors observed that DOLUI management was preoccupied with a long-term project to modernize its systems, resulting in limited availability to engage with AOA representatives.

AOA monitored the progress of each independent accounting firm as they worked to create a functional trial balance for the DOLUI for the fiscal year ending June 30, 2023. Additionally, AOA auditors conducted a trial balance simulation using journal entries prepared by DOLUI staff. AOA's data was then compared with data from CPA firms Santora and BDO. AOA determined that the CPA firms had relied on summary data generated from bank statements and Mainframe system to generate journal entries for a simulated trial balance. The result of this exercise was that none of the CPA firms were able to start with a beginning balance that equaled the prior year's financial statements as reported in the ACFR. In addition, none of the CPA firms were able to obtain detailed information that supported the summary reports from Mainframe or details of daily deposits and disbursements from all bank accounts held.

BDO completed its own version of the cash-basis trial balance of DOLUI on February 27 and presented it to DOA. DOA performed its work regarding year-end adjustments to complete a full-accrual basis of accounting and submitted it to CLA on March 5, 2024.

On March 7, 2024, CLA determined the DOLUI DUCF unauditable.

Key Observations

AOA asserts that DOLUI's internal controls over accounting and financial reporting are not effective. Unless there is remediation to provide details supporting the financial statements, Delaware risks continued disclaimer opinions on the State's ACFR. AOA found multiple factors contributing to the current inability to audit the DUCF:

1. The ACFRs for fiscal years 2020, 2021, and 2022 each had findings classified as *material weaknesses* and *significant deficiencies* directly related to DOLUI's internal controls. While a Corrective Action Plan (CAP) was prepared in 2021, the plans to implement the CAPs, including defining milestones, setting target dates, and establishing a method of monitoring was not fully followed through to ensure that management's objectives were met.

2. DOLUI has a unique fiscal structure that is entirely disconnected from the First State Financials System. Therefore, the accounting deficiencies within DOLUI cannot be observed by oversight entities like AOA or DOA. Additionally, communication between DOLUI and DOA regarding year-end closing reports and journal entries did not take place.

3. Management contributed to a deterioration in business operations by not following internal accounting procedures, and by fiscal year 2023, internal accounting work within the Division had stopped entirely.

Recommendations

1. AOA recommends that immediate action is necessary in the form of a Corrective Action Plan so that records can be audited for fiscal year 2023 and years going forward. In AOA's view, this plan must cover areas including, but not limited to:

   a. Moving forward, all daily accounting reports must match daily employer contributions and benefit payments. All monthly accounting journal entries must be reviewed and entered into a database. Supporting documents must be filed for all entries, and cumulative receipts and disbursements must be filed so those records are reconcilable and available for audit.

   b. All information in existing DOLUI databases must be inspected with the assistance of IT specialists. This information must be evaluated for accuracy.

   c. All banking information and financial activity must be accounted for in detail for fiscal years 2023 and 2024.

   d. Data for all contributing employers, benefit claimants, and combined wage claims reported in other states should be reviewed for accuracy. Refunds should subsequently be paid out if appropriate.

2. Lacking established mechanisms to integrate the fiscal structure of DOLUI with FSF to ensure seamless data flow and enhance oversight capabilities, DOLUI should continually foster open and transparent communication channels between it and oversight entities, particularly AOA and DOA.

3. DOLUI should establish robust internal controls as a part of their basic day-to-day operations. DOA should establish a monthly monitoring requirement to ensure accounting work within DOLUI continues.

AOA will continue to identify and evaluate current internal controls over each unit of DOLUI to see how information flows to management. AOA also plans to observe the Corrective Action Plan for the DOLUI DUCF program to determine if the records for fiscal year 2024 are auditable or require another disclaimer of opinion on the ACFR.

The risks associated with a disclaimer opinion on a portion of the State's ACFR are numerous and can have significant implications for various stakeholders. Addressing the underlying issues and improving financial reporting practices is essential to mitigate these risks ensuring the public trust and credibility.

Accrual Basis – Revenues or expenses recognized when earned or incurred, as opposed to when they are received or paid.

Annual Comprehensive Financial Report (ACFR) – The financial statements of all State of Delaware funds, departments, organizations, bureaus, boards commissions, elected offices, and legal entities. Refer to 29 Del. C. §2906.

Cash Basis - Revenues or expenses recognized when received or paid.

Corrective Action Plan – Management's official response correcting audit findings.

Disclaimer Of Opinion – A statement issued by independent external auditors saying that they cannot express an opinion on financial statements.

Federal Uniform Guidance – A government-wide framework for grants management that provides an authoritative set of rules and requirements for federal awards.

Findings – Conditions reported from auditors to management which raise concerns about the operations of the entity.

First State Financials System – The accounting system of the State of Delaware.

Generally Accepted Accounting Principles – The default accounting standards used by companies and governmental organizations in the United States.

Government Auditing Standards – Standards for auditing laid out by the United States Government Accountability Office.

Internal Controls – Policies and procedures governing financial and performance operations.

Journal Entries – Records of transactions, either economic or non-economic, intended for input into a trial balance.

Material Weaknesses – A deficiency or deficiencies in internal controls that greatly increases the likelihood of serious error in a financial statement.

Proprietary Fund – A fund separate from the Delaware General Fund that is reported in a similar fashion to a business operating in the private sector.

Significant Deficiencies – A deficiency or deficiencies in internal controls that slightly increases the likelihood of serious error in a financial statement.

Statements Of Net Position, Activities, And Cash Flows – Basic financial statements that auditors review to express an opinion.

Trial Balance – An internal financial statement listing the account balances of all the general ledger accounts.

Year-End Closing Entries – Official records of the position of financial accounts at the end of the fiscal year.

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