



MICHIGAN

OFFICE OF THE AUDITOR GENERAL



THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

Audit report information can be accessed at:

<http://audgen.michigan.gov>



Michigan
Office of the Auditor General
REPORT SUMMARY

Management Letter

Michigan Public School Employees' Retirement System

October 1, 2008 through September 30, 2009

Report Number:
 071-0152-10M

Released:
 February 2010

The management letter is used to report significant deficiencies in internal control over financial reporting and other matters that come to the auditor's attention during the completion of the financial audit conducted in accordance with generally accepted government auditing standards. This management letter is being issued in conjunction with our financial audit of the Michigan Public School Employees' Retirement System.

Financial Statements:

Auditor's Report Issued

We have audited the financial statements of the Michigan Public School Employees' Retirement System as of and for the fiscal year ended September 30, 2009 and have issued a separate report thereon dated December 23, 2009. We issued an unqualified opinion on the System's financial statements.

~ ~ ~ ~ ~

Internal Control Over Financial Reporting

We identified a significant deficiency in internal control over financial reporting (Finding 1). We do not consider this significant deficiency to be a material weakness.

The Office of Retirement Services (ORS), Department of Management and Budget, and the Bureau of Investments (BOI), Department of Treasury, should work together to properly account for and report interest and dividends. Also, ORS and BOI should modify their methodology for recording the fair market value of real

estate and alternative investment holdings as of the fiscal year-end. (Finding 1)

~ ~ ~ ~ ~

Noncompliance and Other Matters Material to the Financial Statements

We did not identify any instances of noncompliance or other matters applicable to the financial statements that are required to be reported under *Government Auditing Standards*.

~ ~ ~ ~ ~

Agency Response:

Our management letter includes 1 finding and 2 corresponding recommendations. ORS's preliminary response indicated that it agrees with the finding.

~ ~ ~ ~ ~

Background:

The Michigan Public School Employees' Retirement System is a cost-sharing, multiple employer, Statewide, defined benefit public employee retirement plan governed by the State and operates under the provisions of Public Act 300 of 1980,

as amended. The System's pension plan was established by the State to provide retirement, survivor, and disability benefits to public school employees. In addition, the System's health plan provides all retirees with the option of receiving health, dental, and vision coverage under the Michigan Public School Employees' Retirement Act. There are 721 participating employers. By statute, employees of K-12 public school districts, public school academies, district libraries, tax-supported community colleges, and seven universities may be members.

~ ~ ~ ~ ~

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: <http://audgen.michigan.gov>



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

February 24, 2010

Ms. Diana Osborn, Chair
Michigan Public School Employees' Retirement System Board
General Office Building
and
Ms. Phyllis Mellon, Acting Director
Department of Management and Budget
Lewis Cass Building
and
Mr. Phillip Stoddard, Director
Office of Retirement Services
Department of Management and Budget
General Office Building
Lansing, Michigan

Dear Ms. Osborn, Ms. Mellon, and Mr. Stoddard:

We have audited the financial statements of the Michigan Public School Employees' Retirement System as of and for the fiscal year ended September 30, 2009 and have issued a separate report thereon dated December 23, 2009. In planning and performing our audit of the financial statements of the System, we considered the System's internal control over financial reporting and compliance and other matters. This is our management letter on the internal control over financial reporting and on compliance and other matters of the Michigan Public School Employees' Retirement System for the period October 1, 2008 through September 30, 2009.

This management letter contains our report summary; our independent auditor's report on internal control over financial reporting and on compliance and other matters; our finding, recommendations, and agency preliminary response; and a glossary of acronyms and terms.

The agency preliminary response was taken from the agency's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

TABLE OF CONTENTS

MANAGEMENT LETTER MICHIGAN PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

| | <u>Page</u> |
|--|-------------|
| INTRODUCTION | |
| Report Summary | 1 |
| Report Letter | 3 |
| INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE | |
| Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters | 8 |
| FINDING, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSE | |
| 1. Accounting for Retirement System Investments | 11 |
| GLOSSARY | |
| Glossary of Acronyms and Terms | 15 |

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Internal Control Over
Financial Reporting and on Compliance and Other Matters

Ms. Diana Osborn, Chair
Michigan Public School Employees' Retirement System Board
General Office Building
and
Ms. Phyllis Mellon, Acting Director
Department of Management and Budget
Lewis Cass Building
and
Mr. Phillip Stoddard, Director
Office of Retirement Services
Department of Management and Budget
General Office Building
Lansing, Michigan

Dear Ms. Osborn, Ms. Mellon, and Mr. Stoddard:

We have audited the financial statements of the Michigan Public School Employees' Retirement System as of and for the fiscal year ended September 30, 2009 and have issued our report thereon dated December 23, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Michigan Public School Employees' Retirement System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Michigan Public School Employees' Retirement System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Michigan Public School Employees' Retirement System's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed in the next paragraph, we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiency described in Finding 1 to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiency described in the third paragraph of this section is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan Public School Employees' Retirement System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The agency preliminary response to the finding identified in our audit is included in the body of our management letter. We did not audit the agency preliminary response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Governor, the Legislature, the Michigan Public School Employees' Retirement System Board, management, and others within the Department of Management and Budget and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

December 23, 2009

FINDING, RECOMMENDATIONS, AND
AGENCY PRELIMINARY RESPONSE

FINDING

1. Accounting for Retirement System Investments

The Office of Retirement Services (ORS), Department of Management and Budget (DMB), and the Bureau of Investments (BOI), Department of Treasury, should work together to properly account for and report interest and dividends. Also, ORS and BOI should modify their methodology for recording the fair market value of real estate and alternative investment holdings as of the fiscal year-end.

