MICHIGAN

OFFICE OF THE AUDITOR GENERAL

REPORT ON INTERNAL CONTROL,
COMPLIANCE, AND OTHER MATTERS

STATE OF MICHIGAN
COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE
DEPARTMENT OF TECHNOLOGY, MANAGEMENT, AND BUDGET

Fiscal Year Ended September 30, 2012

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

071-0010-13

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

Report on Internal Control, Compliance, and Other Matters
State of Michigan Comprehensive Annual Financial Report
State Budget Office
Department of Technology, Management, and Budget
Fiscal Year Ended September 30, 2012

Report Number:
071-0010-13

Released:
June 2013

Generally accepted government auditing standards require an auditor to report on internal control over financial reporting; compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements; and other matters coming to the attention of the auditor during the completion of a financial audit. This report is being issued in conjunction with our financial audit of the State of Michigan Comprehensive Annual Financial Report (SOMCAFR).

Financial Statements:

Auditor's Report Issued

We have audited the *SOMCAFR* principally as of and for the fiscal year ended September 30, 2012 and have issued a separate report thereon dated February 28, 2013. We issued unqualified opinions on the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Michigan.

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Internal Control Over Financial Reporting

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

Our consideration of internal control for the limited purpose described in the preceding paragraph 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 that we consider to be material weaknesses; however, we did identify significant deficiencies (Findings 1 through 5). A significant deficiency is a deficiency, or 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.

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Tax Accruals

The Office of Financial Management (OFM), within the Department of Technology, Management, and Budget (DTMB), in conjunction with other State departments should improve internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals. The Department of Treasury's estimated accrual methodologies were used to record payables of $720.8 million and receivables of $2.9 billion for fiscal year 2011-12 (Finding 1).

Medicaid Accrual

The Department of Community Health (DCH) and OFM should continue to improve their internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the Medicaid accrual. In our audit of the accrual, we noted that there was an increased awareness of the need to strengthen internal control over the Medicaid accrual. The accrual components were prepared timely, and DCH was very receptive to our requests for information and has improved its tracking of estimated accrual with actual results. DCH's estimated accrual methodologies were used to record accrued payables of $891.2 million and receivables of $339.9 million for fiscal year 2011-12 (Finding 2).

Capital Assets

DTMB did not have sufficient internal control in place to ensure that computer software acquisition and development costs incurred by State agencies were properly identified and reported to OFM (Finding 3).

Medicaid Physician Adjuster Payments

DCH did not have sufficient internal control in place to ensure that amounts already paid to medical providers through the standard Medicaid reimbursement process were properly aggregated for purposes of calculating Physician Adjuster Program payments (Finding 4).

MDOT Contractor Payments

The Michigan Department of Transportation (MDOT), in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates (Finding 5).

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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:

This report includes 5 findings and 5 corresponding recommendations. OFM indicated that it generally agrees with the recommendations.

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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

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

June 12, 2013

John E. Nixon, C.P.A., State Budget Director
State Budget Office
Department of Technology, Management, and Budget
George W. Romney Building
Lansing, Michigan

Dear Mr. Nixon:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Michigan principally as of and for the fiscal year ended September 30, 2012, which collectively comprise the State's basic financial statements, and have issued a separate report thereon dated February 28, 2013. In planning and performing our audit of the financial statements, we considered the State's internal control over financial reporting and compliance and other matters. This report on internal control, compliance, and other matters is being issued in conjunction with our financial audit of the *State of Michigan Comprehensive Annual Financial Report* for the fiscal year ended September 30, 2012.

This report contains our report summary; our independent auditor's report on internal control over financial reporting and on compliance and other matters; our findings, our recommendations, and the agency preliminary responses and prior year management letter follow-up; and a glossary of acronyms and terms.

Certain findings included in this report specifically relate to other departments. Although the Office of Financial Management, State Budget Office, Department of Technology, Management, and Budget, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your Department's responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The agency preliminary responses were taken from the Department's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with 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.

