



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

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Michigan
Office of the Auditor General
REPORT SUMMARY

Management Letter

Report Number:
 071-0143-11M

*State Sponsored Group Insurance Fund
 Department of Technology, Management &
 Budget, Civil Service Commission, and
 Office of the State Employer*

October 1, 2009 through September 30, 2010

Released:
 March 2011

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 State Sponsored Group Insurance Fund, a proprietary fund of the State of Michigan.

Financial Statements:

Auditor's Report Issued

We have audited the financial statements of the State Sponsored Group Insurance Fund (SSGIF) as of and for the fiscal year ended September 30, 2010 and have issued a separate report thereon dated January 5, 2011. We issued an unqualified opinion on SSGIF's financial statements.

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Internal Control Over Financial Reporting

We identified significant deficiencies in internal control over financial reporting (Findings 1 and 2). We do not consider these significant deficiencies to be material weaknesses.

The Department of Technology, Management & Budget (DTMB) needs to improve its documentation of third party service organizations' (TPSOs') controls

over authorizing, recording, and processing claims on behalf of SSGIF. Also, DTMB could improve its financial monitoring of TPSOs to ensure the completeness and accuracy of SSGIF's financial records. (Finding 1)

DTMB's internal control did not ensure that financial statement transactions for SSGIF were properly classified and recorded in the proper amount and in the proper fiscal year (Finding 2).

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**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*.

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Agency Response:

Our management letter includes 2 findings and 3 corresponding recommendations. DTMB's preliminary response indicates that it agrees with the recommendations.

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Background:

The State Sponsored Group Insurance Fund, a proprietary fund of the State of Michigan, was administratively established to account for employee insurance benefits programs, which are largely self-funded. Five group insurance programs are offered to State employees: health, dental, vision, long-term disability, and life.

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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>



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

March 1, 2011

John E. Nixon, C.P.A., Director
Department of Technology, Management & Budget
George W. Romney Building
Lansing, Michigan
and
Mr. Jeremy S. Stephens, State Personnel Director
Civil Service Commission
Capitol Commons Center
Lansing, Michigan
and
Ms. Janine Winters, Director
Office of the State Employer
Capitol Commons Center
Lansing, Michigan

Dear Mr. Nixon, Mr. Stephens, and Ms. Winters:

We have audited the financial statements of the State Sponsored Group Insurance Fund as of and for the fiscal year ended September 30, 2010 and have issued a separate report thereon dated January 5, 2011. In planning and performing our audit of the financial statements of the Fund, we considered the Fund'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 State Sponsored Group Insurance Fund for the period October 1, 2009 through September 30, 2010.

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 findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to address the audit recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

AUDITOR GENERAL

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**STATE SPONSORED GROUP INSURANCE FUND
DEPARTMENT OF TECHNOLOGY, MANAGEMENT & BUDGET
CIVIL SERVICE COMMISSION
OFFICE OF THE STATE EMPLOYER**

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INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

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

John E. Nixon, C.P.A., Director
Department of Technology, Management & Budget
George W. Romney Building
Lansing, Michigan
and
Mr. Jeremy S. Stephens, State Personnel Director
Civil Service Commission
Capitol Commons Center
Lansing, Michigan
and
Ms. Janine Winters, Director
Office of the State Employer
Capitol Commons Center
Lansing, Michigan

Dear Mr. Nixon, Mr. Stephens, and Ms. Winters:

We have audited the financial statements of the State Sponsored Group Insurance Fund, a proprietary fund of the State of Michigan, Department of Technology, Management & Budget, Civil Service Commission, and Office of the State Employer, as of and for the fiscal year ended September 30, 2010 and have issued our report thereon dated January 5, 2011. 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 State Sponsored Group Insurance Fund'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 State Sponsored Group Insurance Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State Sponsored Group Insurance Fund's internal control over financial reporting.

A deficiency in internal control 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 and correct, misstatements on a timely basis. A material weakness is 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined in the preceding paragraph. However, we identified certain deficiencies in internal control over financial reporting, as described in Findings 1 and 2, that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is 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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State Sponsored Group Insurance Fund'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 State Sponsored Group Insurance Fund's preliminary responses to the findings identified in our audit are included in the body of our report. We did not audit the State Sponsored Group Insurance Fund preliminary responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Governor; the Legislature; the Department of Technology, Management & Budget; the Civil Service Commission; the Office of the State Employer; and others within the Fund's management 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

January 5, 2011

FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

BACKGROUND

The State Sponsored Group Insurance Fund (SSGIF), a proprietary fund of the State of Michigan, was administratively established to account for employee insurance benefits programs, which are largely self-funded. Five group insurance programs are offered to State employees: health, dental, vision, long-term disability, and life. The Department of Technology, Management & Budget (DTMB) is responsible for processing insurance transactions for current and retired State employees.

