

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

State of Washington July 1, 2019 through June 30, 2020

2020-001 The State's internal controls were insufficient to prevent fraudulent unemployment benefit payments.

Background

State management is responsible for designing, implementing and maintaining internal controls to ensure the financial statements are fairly presented, and to provide reasonable assurance regarding the reliability of financial reporting and to prevent and detect fraud. We identified deficiencies in internal controls at the Employment Security Department (ESD) that adversely affected the State's ability to prevent and detect fraud.

ESD administers Washington State's unemployment insurance program. In response to the COVID-19 pandemic, the United States Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act to provide economic relief to people who suffered financially because of the pandemic. The Act created three initiatives for states that expanded the amount of time a person may collect benefits, increased the amount of benefits a person may receive by \$600 a week, and included people who otherwise would not qualify for benefits, such as independent contractors, and self-employed individuals. For fiscal year 2020, ESD paid out more than \$7.5 billion in unemployment insurance benefits to 926,815 people. This is 684% more funding (about eight times) and 390% more people (about five times) than ESD served in fiscal year 2019.

Description of Condition

Our audit identified the following deficiencies in internal controls over financial reporting that, when taken together, represent a material weakness.

ESD did not have effective internal controls in place to ensure unemployment benefit payments were made only to eligible claimants. We noted:

- Verification of a claimant's employment information to establish eligibility was not always performed before payment. Prior to March 18, 2020, the one week waiting period allowed the ESD time to verify a claimant's employment status.
- ESD performs a discovery process to identify claims at high risk of identity theft for investigation. Prior to May 14, 2020, this process was not performed until after claims had already been paid.

Cause of Condition

After the surge in claims due to the pandemic and the implementation of the CARES Act, existing controls over claims were modified and/or eliminated. Issues contributing to the control weaknesses include:

- Large volume of claims
- Short time to implement new federal initiatives with little guidance
- By emergency proclamation, the Governor waived the required one week waiting period and benefits began being paid within one business day
- The new Pandemic Unemployment Assistance Program, which extended unemployment benefits to individuals not traditionally eligible for them, did not require claimants to submit documentation to substantiate employment or self-employment wages

Effect of Condition

As of November 19, 2020, ESD estimates it paid out over 122,000 known or probable fraudulent claims totaling over \$600 million in fiscal year ending June 30, 2020. Of this amount, approximately \$250 million has been recovered to date, resulting in an estimated net loss of \$350.9 million. Efforts to identify and investigate known and suspected claims and recover fraudulent amounts are ongoing.

Recommendations

We recommend ESD continue working with the federal Department of Justice to recover the remaining fraudulent payments.

We further recommend ESD improve internal controls to better detect and prevent fraud before payments are made.

State's Response

Washington was out in front in implementing the Pandemic Unemployment Assistance Program (PUA) and other CARES Act benefits and has one of the highest weekly benefit amounts. This, combined with the fact Washington State has no income tax, made Washington an attractive state for a targeted fraud attack. ESD has been transparent and forthcoming about the dollar amounts lost to a targeted fraud attack in May of 2020 and has reported that correctly on its financial statements. During fiscal year 2020, ESD paid out \$7.5 billion in benefits for Unemployment Insurance and CARES Act programs. The amount lost to the targeted fraud attack is less than 8% of total benefits paid. Through aggressive recovery efforts, this loss has been reduced to 5% of total benefits paid during fiscal year 2020.

The discovery process was working as intended during this time period, which was to run as a batch every night. During normal operations, high risk claims would be identified and investigated prior to payment. Waiving the one-week waiting period and the high volume of claims impacted the Department's ability to identify high risk claims and investigate them before they were paid.

We appreciate the two primary recommendations from the State Auditor as they affirm the actions and investments ESD has already made and on which they are seen as a national leader.

ESD recovered a total of \$356.4 million but must complete investigations of suspected fraudulent claims in order to assign the recovered funds. So far they have been able to assign \$250.7 million to known or probable fraudulent claims. ESD continues its investigations into suspected fraudulent claims and to work with the federal Department of Justice to recover the remaining fraudulent payments.

Prior to the surge in fraudulent claims, ESD was already engaged in strong controls required and recommended by the U.S. Department of Labor (USDOL) to prevent imposter fraud, including those identified in UIPL 23-20 on Program Integrity for the Unemployment Insurance (UI) Program and UI programs authorized by the CARES Act. Those activities include use of the NASWA Integrity Data Hub (IDH), namely: identification verification, incarceration cross match, and Suspicious Actor Repository (SAR) checks.