Sincerely,

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

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GLOSSARY

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
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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., State Budget Director
State Budget Office
Department of Technology, Management, and Budget
George W. Romney Building
Lansing, Michigan

Dear Mr. Nixon:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Michigan, principally as of and for the fiscal year ended September 30, 2012, which collectively comprise the State's basic financial statements, and have issued our report thereon dated February 28, 2013. 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

Management of the State Budget Office is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the State's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State'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 through 5, 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'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*.

Certain findings included in this report specifically relate to other departments. Although the Office of Financial Management, State Budget Office, Department of Technology, Management, and Budget, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your Department's responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The Department's preliminary responses to the findings identified in our audit are included in the body of our report. We did not audit the Department's 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, and the State'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.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General
February 28, 2013

FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES AND PRIOR YEAR MANAGEMENT LETTER FOLLOW-UP

Fiscal Year 2011-12
Findings, Recommendations, and
Agency Preliminary Responses

FINDING

1. Tax Accruals

The Office of Financial Management (OFM), within the Department of Technology, Management, and Budget (DTMB), in conjunction with other State departments should improve internal control* to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals. The Department of Treasury's (Treasury's) estimated accrual methodologies were used to record payables of $720.8 million and receivables of $2.9 billion for fiscal year 2011-12.

The lack of internal control resulted in the following misstatements:

	Net Misstatement (in millions)
General Fund:	
Assets	Overstated $26.0
Liabilities	Understated $18.6
Revenues	Overstated $45.6
Expenditures	Overstated $ 1.0
Fund Balance	Overstated $44.6
School Aid Fund:	
Assets	Overstated $ 1.6
Liabilities	Overstated $ 0.3
Revenues	Overstated $ 1.3
Fund Balance	Overstated $ 1.3
Michigan Transportation Fund:	
Assets	Understated $ 4.7
Liabilities	Overstated $ 1.4
Revenues	Understated $ 6.1
Fund Balance	Understated $ 6.1
Governmental Activities of the Government-wide Financial Statements:	
Assets	Overstated $22.9
Liabilities	Understated $21.7
Revenues	Overstated $45.7
Expenses	Overstated $ 1.0
Net Assets	Overstated $44.7

** See glossary at end of report for definition.*

Subsequent to our review and prior to the issuance of the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*, OFM, in conjunction with other State departments, recorded adjusting entries to correct most of the misstatements. Although OFM made the correcting entries and the financial statements were materially correct, the internal control weaknesses should be corrected to help ensure the accuracy of the tax accruals in subsequent fiscal years.

Section 18.1141 of the *Michigan Compiled Laws* (Section 141, Act 431, P.A. 1984, as amended) provides that DTMB shall establish a comprehensive system of internal controls in the management of the State's financial affairs and record transactions in accordance with generally accepted accounting principles*. In addition, Section 18.1485 of the *Michigan Compiled Laws* (Section 485, Act 431, P.A. 1984, as amended) provides that the department head of each principal department shall establish and maintain an internal accounting and administrative control system within that principal department using generally accepted accounting principles and in conformance with directives issued pursuant to Section 18.1141(d) of the *Michigan Compiled Laws*.

We issued a total of 11 audit memorandums related to tax accruals. Following are four examples of the significant misstatements and internal control weaknesses noted during our review of the tax accruals:

a. Treasury and OFM did not use the appropriate set of collectibility percentages to estimate and record taxes receivable in relation to receivables to be assessed. As a result, we estimated that assets were overstated by $8.1 million, liabilities were overstated by $0.5 million, and revenues and fund balance were overstated by $7.6 million in the General Fund. In addition, we estimated that assets were overstated by $1.6 million, liabilities were overstated by $0.3 million, and revenues and fund balance were overstated by $1.3 million in the School Aid Fund and assets, revenues, and net assets were overstated by $9.7 million in the governmental activities of the government-wide financial statements.

** See glossary at end of report for definition.*

At the end of each fiscal year, Treasury identifies tax assessments that it intends to assess against taxpayers in the months of October and November. The assessment totals are grouped by type of tax and whether the individual assessment amounts are less than or greater than $20,000. An automated program is run within the State Treasurer's Accounts Receivable system that determines the estimated collectibility percentages that should be applied to the gross assessment amounts in determining the total receivable amounts to record within the *SOMCAFR*. The collectibility percentage ultimately applied to the gross assessment amount is actually a three-year average of the percentage determined for the current fiscal year and the prior two fiscal years.