Although initially recorded in SSGIF, all retiree-related activity (except for life insurance), including accumulated net assets, is transferred to certain other employee benefit trust funds in the *State of Michigan Comprehensive Annual Financial Report*, whereas retiree life insurance activity is transferred to the General Fund at the end of the fiscal year. Retiree activity does not remain in SSGIF because the State of Michigan adopted Governmental Accounting Standards Board* (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, beginning in fiscal year 2007-08, which prohibits the reporting of retiree-related postemployment benefits within SSGIF.

FINDING

1. Controls Over State Transactions at Third Party Service Organizations

DTMB needs to improve its documentation of third party service organizations' (TPSOs') controls over authorizing, recording, and processing claims on behalf of SSGIF. Also, DTMB could improve its financial monitoring of TPSOs to ensure the completeness and accuracy of SSGIF's financial records. Improving documentation and monitoring of TPSOs' controls can help DTMB ensure that the TPSOs are meeting contractual obligations and making proper payments.

Section 18.1485 of the *Michigan Compiled Laws* requires that each department establish and maintain an internal accounting and administrative control system for the management of its financial affairs, including internal control* techniques that are effective. In addition, Part VII, Chapter 1, Section 1000 of the State of Michigan Financial Management Guide extends that requirement to services provided or transactions processed on behalf of the departments by TPSOs. DTMB Administrative Guide procedure 0610.03 requires DTMB to ensure that TPSOs meet contractual obligations, such as claims payment accuracy.

* See glossary at end of report for definition.

Eight TPSOs processed claims and fees totaling \$852.3 million (\$457.8 million for active employees and \$394.6 million for retired employees) during fiscal year 2009-10. As a result, it is critical that DTMB and TPSOs maintain effective internal control over claims processing to ensure the validity of claims and that claims are complete, accurate, and properly recorded throughout the fiscal year.

DTMB can obtain assurances regarding controls over TPSO activities using a variety of methods, including developing compensating controls within DTMB to minimize risk at the TPSO; conducting an audit or evaluation of the control system at the TPSO; or employing an independent auditor to conduct an audit (typically done in accordance with Statement on Auditing Standards No. 70, *Service Organizations*, which is known as a SAS 70 report*).

We identified 4 TPSOs that processed claims and fees totaling \$587.4 million (68.9% of the total claims and fees processed by DTMB's TPSOs) for which DTMB obtained and reviewed SAS 70 reports and/or performed financial monitoring of the TPSOs. However, our review of DTMB's process for obtaining assurances regarding controls over the remaining 4 TPSOs' activities and process for financial monitoring disclosed:

- a. DTMB did not have appropriate documentation of the 4 TPSOs' controls over claims processing performed on behalf of the State of Michigan. DTMB requests and reviews the TPSOs' SAS 70 reports as a means to gain an understanding of the controls at the TPSOs; however, SAS 70 reports were not obtained and reviewed for these TPSOs. DTMB informed us that it also relied on a claims audit and on a financial audit* of 1 TPSO, which were both performed by independent auditors and contractors. Our review of the claims audit disclosed that the audit scope did not include a determination of whether the TPSO's controls or the TPSO's information technology contractor's controls were in place and operating as intended and the audit period did not include fiscal year 2009-10. In addition, our review of the financial audit for the period ended December 31, 2009 disclosed that the audit was a financial audit of the TPSO's parent company and did not disclose whether the TPSO's controls were included in the audit scope.

* See glossary at end of report for definition.

- b. DTMB did not obtain assurances regarding the completeness and accuracy of claims data processed by TPSOs. As part of its financial monitoring, the Civil Service Commission and the Office of the State Employer employ an independent contractor to conduct claims audits to ensure that all insurance claims were complete, accurate, and properly recorded throughout the fiscal year; however, our review identified 2 TPSOs that processed claims and fees totaling \$120.8 million that did not have claims audits performed. DTMB informed us that the prior audits of these TPSOs did not disclose any material errors. Also, DTMB informed us that, as a compensating control, it obtains trend factors from the TPSOs, develops expectations for the fiscal year, and continually compares those expectations to claims reported by the TPSOs. In addition, DTMB informed us that the contractors conducting the claims audits review the trend factors for reasonableness.