Since the discovery of the surge in fraudulent claims in May 2020, ESD has instituted many additional controls and countermeasures to fraud, to include:

- Stood up a 100-person customer service in-take team to handle reports of fraud.*
- Established a secure portal for receiving verification information from victims and businesses to more quickly identify fraudulent claims, suspend payments and identify payments to recover.*
- Implemented a two-day hold on payments to help investigate fraudulent claims prior to payment, with the help of the McKinsey consulting company*
- Enacted emergency rule WAC 192-140-096 to allow suspension of payments suspected to be fraudulent until an investigation can be completed.*
- Reallocated resources and increased staffing for fraud investigations. Often surging capacity to include hundreds of other agency staff and the Washington National Guard.*
- Repurposed staff for data analytics to detect trends in fraud and improve the discovery process.*

The data shows all of these and other controls implemented are proving to be effective as there has been a dramatic reduction in fraudulent claim attempts since June 2, 2020.

For PUA claims, under the CARES Act language, states were required to rely on applicants' self-certification of eligibility for benefits. States were also required to pay claimants the minimum PUA weekly benefit amounts until documents could be verified and used to increase the weekly benefit amount if applicable. Those who didn't provide any documentation continued to receive the minimum weekly benefit amount. ESD was not allowed to establish stricter controls. The high risk of fraud for the PUA program was noted by the U.S. Department of Labor's Office of Inspector General in reports in April and May 2020, both because of the inherent risk in implementing benefit programs and because of the CARES Act requirements. The challenges are not unique to Washington but are, instead, nationwide.

Auditor's Remarks

We are aware that the pandemic presented a significant challenge to the ESD.

We reaffirm our finding and will follow-up on the status of this finding during the next audit of the state's comprehensive annual financial report.

Applicable Laws and Regulations

WAC 192-110-020

How will the department verify my identity?

When you apply for benefits, the information you provide must be sufficient for the department to confirm your identity to its satisfaction.

(1) If we can verify your identity with this information, we will file your application for benefits.

(2) If we cannot verify your identity, we will request additional verification.

(a) If the additional information provides satisfactory evidence of your identity, your claim will be effective based on the date you first applied for benefits, unless it is backdated as provided in WAC 192 110-095.

(b) If the additional information does not satisfy the department of your identity, we will deny your benefits.

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, July 2018 Revision, paragraph 6.40 establishes reporting requirements related to significant deficiencies or material weaknesses in internal control.

Government Auditing Standards, July 2018 Revision, paragraph 6.41 establishes reporting requirements related to instances of fraud or noncompliance with provisions of laws, regulations, contracts, or grant agreements.

The American Institute of Certified Public Accountants defines significant deficiencies and material weaknesses in its Codification of Statements on Auditing Standards, section 265, Communicating Internal Control Related Matters Identified in an Audit, paragraph 7.

2020-002 The State did not have adequate internal controls over financial reporting to ensure financial activity is properly classified, recorded in the correct period and reconciles to its financial statements.

Background

State management is responsible for designing, implementing and maintaining internal controls to ensure the financial statements are fairly presented, and to provide reasonable assurance regarding the reliability of financial reporting. We identified deficiencies in internal controls that could adversely affect the State's ability to prevent, or quickly detect and correct, misstatements in the financial statements.

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

State Board for Community and Technical Colleges

The State Board for Community and Technical Colleges (SBCTC) advocates for, coordinates and directs Washington's system of 34 public community and technical colleges. One of SBCTC's responsibilities is to collect and consolidate community and technical college financial data for reporting in the State's general ledger accounting system. During the previous three audits, we identified and communicated deficiencies in controls over the reporting of community and technical college financial data.

Office of Financial Management

The Office of Financial Management (OFM) is responsible for preparing the State's financial statements in accordance with generally accepted accounting principles (GAAP). These statements provide a thorough and detailed presentation of the State's overall financial condition. OFM is responsible for the overall coordination of financial data across the State used to prepare these statements. At year-end, OFM is also responsible for ensuring the accuracy of the financial information presented in the statements.

Employment Security Department

The Employment Security Department (ESD) is led by a Governor-appointed Commissioner. The Department has approximately 2,032 employees in offices across the state. It operates on a biennial budget of approximately \$1.956 million. The Department administers Washington State's unemployment insurance program. They processed approximately \$1.09 billion in Unemployment Insurance Premium payments and approximately \$105 billion in taxable wage information from employers. The Department paid out more than \$7.5 billion in Unemployment Insurance and

CARES Act benefits to over 926,815 individuals to assist them during the transition to a new job. During fiscal year 2020, ESD estimates it paid about \$600 million in known or likely fraudulent claims.