Although Treasury determines separate collectibility percentages for assessments greater than $20,000, it applied the percentages associated with assessments less than $20,000 to all assessments regardless of amounts in calculating the amounts recorded within the *SOMCAFR*. The collectibility percentages for assessments less than $20,000 are typically greater than the percentages for assessments greater than $20,000. As a result, the methodology used inappropriately inflated estimated receivable amounts recorded for assessments greater than $20,000.

b. Treasury and OFM did not ensure that liabilities relating to the Michigan Business Tax (MBT) were properly recorded. As a result, payables were understated and revenues and fund balance/net assets were overstated by $23.4 million in the General Fund and the governmental activities of the government-wide financial statements.

Treasury records a liability at the end of the fiscal year for: (1) MBT refunds issued during October and November of the subsequent fiscal year; (2) processed MBT tax returns claiming a refund for which Treasury has not yet issued the refund as of November 30; and (3) unprocessed MBT returns received by November 30, 2012 claiming a refund. Treasury determines the amounts to record for each component of the liability from separate reports produced from the automated MBT system.

Our review of unprocessed MBT returns identified discrepancies between the refund amount claimed by the taxpayer on the return and the amount included within the liability recorded by Treasury. In fiscal year 2011-12, Treasury requested its Returns Processing Division (RPD) to perform a cursory review of unprocessed MBT returns on which significant refunds were claimed by the taxpayer. RPD informed us that the cursory review consisted primarily of identifying the system-determined refund amount and led Treasury to reduce the amount it would have otherwise included in the year-end liability by $166.3 million. Subsequent to the cursory review, Treasury asked RPD to check whether the system-determined amount changed for selected returns. Based on this follow-up review, Treasury increased the recorded liability by $72.7 million. However, our analysis identified five tax returns for which Treasury did not properly increase the refund amount included within the adjusted liability total. As a result, payables were understated and revenues and fund balance/net assets were overstated by $22.2 million. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with Treasury, recorded adjusting entries to correct the $22.2 million misstatement.

In addition, our review of processed MBT returns for which Treasury had not issued the refund as of November 30, 2012 identified four tax returns that were improperly excluded from the MBT system report. Treasury indicated that these four tax returns, with refund amounts totaling $1.2 million, should have been included within the recorded liability but did not appear within the MBT system report because of a programming code change that was not put into production. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with Treasury, recorded adjusting entries to correct the $1.2 million misstatement.

c. Treasury and OFM did not ensure that MBT cash collections were properly recorded in fiscal year 2011-12. As a result, assets, revenues, and fund balance/net assets were understated by $7.2 million in the General Fund and the governmental activities of the government-wide financial statements.

Treasury records a receivable at fiscal year-end for MBT collections received in October and November related to tax periods ending prior to October 1. Treasury identifies the amount of MBT collections to accrue using reports from the automated MBT system.

In addition to MBT collection amounts recorded with the automated MBT system, a limited amount of MBT collections are initially recorded within the automated Single Business Tax (SBT) system based on the remittance information provided by the taxpayer. Periodically, Treasury runs a query from the SBT system to identify any MBT amounts that need to be manually transferred to the MBT system. However, Treasury had not performed this transfer for a period of time leading up to when the MBT system report was generated for the fiscal year 2011-12 accrual. Therefore, the amounts were not reflected within the MBT system report used to calculate the accrual. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with Treasury, recorded adjusting entries to correct the $7.2 million misstatement.

d. Treasury and OFM did not ensure that delinquent tax assessments included within estimated receivable calculations represented valid amounts owed to the State. As a result, assets were overstated by $21.2 million, deferred revenues were overstated by $2.1 million, and revenues and fund balance were overstated by $19.1 million in the General Fund and assets, revenues, and net assets were overstated by $21.2 million in the governmental activities of the government-wide financial statements.

   We noted an exceptionally high dollar amount for an individual taxpayer included by Treasury in its calculation of tax assessments to record as taxes, interest, and penalties receivable. Because of the dollar amount of this single tax assessment, we requested that Treasury re-examine its validity. Treasury concluded that the taxpayer was actually due a refund in the amount of $1.8 million. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with Treasury, recorded adjusting entries to correct the misstatements.