Our review of the accounting and reporting of investments by ORS and BOI disclosed:

- a. ORS did not present interest and dividends of \$93.4 million in the financial statements in a manner consistent with prior years. This inconsistency, while not material to the financial statements taken as a whole, may impair users' analysis and understanding of the comparative accounting data.

According to Section Pe5.121d, footnote 10, of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by the Governmental Accounting Standards Board* (GASB), interest and dividends and net appreciation (depreciation) may be reported separately or within the same line item on the face of the financial statements. However, in prior years, ORS has reported net appreciation (depreciation) and interest and dividends in separate financial statement line items. *FASB Accounting Standards Codification* (FASB Codification) 250-10-45-11 states that once an accounting principle is adopted, it shall be used consistently in accounting for similar events and transactions. FASB Codification 250-10-45-12 states that an entity may change how it applies an accounting principle if it justifies the use of the alternative principle on the basis that it is preferable. Although the combined presentation was allowable, we do not believe it was a clearly preferable change in the application of the accounting principle.

Therefore, ORS and BOI need to ensure proper classification of interest and dividends in the accounting records to support the consistent and preferable presentation of interest and dividends in separate financial statement line items. BOI informed us that some of the issues that would need to be

* See glossary at end of report for definition.

resolved include evaluating the increased number of transactions that BOI would have to process per month, ensuring that a new process would still allow BOI to evaluate the performance of the external managers, and implementing a process for BOI to perform additional analysis on certain data provided from State Street Bank to ensure that the items are properly classified.

- b. BOI's methodology for determining the fair market value of real estate and alternative investments did not consider significant changes in fair value during the last quarter of 2009. As a result, ORS and BOI overstated real estate investments by \$414.9 million, understated alternative investments by \$506.5 million, and understated net appreciation (depreciation) by \$91.5 million. After we reported this to ORS and BOI, they made the necessary adjustments to the financial statements.

GASB Codification Section Pe5.116 states that plan investments, whether equity or debt securities, real estate, investment derivatives instruments, or other investments (excluding insurance contracts), should be reported at their fair value at the reporting date. This section further states that fair value should be measured by the market price if there is an active market for the investment. If there is not an active market for the investment but there is an active market for similar investments, selling prices in that market may be helpful in estimating fair value.

BOI estimated the market value of real estate and alternative investments using the industry standard of pricing these types of investments based on the June 30 financial statements of the holdings plus or minus any cash activity related to the investment from July through September. However, because of the volatility in the market, the fair market value of these investments had fluctuated significantly from July through September 2009. Our review of the September 30, 2009 financial statements for approximately 70% of these investments showed that the real estate investments had depreciated about 8.9% and the alternative investments had appreciated about 6.4% since June 30.

BOI indicated that it does not always have information related to the fair value of these investments when processing closing entries in October. However,

we noted that it did have a majority of the information needed before the financial statements were released. Therefore, BOI could evaluate the information it receives prior to release of the financial statements in early December and, in conjunction with ORS, determine if an adjusting entry is needed to reflect significant changes in the fourth quarter fair market value of these investments.

RECOMMENDATIONS

We recommend that ORS and BOI work together to properly account for and report interest and dividends.

We also recommend that ORS and BOI modify their methodology for recording the fair market value of real estate and alternative investment holdings as of the fiscal year-end.

AGENCY PRELIMINARY RESPONSE

ORS agrees with the finding. ORS informed us that DMB Financial Services will work with BOI to review proper classification and reporting of interest and dividends from externally managed investments. ORS also informed us that DMB Financial Services will work with BOI to review and modify the current methodology for determining the fair market value of real estate and alternative investments, while also adhering to the Office of Financial Management's year-end closing schedule. ORS indicated that the review will be completed so that any changes to the estimation process can be implemented for the fiscal year 2009-10 year-end closing.

GLOSSARY

Glossary of Acronyms and Terms

| | |
|---|--|
| BOI | Bureau of Investments. |
| control deficiency in internal control over financial reporting | The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. |
| DMB | Department of Management and Budget. |
| FASB | Financial Accounting Standards Board. |
| FASB Codification | <i>FASB Accounting Standards Codification.</i> |
| financial audit | An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting. |
| GASB Codification | <i>Codification of Governmental Accounting and Financial Reporting Standards</i> , published by GASB. |
| Governmental Accounting Standards Board (GASB) | The board that provides authoritative guidance on accounting and reporting for state and local governmental entities. |
| internal control | A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. |
| material misstatement | A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not |

present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.

material weakness in internal control over financial reporting

A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial schedules and/or financial statements will not be prevented or detected.

ORS

Office of Retirement Services.

significant deficiency in internal control over financial reporting

A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial schedules and/or financial statements that is more than inconsequential will not be prevented or detected.

unqualified opinion

An auditor's opinion in which the auditor states that:

- a. The financial schedules and/or statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting; or
- b. The financial schedules and/or financial statements presenting supplemental financial information are fairly stated in relation to the basic financial schedules and/or financial statements. In issuing an "in relation to" opinion, the auditor has applied auditing procedures to the supplemental financial schedules and/or financial statements to the extent necessary to form an opinion on the basic financial schedules and/or financial statements, but did not apply auditing procedures to the extent that would be necessary to express an opinion on the supplemental financial schedules and/or financial statements taken by themselves.