The 4 TPSOs processed \$264.9 million (31.1%) of the total reported claims and service fees (\$115.7 million for active employees and \$149.2 million for retired employees).

RECOMMENDATIONS

We recommend that DTMB improve its documentation of TPSOs' controls over authorizing, recording, and processing claims on behalf of SSGIF.

We also recommend that DTMB improve its financial monitoring of TPSOs to ensure the completeness and accuracy of SSGIF's financial records.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendations and informed us that it will update procedures associated with the monitoring and oversight of the TPSOs' activities for SSGIF to help ensure the accuracy and reliability of financial data from the various TPSOs.

FINDING

2. Proper Recording of Financial Statement Transactions

DTMB's internal control did not ensure that financial statement transactions for SSGIF were properly classified and recorded in the proper amount and in the proper fiscal year. As a result, nonoperating revenues were overstated and

operating revenues were understated by \$11.8 million and accounts payable and other liabilities and operating expenses were understated by \$72,408 for the fiscal year ended September 30, 2010.

Our audit of SSGIF disclosed:

- a. DTMB did not properly record transactions relating to the long-term disability (LTD) program.

The State of Michigan provides a self-funded LTD insurance plan for eligible State employees. The Office of the State Employer contracted with a TPSO to administer the LTD insurance plan. The TPSO determines eligibility of the claimant and calculates the LTD payment for benefits. If claimants are deemed permanently unable to return to work at their "usual" or any "reasonable occupation," the claimants may be eligible to receive social security disability and/or pension disability retroactive to periods initially covered by LTD. If this occurs, the claimant is expected to reimburse the LTD insurance plan for the amount calculated by the TPSO.

Subsequent to the end of fiscal year 2009-10, DTMB recorded a receivable and a corresponding nonoperating revenue for the amount identified as overpayments for LTD that related to current and prior years' activity. Our review indicates that this revenue is related to SSGIF's principal ongoing operations and should be recorded as operating revenue. As a result, nonoperating revenues were overstated and operating revenues were understated by \$11.8 million for the fiscal year ended September 30, 2010.

Section P80, footnote 9 of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by GASB, identifies operating revenue and expense as those transactions that constitute a fund's principal ongoing operations.

- b. DTMB did not accurately record the amount due to the life insurance TPSO at year-end.

The State of Michigan provides group life insurance for eligible State employees, retirees, and dependents. The Civil Service Commission contracted with a TPSO to administer the self-funded group life insurance. At

year-end, the TPSO reconciles the premiums accrued, claim charges, the TPSO's expenses, and payment to or by the State for interest charges based on any surplus or deficit in the reserve fund over the year. Any positive balance in the reserve fund at the end of the plan year is refunded to the State; the State shall alternatively pay the TPSO the amount of any shortfall in year-end balances. The TPSO's year-end settlement invoice disclosed that DTMB did not record the entire amount due to the TPSO. As a result, accounts payable and other liabilities and operating expenses were understated by \$72,408.

GASB Codification Section 1600.130 states that proprietary fund financial statements should be presented using the accrual basis of accounting, that is, liabilities and expenses should be recognized when the transactions occur.

RECOMMENDATION

We recommend that DTMB improve its internal control to ensure that financial statement transactions for SSGIF are properly classified and recorded in the proper amount and in the proper fiscal year.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation and informed us that it will improve transaction processing and review to avoid such oversights. DTMB emphasized that the classification errors noted in the finding did not result in inaccurate fund balances at the end of fiscal year 2009-10, and DTMB considers the understated payable amount to be immaterial.

GLOSSARY

Glossary of Acronyms and Terms

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 and correct, misstatements on a timely basis.
DTMB	Department of Technology, Management & Budget.
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.
Governmental Accounting Standards Board (GASB)	An arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of 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.
LTD	long-term disability.
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 deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial schedules and/or financial statements will not be prevented, or detected and corrected, on a timely basis.
SAS 70 report	Statement on Auditing Standards No. 70 report. SAS No. 70 provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors. There are two types of SAS 70 reports. A "report on controls placed in operation" contains a description of the service organization's controls that may be relevant to a user of the service organization's internal control. A "report on controls placed in operation and tests of operating effectiveness" states whether controls were suitably designed to achieve specified control objectives, whether they had been placed in operation as of a specific date, and whether the controls that were tested were operating with sufficient effectiveness.
significant deficiency in internal control over financial reporting	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.
SSGIF	State Sponsored Group Insurance Fund.
TPSO	third party service organization.
unqualified opinion	An auditor's opinion in which the auditor states that the financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting.