RECOMMENDATION

We recommend that OFM, in conjunction with other State departments, improve internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals.

AGENCY PRELIMINARY RESPONSE

Treasury and OFM neither agree nor disagree with part a. of the finding. OFM informed us that, at this time, insufficient historical data is available to determine whether it is appropriate to revise the estimation methodology. Treasury and OFM will reevaluate part a. of the finding when sufficient historical data becomes available.

Treasury and OFM agree with parts b., c., and d. of the finding. OFM reiterated that the identified errors were corrected prior to the issuance of the *SOMCAFR* and informed us that, as part of the annual review of tax accrual methodologies, Treasury and OFM will determine if changes are needed to minimize the risk of similar types of errors in the future.

FINDING

2. Medicaid Accrual

The Department of Community Health (DCH) and OFM should continue to improve their internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the Medicaid accrual. In our audit of the accrual, we noted that there was an increased awareness of the need to strengthen internal control over the Medicaid accrual. The accrual components were prepared timely, and DCH was very receptive to our requests for information and has improved its tracking of estimated accruals with actual results. DCH's estimated accrual methodologies were used to record accrued payables of $891.2 million and receivables of $339.9 million for fiscal year 2011-12.

We identified multiple misstatements, resulting in net understatements of $15.1 million in assets, $12.8 million in liabilities, $6.7 million in revenues, $4.4 million in expenditures/expenses, and $2.3 million in fund balance/net assets in the General Fund financial statements and in the governmental activities of the government-wide financial statements. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with DCH, recorded adjusting entries to correct the misstatements. Although OFM made the correcting entries and the financial statements were materially correct, the internal control weaknesses should be corrected to help ensure the accuracy of the Medicaid accrual in subsequent fiscal years.

Section 18.1141 of the *Michigan Compiled Laws* (Section 141, Act 431, P.A. 1984, as amended) provides that DTMB shall establish a comprehensive system of internal controls in the management of the State's financial affairs and record transactions in accordance with generally accepted accounting principles. In addition, Section 18.1485 of the *Michigan Compiled Laws* (Section 485, Act 431, P.A. 1984, as amended) provides that the department head of each principal department shall establish and maintain an internal accounting and administrative control system within that principal department using generally accepted accounting principles and in conformance with directives issued pursuant to Section 18.1141(d) of the *Michigan Compiled Laws*.

The Medical Assistance Program (Medicaid) provides medical assistance to individuals and families who meet the Medicaid financial and nonfinancial eligibility factors. The goal of the Medicaid program is to ensure that essential healthcare services are made available to those who would otherwise not have financial resources to purchase them. The Medicaid year-end accruals represent an estimate of the State's liability for those medical services provided to eligible recipients during the fiscal year for which claims have yet to be submitted and/or approved for payment.

We issued a total of 9 audit memorandums related to the Medicaid accrual. Following are four examples of the significant or recurring misstatements and internal control weaknesses noted during our review of the Medicaid accrual:

a. DCH and OFM did not properly estimate the payable for the Health Plan Services component of the Medicaid accrual. As a result, liabilities and expenditures/expenses were overstated by $11.9 million, assets and revenues were overstated by $7.9 million, and fund balance/net assets were understated by $4.0 million in the General Fund and the governmental activities of the government-wide financial statements.

   DCH compares the number of Medicaid beneficiaries enrolled in a health maintenance organization (HMO) to the number of Medicaid beneficiaries with paid HMO capitations*. The difference is the number of beneficiaries whose capitation payment has not yet been paid by DCH and should be included

** See glossary at end of report for definition.*

within the accrual calculation. The number of beneficiaries identified through the preceding step is multiplied by the average capitation payment amount during the applicable fiscal year to determine the estimated payable.