Description of Condition

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

SBCTC

The SBCTC did not complete a timely and accurate reconciliation of college financial data with amounts recorded in the State's accounting system before the State closed its books.

OFM

In preparing the State's financial statements, OFM did not identify and separately report fraudulent unemployment benefit payments from legitimate unemployment benefit payments.

ESD

The ESD did not report all receivables in the State's accounting system at June 30, 2020, that resulted from fraudulent claim payments.

Cause of Condition

SBCTC

The SBCTC did not dedicate sufficient time or resources to reconciling the balances and making appropriate adjustments to the State's accounting system. The difficulty of this reconciliation has increased as seven colleges had converted to a new, modernized computer system by fiscal year end while the remainder of schools remained on legacy software.

OFM

OFM did not separately report fraudulent unemployment benefit payments because it does not believe the State has incurred a fraud loss. OFM stated the vast majority of the fraudulent claims were expanded benefits under the federal CARES Act. The Unemployment Compensation Fund is reimbursed for the claim payments and related expenses from the federal government. OFM does not expect the federal Department of Labor to hold the State liable and require repayment.

ESD

The ESD did not report the receivables until the subsequent fiscal year to allow time to investigate and finalize the amounts.

Effect of Condition

SBCTC

We found numerous unexplained variances between consolidated college financial data and amounts recorded in the State's accounting system. Some of these variances include:

- In governmental activities funds, the State's accounting system had larger balances than the consolidated college financial data. These variances included depreciable assets (\$74 million), charges for services (\$63 million), operating grants and contributions (\$163 million), and education expenses (\$198 million).
- In the higher education special revenue funds, the State's accounting system had larger balances than the consolidated college financial data. These variances included cash (\$82 million), charges for services (\$62 million), federal grants-in-aid (\$2 million), and education expenditures (\$65 million).
- In the higher education student services funds, the State's accounting system had a larger balance than the consolidated college financial data for cash (\$19 million).

These errors were not corrected in the financial statements.

OFM

- In the unemployment compensation fund, about \$350 million was inappropriately classified as premiums and claims expense instead of being separately reported as estimated fraud loss expense.

These errors were not corrected in the financial statements.

ESD

The following accounts were misstated in the unemployment compensation fund:

- Receivables was understated by \$111 million.
 - Due to other governments was understated by \$54 million.
 - Accrued expenditures was understated by \$57 million.
- These errors were corrected in the financial statements.

Recommendations

We recommend the following:

SBCTC

Perform a complete and timely reconciliation of college financial data to the State's accounting system throughout the fiscal year

OFM

Implement controls to ensure expenses are presented at a detailed level and accurately describe the accounting event. We further recommend OFM seek confirmation from the Department of Labor that the State will not be held liable to repay the fraudulent claim payments.

ESD

Implement a review process to ensure receivable entries are recorded in the State's accounting system in the correct fiscal year.

State's Response

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

OFM will work with the two agencies included in the finding to improve their internal controls over the processing and reporting of financial activities. OFM will continue to provide assistance to the State Board of Community and Technical Colleges in its effort to complete the automated process of transmitting college financial data into the State's accounting system.

Auditor's Remarks

We appreciate the State's commitment to resolve this finding and thank OFM for its cooperation and assistance during the audit. We will review the corrective action taken during the next audit of the state's comprehensive annual financial report.

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 establishes reporting requirements related to significant deficiencies or material weaknesses in internal control, instances of fraud or abuse, and noncompliance with provisions of law, regulations, contracts, or grant agreements.

The American Institute of Certified Public Accountants defines significant deficiencies and material weaknesses in its Codification of Statements on Auditing Standards, section 265, Communicating Internal Control Related Matters Identified in an Audit, paragraph 7.

Governmental Accounting Standards Board Codification
P80.114 PROPRIETARY FUND ACCOUNTING AND FINANCIAL REPORTING

The statement of revenues, expenses, and changes in fund net position should be presented in the following sequence using the all-inclusive format...Operating expenses (detailed)

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

Section 20.15.30 Annual requirements for agencies related to statewide reporting

The Office of Financial Management (OFM) prepares the state's Comprehensive Annual Financial Report (CAFR) annually. While OFM has final responsibility for the contents of the CAFR, the data in the financial statements and many of the notes to the financial statements are generated from Agency Financial Reporting System (AFRS) transactions input by agencies. Because agencies are in control of transactions entered into AFRS, OFM relies on agency internal control systems and the monitoring of those systems to assert in writing that the CAFR is correct and complete.