During our review, we noted that the proper number of Medicaid beneficiaries enrolled in an HMO during the preceding fiscal year was not included in the accrual calculation. DCH used numbers that were applicable to fiscal year 2009-10, which were larger than the corresponding numbers for fiscal year 2010-11. Therefore, DCH's calculation overstated the number of beneficiaries whose capitation amounts remained unpaid in relation to fiscal year 2010-11. We also noted that the proper amounts of capitation payments made during fiscal years 2010-11 and 2011-12 were not included in the accrual calculation. The payment data query used by DCH improperly included $1.1 billion of payment amounts, which ultimately overstated the average capitation payment amounts used to calculate the estimated payable.

Subsequent to our review and prior to issuance of the *SOMCAFR*, DCH recalculated the proper accrual amount and OFM, in conjunction with DCH, recorded adjusting entries to correct the misstatements.

b. DCH and OFM did not properly estimate the payable and receivable for the long term care (LTC) Quality Assurance Supplement (QAS) Program reconciliations component of the Medicaid accrual.

DCH compares QAS program payments made through August of the current fiscal year with the QAS amount earned by the provider, which is based on the number of routine care days approved and the provider's corresponding QAS rate. The difference is recorded as the payable or receivable due to or from the provider.

During our review, we noted that DCH inappropriately included the QAS payment made during September 2012 within the comparison for 63 LTC providers. The providers' routine care days for the month of September were not submitted and/or approved at the time of the QAS reconciliation. Therefore, including these payments without a corresponding number of approved care days resulted in an invalid receivable amount from the provider.

As a result, liabilities were understated by $1.3 million, federal revenues were understated by $2.7 million, expenditures/expenses were understated by $4.0 million, and fund balance/net assets were overstated by $1.3 million in the General Fund and the governmental activities of the government-wide financial statements. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with DCH, recorded adjusting entries to correct the misstatements.

c. DCH and OFM did not properly estimate the receivable for the third party liability recovery component of the Medicaid accrual. As a result, assets and fund balance/net assets were overstated by $1.1 million, expenditures/expenses were understated by $3.2 million, and revenues were understated by $2.1 million in the General Fund and the governmental activities of the government-wide financial statements.

   DCH estimates the amount of Medicaid payment recoveries it expects to receive from third parties during the next fiscal year based on the average amount of collections received in prior years. However, DCH did not identify and evaluate third party liability recoveries that related to current year services within its calculation. Instead, DCH treated all current year recoveries as relating to prior year services. Based on the use of this methodology, DCH accrued 100% ($24.1 million) of the estimated fiscal year 2012-13 third party liability recovery collections. Subsequent to our review and prior to issuance of the *SOMCAFR*, OFM, in conjunction with DCH, recorded adjusting entries to correct the misstatements.

d. DCH and OFM should continue to improve internal control and fully implement a comprehensive tracking process to ensure that the processes used to develop the accounting estimates are reliable. A DCH comparison of the accounting estimates with subsequent activity would help provide assurance regarding the reliability of the processes used to develop the estimates.

   We initially identified this issue during the fiscal year 2009-10 *SOMCAFR* audit. In the fiscal year 2010-11 management letter, we reported that DCH did not complete a comparison or it did not compare prior year estimates to subsequent actual activity for 10 (91%) of the 11 components we reviewed

during that period. In response to the fiscal year 2010-11 management letter, DCH and OFM informed us that they would strive to improve formalized documentation of the validation processes and, for those components where methodologies did not include tracking procedures, they would assess and implement changes where appropriate and cost beneficial.

During fiscal year 2011-12, we noted progress in DCH's efforts to improve its tracking process. For 5 of 13 accrual components, DCH identified relevant data sources of subsequent activity, compiled this subsequent activity data, and documented more comparisons of the prior estimates to subsequent activity than we observed during the prior audit. However, in 1 case in which the comparison showed a significant variation between the estimate and subsequent activity, DCH did not document its assessment of the variance and the impact on the reliability of the estimate. Also, DCH had not fully and accurately implemented tracking and validation processes for the remaining 8 accrual components.

RECOMMENDATION

We recommend that DCH and OFM continue to improve internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the Medicaid accrual.

AGENCY PRELIMINARY RESPONSE

DCH and OFM generally agree with the recommendation. OFM reiterated that the identified errors were corrected prior to the issuance of the *SOMCAFR* and informed us that, as part of the annual review of the Medicaid accrual and tracking methodologies, OFM and DCH will determine if changes are needed to minimize the risk of future errors.

FINDING

3. Capital Assets

DTMB did not have sufficient internal control in place to ensure that computer software acquisition and development costs incurred by State agencies were properly identified and reported to OFM. As a result, DTMB, in conjunction with OFM, could not ensure that applicable costs were capitalized within the government-wide financial statements.

Section 18.1141 of the *Michigan Compiled Laws* (Section 141, Act 431, P.A. 1984, as amended) provides that DTMB shall establish a comprehensive system of internal controls in the management of the State's financial affairs and record transactions in accordance with generally accepted accounting principles.

Governmental Accounting Standards Board (GASB) Codification Section 1400 provides accounting guidance for reporting capital assets. The State of Michigan Financial Management Guide (FMG) (Part II, Chapter 21) provides State agencies with guidance on the accounting and reporting of capital assets.

DTMB relies on the individual State agencies to identify and report computer software acquisition and development costs to OFM, regardless of whether DTMB was involved in the project.

In fiscal year 2011-12, DTMB reported that it incurred $42.5 million in capitalized costs related to software development projects that DTMB managed on behalf of three State agencies. However, the $42.5 million did not include any project costs incurred by the agencies and the agencies did not include any costs in their respective year-end reports to OFM. DTMB indicated that, considering the size of the projects, it was reasonably possible that the departments incurred capitalizable costs in relation to these projects, but that the amounts were unknown to DTMB.

Also, we noted a fourth project managed by DTMB on behalf of the Department of Natural Resources (DNR) for which DTMB did not identify that it had incurred any capitalizable costs. DNR did not include the project, or applicable costs, in its year-end reporting to OFM. Based on discussions with DNR and DTMB, DNR incurred an estimated $3 million of software development costs in relation to the project that were not capitalized within the fiscal year 2011-12 government-wide financial statements.

We initially identified this issue during the fiscal year 2010-11 *SOMCAFR* audit. In response to the prior audit management letter, OFM revised the applicable sections of the FMG for the fiscal year 2011-12 year-end closing.

RECOMMENDATION

We recommend that DTMB improve internal control to ensure that computer software acquisition and development costs incurred by State agencies are properly identified and reported to OFM.

AGENCY PRELIMINARY RESPONSE

DTMB and OFM agree with the recommendation. OFM informed us that it will work with DTMB to ensure that capitalizable computer software acquisition and development costs incurred by State agencies are identified and appropriately reported to OFM.

FINDING

4. Medicaid Physician Adjuster Payments

DCH did not have sufficient internal control in place to ensure that amounts already paid to medical providers through the standard Medicaid reimbursement process were properly aggregated for purposes of calculating Physician Adjuster Program payments. As a result, DCH made payments to providers in excess of the estimated average commercial rate calculated by DCH.

DCH administers the Physician Adjuster Program under Title XIX of the Social Security Act. To maximize medical provider participation in Medicaid, the Physician Adjuster Program adjusts providers' qualified claims that were initially paid at the standard Medicaid rate upward to approximate commercial market rates. DCH calculates and makes Physician Adjuster Program payments on a quarterly basis.

To calculate the amount of the payment under the Physician Adjuster Program, DCH queries the Medicaid claims submitted by providers over the relevant time period. The query detail identifies the amount of submitted charges as well as amounts already paid to the providers through DCH's standard Medicaid reimbursement process. DCH then applies a complex rate factor to the submitted charges to arrive at an average commercial rate estimate. The difference between the average commercial rate estimate and the payments already made to the provider through the standard Medicaid reimbursement process is the Physician Adjuster Program payment amount.

Our analysis of $22.6 million of the $197.5 million paid under the Physician Adjuster Program in fiscal year 2011-12 disclosed that DCH paid approximately $633,000 (2.8%) more because the query did not properly aggregate amounts already paid to a provider through the standard Medicaid reimbursement process. Specifically, multiple payments to a provider for the same dollar amount were only identified once in DCH's query instead of in their aggregate. Based on total Physician Adjuster Program payments of $197.5 million for fiscal year 2011-12, we estimated that DCH paid $5.5 million (2.8%) more than would otherwise have been paid if the query properly aggregated the standard Medicaid reimbursement amounts already paid to providers.

DCH acknowledged that there were issues with its query and indicated that it would correct the query for subsequent calculations.

RECOMMENDATION

We recommend that DCH improve internal control to ensure that amounts already paid to medical providers through the standard Medicaid reimbursement process are properly aggregated for purposes of calculating Physician Adjuster Program payments.

AGENCY PRELIMINARY RESPONSE

DCH and OFM agree with the recommendation. OFM informed us that DCH has modified the aggregate query for determining future payments to providers.

FINDING

5. MDOT Contractor Payments

The Michigan Department of Transportation (MDOT), in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates. Consequently, construction expenditures may have been recorded in the wrong fiscal year.

The FMG (Part II, Chapter 14, Section 100) requires agencies to record payables for goods and services received by September 30.

MDOT project managers submit estimated accounts payable work sheets to the Contract Services Division for each outstanding project at the end of the fiscal year. The estimated payables are compiled by the Contract Services Division staff and recorded by the Accounting Services Division within MDOT.

MDOT's practice is to apply all payments made during the current fiscal year against the estimated payable established at the end of the prior fiscal year until the payable balance is reduced to zero. The actual date the work was completed is not taken into consideration. If payments in the current year for a project are less than the estimated payable established in relation to that project at the end of the prior fiscal year, the remaining payable balance is written off. On average, MDOT wrote off 14.0% of the estimated payables established for fiscal years 2010-11, 2009-10, and 2008-09. The write-off percentage is most likely understated because of MDOT's practice of applying all payments made during the current fiscal year against the estimated payable regardless of the date that work was completed.

MDOT project managers use inspector's daily reports (IDRs) to track the daily activity of a project. IDRs are then used to upload completed work into the Field Manager System for payment processing. A project manager may decide to withhold an entire IDR, or certain items within an IDR, from payment processing until satisfied that work is complete. Because of this, payments can include IDRs related to work performed during that pay period or weeks before, or even months before, the IDR item is submitted for payment processing. The information related to the dates of service is available from the IDRs but not in the Field Manager System from which contractor payments are processed.

RECOMMENDATION

We recommend that MDOT, in conjunction with OFM, improve internal control to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates.

AGENCY PRELIMINARY RESPONSE

MDOT and OFM agree with the recommendation. OFM informed us that MDOT will improve its internal control to evaluate dates of service when processing contractor payments and liquidating prior year accounts payable estimates.

Fiscal Year 2010-11
Management Letter Follow-Up

In the follow-up of our fiscal year 2010-11 *SOMCAFR* management letter, we noted that OFM and State agencies had complied with 2 of the 4 recommendations and partially complied with the other 2 recommendations (Findings 2 and 3).

GLOSSARY

Glossary of Acronyms and Terms

capitation	A fixed amount of money per patient per unit of time paid to the physician for the delivery of healthcare services.
DCH	Department of Community Health.
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.
DNR	Department of Natural Resources.
DTMB	Department of Technology, Management, and Budget.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial statements of an audited entity are presented fairly, in all material respects, in conformity with the disclosed basis of accounting.
FMG	Financial Management Guide.
generally accepted accounting principles	A technical accounting term that encompasses the conventions, rules, guidelines, and procedures necessary to define accepted accounting practice at a particular time; also cited as "accounting principles generally accepted in the United States of America."
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.
HMO	health maintenance organization.

IDR	inspector's daily report.
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.
LTC	long term care.
material misstatement	A misstatement in the financial statements that causes the 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 statements will not be prevented, or detected and corrected, on a timely basis.
MBT	Michigan Business Tax.
MDOT	Michigan Department of Transportation.
OFM	Office of Financial Management.
QAS	Quality Assurance Supplement.
RPD	Returns Processing Division.
SBT	Single Business Tax.

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.
SOMCAFR	*State of Michigan Comprehensive Annual Financial Report.*
Treasury	Department of Treasury.
unqualified opinion	An auditor's opinion in which the auditor states that the financial statements presenting the basic financial information of the audited entity are fairly presented in conformity with the disclosed basis of accounting.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL