MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

MANAGEMENT LETTER

STATE OF MICHIGAN
COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE
DEPARTMENT OF TECHNOLOGY, MANAGEMENT AND BUDGET

Fiscal Year 2008-09

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

071-0010-10

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

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REPORT SUMMARY

Management Letter

State of Michigan Comprehensive Annual Financial Report

State Budget Office

Department of Technology, Management and Budget

Report Number:
071-0010-10

Released:
May 2010

Generally accepted auditing standards require that significant deficiencies that come to the auditor's attention during the audit be reported. This management letter is the result of such items coming to our attention during the audit of the fiscal year 2008-09 State of Michigan Comprehensive Annual Financial Report *(*SOMCAFR*), which resulted in an unqualified opinion 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.*

Significant Deficiencies:

Single Business Tax (SBT) Accrual Calculation
The Department of Treasury did not ensure that the SBT receivable accrual calculation included the proper amount of SBT collections (Finding 1).

Michigan Business Tax (MBT) Collections
The Department of Treasury did not record MBT collections in the proper fiscal year (Finding 2).

Consistency of Use of SBT Historical Data
The Department of Treasury did not consistently apply its methodology related to the use of SBT historical data to estimate MBT receivables (Finding 3).

MBT Transfer to the School Aid Fund
The Department of Treasury did not transfer the proper amount of MBT revenue from the General Fund to the School Aid Fund (Finding 4).

Recording and Calculation of Accruals
The Office of Financial Management (OFM), in conjunction with other State departments, did not ensure that all expenditures/expenses and program revenues were properly accrued for amounts due or for amounts not yet collected at September 30, 2009 (Finding 5).

DELEG Transfer of GEAR UP Funds to the Department of Treasury
The Department of Energy, Labor & Economic Growth (DELEG) did not properly record the transfer of Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP) funds to the Department of Treasury (Finding 6).

On-Behalf Payments for Other Postemployment Benefits (OPEB)
OFM did not recognize expenditures/expenses and revenue associated with on-behalf payments made

by the federal government related to OPEB (Finding 7).

Department of Community Health (DCH) Integrity of Data in the Data Warehouse
DCH did not have sufficient internal control over the data warehouse to ensure the integrity of the data related to the volume of pharmaceuticals purchased (Finding 8).

General Controls Over State Information Systems
The Department of Technology, Management and Budget (DTMB), in conjunction with other State departments, needs to improve information technology general controls for significant financial related information systems (Finding 9).

Recording of Net Pension Obligations (NPOs) and Net Other Postemployment Benefits Obligations (NOPEBOs)
OFM did not estimate the long-term obligations for NPOs and NOPEBOs for non-State employees (Finding 10).

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Agency Response:
Our management letter includes 10 findings and 10 corresponding recommendations.

OFM agrees with 7 of the recommendations, disagrees with 1 recommendation, and did not express agreement or disagreement with 2 recommendations and acknowledges that there were financial statement errors. However, the financial statements fairly present, in all material respects, the respective financial position of the funds reported. Although OFM did not correct the noted errors due to timing and materiality in fiscal year 2008-09, OFM will take corrective action in fiscal year 2009-10, if necessary, to address the General Fund unreserved fund balance overstatement of $4.0 million; the School Aid Fund reserved fund balance understatement of $7.9 million; and the entity-wide total net assets overstatement of $36.4 million.

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Background:
Executive Order No. 2009-55 renamed the Department of Management and Budget as the Department of Technology, Management and Budget (DTMB), effective March 21, 2010. It also transferred all of the authority, powers, duties, functions, responsibilities, records, personnel, appropriations, etc., of the Michigan Department of Information Technology (MDIT) to DTMB by a Type III transfer and abolished MDIT. In addition, it renamed the Office of the State Budget as the State Budget Office.

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AUDITOR GENERAL

May 4, 2010

Mr. Robert L. Emerson, State Budget Director
State Budget Office
Department of Technology, Management and Budget
George W. Romney Building
Lansing, Michigan

Dear Mr. Emerson:

In planning and performing our audit of the basic financial statements of the State of Michigan principally as of and for the fiscal year ended September 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the Statewide internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Statewide internal control. Accordingly, we do not express an opinion on the effectiveness of the Statewide internal control.

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

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. Significant deficiencies are described in Findings 1 through 10.

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. We do not consider the significant deficiencies identified in the previous paragraph to be material weaknesses.

Certain findings included in this management letter 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 written response to the significant deficiencies identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the State's management, others within the organizations, and the Legislature 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.

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

AUDITOR GENERAL

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MANAGEMENT LETTER

STATE OF MICHIGAN COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE

DEPARTMENT OF TECHNOLOGY, MANAGEMENT AND BUDGET

Fiscal Year 2008-09
Findings, Recommendations, and
Agency Preliminary Responses

This section contains 8 new findings and 8 corresponding recommendations identified in our fiscal year 2008-09 *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)* audit.

FINDING

1. Single Business Tax (SBT) Accrual Calculation

The Department of Treasury did not ensure that the SBT receivable accrual calculation included the proper amount of SBT collections. As a result, taxes receivable and deferred revenue were overstated in the General Fund by $65.5 million. In addition, taxes receivable, general revenues, and unrestricted net assets were overstated in the governmental activities of the government-wide statements by $65.5 million.

SBT was phased out at the end of calendar year 2007, and the new Michigan Business Tax (MBT) was implemented at the beginning of calendar year 2008. The Department of Treasury continued to record a full accrual receivable for SBT for fiscal year 2008-09 but decided that it would not recognize a full accrual receivable for MBT because historical data was not available to calculate a reasonable estimate. During our review of the full accrual SBT calculation, we noted:

a. The Department of Treasury included MBT collections for insurance company retaliatory taxes in the SBT full accrual calculation. Because the Department of Treasury is not recording a full accrual receivable for MBT, this resulted in an overstatement of $70.4 million in taxes receivable and deferred revenue in the General Fund. In addition, it resulted in an overstatement of taxes receivable, general revenues, and unrestricted net assets in the governmental activities of the government-wide statements by the same amount.

b. In fiscal year 2007-08, the Department of Treasury did not ensure that SBT and MBT collections were properly coded as to tax type within total tax revenues in the State's accounting records.

Because the accrual calculation is based on prior year collection history, this misstatement also affected the fiscal year 2008-09 accrual calculation. Although the Department of Treasury adjusted the fiscal year 2008-09 SBT taxes receivable and deferred revenue balances to reflect fiscal year 2008-09 activity, fiscal year 2008-09 taxes receivable, general revenues, and net assets were still understated by $5 million in the governmental activities of the government-wide statements related to the SBT error noted in fiscal year 2007-08. In addition, we determined that taxes receivable and deferred revenue were understated by the same amount in the General Fund statements.

RECOMMENDATION

We recommend that the Department of Treasury ensure that the SBT receivable accrual calculation includes the proper amount of SBT collections.

AGENCY PRELIMINARY RESPONSE

The Office of Financial Management (OFM) and the Department of Treasury agree with the recommendation. The Department of Treasury informed us that it has modified its processes to ensure that only SBT related collections are included in its calculation of the SBT accrual. In addition, OFM would like to note that the overstatements of General Fund taxes receivable and deferred revenue offset each other, so there was no impact on the September 30, 2009 General Fund balance.

FINDING

2. MBT Collections

The Department of Treasury did not record MBT collections in the proper fiscal year. As a result, fiscal year 2008-09 revenue, taxes receivable, and fund balance were understated by $12.6 million in the General Fund statements and revenue, taxes receivable, and net assets were understated by the same amount in the entity-wide statements.

Section 1600.106 of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by the Governmental Accounting Standards Board* (GASB) states that revenues are recognized in the accounting

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

period in which they become susceptible to accrual, that is, when they become both measurable and available. "Available" means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.

It is the Department of Treasury's policy to record tax collection amounts received in October and November as revenue of the fiscal year ended in September to the extent that the activities being taxed occurred prior to October 1. For MBT taxpayers with quarterly or monthly filings due October 31, 100% of the payment relates to activities prior to October 1. Therefore, it is the Department of Treasury's policy to record the entire amount collected in October and November, for these filers, as revenue of the prior fiscal year. For MBT taxpayers with quarterly filings due November 30, two-thirds of the payment is attributed to activities prior to October 1. Therefore, it is the Department of Treasury's policy to record two-thirds of the amounts collected in October and November, for these filers, as revenue of the prior fiscal year.

During our review of the MBT collection amounts received in October and November 2009, we noted that the Department of Treasury did not properly record the quarterly and monthly payments related to fiscal year 2008-09 taxes. The Department of Treasury informed us that it did not record these payments in fiscal year 2008-09 because the electronic payment information maintained in the MBT automated information system indicated that the payments were related to the taxpayers' income and earnings for periods after September 30, 2009. However, our review disclosed that the file payment date recorded in the MBT system was not always accurate and did not always represent the taxpayers' business earnings and income period.

RECOMMENDATION

We recommend that the Department of Treasury record MBT collection amounts in the proper fiscal year.

AGENCY PRELIMINARY RESPONSE

OFM and the Department of Treasury agree with the recommendation. The Department of Treasury informed us that it will evaluate and revise its processes to ensure that revenue collections are recorded in the proper fiscal year. In addition, OFM would like to note that, although revenues were recorded in the wrong fiscal year, current General Fund balance is now correct.

FINDING

3. Consistency in Use of SBT Historical Data

The Department of Treasury did not consistently apply its methodology related to the use of SBT historical data to estimate MBT receivables. As a result, taxes receivable were overstated by $3.2 million, deferred revenue was overstated by $.4 million, and tax revenue and fund balance were overstated by $2.8 million in the General Fund. In addition, taxes receivable were overstated by $3.2 million, and general revenues and net assets were both overstated by $3.2 million in the governmental activities of the government-wide statements.

The Department of Treasury decided that it would not recognize a full accrual receivable for the MBT revenue because historical data was not available to calculate a reasonable estimate. In its position paper, the Department of Treasury concluded that SBT and MBT have significant differences and independent MBT estimates would not be measurable until historical data is available. However, in its calculation of the 60-day accrual, the Department of Treasury used the historical SBT collectability percentages to estimate the MBT receivables to be assessed.

RECOMMENDATION

We recommend that the Department of Treasury consistently apply its methodology related to the use of SBT historical data to estimate MBT receivables.

AGENCY PRELIMINARY RESPONSE

OFM and the Department of Treasury agree with the recommendation. The Department of Treasury informed us that it will evaluate and revise its processes to ensure that the SBT and MBT receivables are calculated in accordance with approved methodologies. The Department of Treasury indicated that it will also correct the overstatements in fiscal year 2009-10.

FINDING

4. MBT Transfer to the School Aid Fund

The Department of Treasury did not transfer the proper amount of MBT revenue from the General Fund to the School Aid Fund. As a result, revenue, current assets, and fund balance were overstated by $8.0 million in the General Fund and understated by $8.0 million in the School Aid Fund.

Section 208.1515(1) of the *Michigan Compiled Laws* requires that $729 million of the MBT revenue collected in fiscal year 2008-09 be deposited in the School Aid Fund. Section 208.1515(2) of the *Michigan Compiled Laws* reduces the amount of MBT revenue that is required to be transferred to the School Aid Fund by the amount of medical services use tax distributed for the year.

The Department of Treasury initially transferred the entire $729 million of MBT revenue collected to the School Aid Fund. It later made the adjustment to account for the medical services use tax and moved $59.7 million to the General Fund instead of the $51.7 million actually collected in fiscal year 2008-09. The difference of $7.9 million in revenue was actually recorded in fiscal year 2009-10 and was not included in the fiscal year 2008-09 School Aid Fund revenue.

It is the Department of Treasury's policy to record tax collection amounts received in October and November as revenue of the fiscal year ended in September. Therefore, the medical services use tax revenue was accrued in the proper fiscal year.

RECOMMENDATION

We recommend that the Department of Treasury transfer the proper amount of MBT revenue from the General Fund to the School Aid Fund.

AGENCY PRELIMINARY RESPONSE

OFM and the Department of Treasury agree with the recommendation. The Department of Treasury informed us that it will evaluate and revise its processes to ensure that revenue distributions are properly made to the General Fund and the School Aid Fund. The Department of Treasury indicated that it will also correct the revenue distribution to the School Aid Fund in fiscal year 2009-10.

FINDING

5. Recording and Calculation of Accruals

OFM, in conjunction with other State departments, did not ensure that all expenditures/expenses and program revenues were properly accrued for amounts due or for amounts not yet collected at September 30, 2009. As a result, net understatements of $7.3 million were noted in liabilities, $1.4 million in current assets, $2.7 million in expenditures/expenses, and $1.5 million in revenues and net overstatements of $4.8 million were noted in beginning fund balance/net assets and $5.9 million in fund balance/net assets in the General Fund statements and in the governmental activities of the government-wide financial statements.

GASB Codification Section 1600.106 states that revenues and other governmental fund financial resource increments are recognized in the accounting period in which they become susceptible to accrual. GASB Codification Section 1600.116 states that most expenditures and transfers out are measurable and should be reported when the related liability is incurred.

Our review of various programs during the *SOMCAFR* audit disclosed:

a. The Department of Corrections (DOC) did not record an expenditure/expense or corresponding liability for prisoner medical service costs. As a result, expenditures/expenses and accounts payable and other liabilities were understated by $0.7 million and $5.4 million, respectively, and fund balance/net assets were overstated by $5.4 million for fiscal year 2008-09. In addition, DOC did not record a similar liability and expenditure/expense in fiscal year 2007-08, which caused beginning fund balance/net assets for fiscal year 2008-09 to be overstated by $4.8 million in the General Fund statements and in the governmental activities of the government-wide statements. In fiscal year 2008-09, DOC paid these medical service charges that were incurred in fiscal year 2007-08, which offset the expenditure/expense error for costs incurred in fiscal year 2008-09.

   DOC contracts with a medical service provider for prisoner health care services. DOC received a periodic billing for the estimated services to be provided based on DOC's prison population throughout the fiscal year. In addition, DOC received monthly billing reconciliations from the medical service provider invoicing DOC for the difference between actual medical service costs and the estimated amount previously paid. However, DOC did not make the appropriate year-end adjusting entries to ensure that the actual costs were recorded in the proper fiscal year.

b. The Department of Human Services (DHS) did not record prepaid expenditures/expenses for the State-funded portion of Supplemental Security Income (SSI) benefits in the proper fiscal year. As a result, accounts payable and other liabilities and other current assets were understated in the General

Fund and in the governmental activities of the government-wide statements by $1.9 million.

The SSI program provides cash benefits to needy persons who are aged (at least 65), blind, or disabled. It is a federal program administered by the Social Security Administration (SSA) in which states have the option to supplement the federal benefit with state funds. In Michigan, SSI benefits include a basic federal benefit and an additional amount paid with State funds. SSI benefits are paid by the SSA monthly, with payments made on the first of every month. The SSA requires DHS to pay the State-funded portion in advance of the monthly benefit issuance.

Our review disclosed that DHS was obligated to pay the SSA the State-funded portion of SSI for October 2009 in advance on September 30, 2009. DHS informed the SSA that payment would not be made until October 1, 2009 and did not record the obligation in fiscal year 2008-09. The SSA acknowledged that the payment would be made in October; however, it did not provide approval for DHS to make the payment on October 1, 2009.

Part II, Chapter 11, Section 300 of the Financial Management Guide states that an agency should process payments for new year services, which must be made prior to October 1, in the old fiscal year. After the agency initially processes the payment in the old fiscal year, the agency should then make an adjusting entry in the old fiscal year to reclassify the payment as a prepaid expenditure and also process an entry in the new fiscal year to record the final expenditure.

c. The Department of Community Health (DCH) recorded receivables and payables related to Long-Term Care facilities that had notified DCH that they had filed for bankruptcy or that they had been sold or closed without considering the collectability. As a result, expenditures/expenses were understated by $2.0 million, revenue was understated by $1.5 million, and current assets and fund balance/net assets were overstated by $0.5 million in the General Fund statements and the governmental activities of the government-wide statements.

During our review of the Long-Term Care settlement accrual, we noted payables and receivables that had not changed from the previous year, indicating that DCH did not pay or receive any money from the facility during the fiscal year. DCH informed us that although it is doubtful that it would receive repayment for some or all of the debt, it continues to include these facilities in the accrual until it receives documentation to the contrary.

RECOMMENDATION

We recommend that OFM, in conjunction with other State departments, ensure that all expenditures/expenses and program revenues are properly accrued for amounts due and for amounts not yet collected at the end of the fiscal year.

AGENCY PRELIMINARY RESPONSE

OFM did not express agreement or disagreement with the recommendation. OFM informed us that it will work with each agency to ensure that accruals are recorded in accordance with approved methodologies and accounting standards. If necessary, the agencies will modify their methodologies in fiscal year 2009-10 to ensure that accruals are properly recorded.

FINDING

6. DELEG Transfer of GEAR UP Funds to the Department of Treasury

The Department of Energy, Labor & Economic Growth (DELEG) did not properly record the transfer of Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP) funds to the Department of Treasury. As a result, expenditures/expenses and revenue were overstated by $1.8 million in both the General Fund and the governmental activities of the government-wide statements.

Part II, Chapter 16, Section 100 of the Financial Management Guide states that accounting activity between a payer and a payee that is recorded in the same appropriated fund should be handled as a reimbursement or a revenue pass-through. Therefore, any expenditure recorded by the paying agency needs to be offset by an expenditure credit in the receiving agency and any revenue passed on should be debited in the paying agency and credited in the receiving agency.

DELEG has an interagency agreement with the Department of Treasury to provide oversight of the scholarship component and all financial aid issues of GEAR UP, which includes administering and disbursing the scholarship funds to qualifying GEAR UP students, conducting financial aid workshops and training, etc.

Instead of recording a revenue reduction in the General Fund, which would have offset the revenue that DELEG recorded when it originally received the funds, DELEG processed the transfer of funds to the Department of Treasury as a payment by recording an expenditure and a credit to revenue in the General Fund within the Department of Treasury, thereby overstating expenditures and revenue in the General Fund and expenses and program revenue in the government-wide statements by $1.8 million.

RECOMMENDATION

We recommend that DELEG properly record the transfer of GEAR UP funds to the Department of Treasury.

AGENCY PRELIMINARY RESPONSE

OFM, DELEG, and the Department of Treasury agree with the recommendation. DELEG and the Department of Treasury informed us that they will properly record GEAR UP federal revenue and related expenditures/expenses in fiscal year 2009-10.

FINDING

7. On-Behalf Payments for Other Postemployment Benefits (OPEB)

OFM did not recognize expenditures/expenses and revenue associated with on-behalf payments made by the federal government related to OPEB. As a result, expenditures/expenses and revenue were understated by $22.5 million in the General Fund and the governmental activities of the government-wide statements.

GASB Technical Bulletin No. 2006-1, question 3, provides that a retiree drug subsidy payment from the federal government to a defined benefit OPEB plan is an on-behalf payment for fringe benefits, as discussed in GASB Codification Section N50.129. Further, GASB Codification Section N50.130 states that an employer government should recognize revenue and expenditures for on-behalf payments for fringe benefits and salaries.

During fiscal year 2008-09, the State of Michigan administered and made contribution payments to three single-employer OPEB plans (the Legislative Retirement System [LRS], State Police Retirement System [SPRS], and State Employees' Retirement System [SERS]). In addition, it made contribution payments for other postemployment benefits for life insurance. The State of Michigan is the employer for these plans. The LRS, SPRS, and SERS plans also received contribution payments of $22.5 million directly from the federal government pursuant to retiree drug subsidy provisions of Medicare Part D. These on-behalf payments should have been recorded as expenditures and revenue in the General Fund and as expenses and program revenue in the government-wide statements.

RECOMMENDATION

We recommend that OFM recognize expenditures/expenses and revenue associated with on-behalf payments made by the federal government related to OPEB.

AGENCY PRELIMINARY RESPONSE

OFM agrees with the recommendation. OFM and the Department of Technology, Management and Budget (DTMB) informed us that they will properly record Medicare Part D federal revenues and related expenditures in the General Fund in fiscal year 2009-10. In addition, OFM would like to note that the understatement of General Fund revenues and expenditures offset each other, so there was no impact on the September 30, 2009 General Fund balance.

FINDING

8. DCH Integrity of Data in the Data Warehouse

DCH did not have sufficient internal control* over the data warehouse to ensure the integrity of the data related to the volume of pharmaceuticals purchased. As a result, DCH could not ensure that its reconciliations provided assurance that the pharmaceutical drug manufacturer rebates were accurate. During fiscal year 2008-09, the State billed pharmaceutical drug manufacturers approximately $219 million for rebates.

Pharmaceutical drug manufacturers issue rebates to DCH because of the high volume of drug purchases for the Medicaid Drug Program. DCH contracts with First Health Services Corporation to bill the pharmaceutical drug manufacturers for these rebates. On a quarterly basis, DCH performs a reconciliation between the

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

billings from First Health Services Corporation and the volume of drugs purchased to ensure that the appropriate amount of rebates was included in the billing. The data used in the reconciliation is obtained from the pharmaceutical drug manufacturers and stored in the data warehouse.

During our review of the rebates, we attempted to verify the appropriateness and accuracy of DCH's rebate reconciliation. However, after recalculating two reconciliations for amounts related to fiscal year 2008-09, we found that our results were not comparable to DCH's results. Through discussions with DCH staff, we were informed that the data warehouse may no longer contain the same data as when DCH originally performed its reconciliation potentially because of timing differences, weaknesses in tracking adjustments, and conversion to a new system.

RECOMMENDATION

We recommend that DCH improve its internal control over the data warehouse to ensure the integrity of the data related to the volume of pharmaceuticals purchased.

AGENCY PRELIMINARY RESPONSE

OFM and DCH agree with the recommendation. DCH informed us that it will revise its reconciliation procedures to facilitate the reproduction of the reconciliation results at different points in time.

Fiscal Year 2007-08
Management Letter Follow-Up

In the follow-up of our fiscal year 2007-08 *SOMCAFR* management letter, we noted that OFM and State agencies had complied with 9 of the 13 recommendations. Of the other 4 recommendations, we have forwarded 2 recommendations for further follow-up in our financial audit, including the provisions of the Single Audit Act, of DCH and have repeated 2 recommendations in this section of our 2008-09 management letter.

FINDING

9. General Controls Over State Information Systems

DTMB, in conjunction with other State departments, needs to improve information technology (IT) general controls for significant financial related information systems. Improved general controls will help ensure that all transactions are properly initiated, processed, and recorded in the State's accounting records.

DTMB Administrative Guide procedure 1270.12 states that State agencies are responsible for establishing and maintaining appropriate internal control over IT systems. The procedure also states that, in coordination with OFM and DTMB, which includes the former Michigan Department of Information Technology (MDIT), State agencies will develop, maintain, and monitor appropriate IT related controls. General controls are policies and procedures that help ensure the continued proper operation of IT systems. General controls also support the functioning of application controls, which ensure the completeness and accuracy of information processing.

We evaluated general controls relating to access, configuration management, and contingency planning for significant applications residing on the IBM, Unisys, Bull, Windows, and UNIX operating system platforms. We performed procedures to assess the effectiveness of the general controls' design and to determine whether general controls had been placed in operation. Our review disclosed:

a. DTMB needs to improve access controls over mainframe, client server operating systems, and significant financial related applications. Weak access controls may allow individuals to bypass existing controls to gain access to sensitive data, programs, or password files. For example, we identified control deficiencies related to password and account lockout policy, authentication protocols, vulnerable services, access to sensitive directories and files, monitoring for security violations, and monitoring of privileged accounts and users.

b. DTMB's Technical Services Division and Bureau of Agency Services had not fully implemented procedures requiring all operating system and application program changes to go through DTMB's Service Management Center (SMC). SMC helps ensure that all changes to operating system configurations and application programs are properly authorized, approved, tested, tracked, and monitored. Without effective configuration management controls, State agencies and DTMB cannot ensure that only authorized modifications of operating system configurations and application programs are implemented. We identified instances in which changes to client server operating system configurations and application programs were not documented and approved in SMC.

c. DTMB had not fully established mechanisms, such as documenting baseline configurations and utilizing integrity checking software, to monitor for changes impacting security. Such mechanisms would help ensure that only approved configuration changes were made to operating systems and application programs. According to National Institute of Standards and Technology* (NIST) Special Publication 800-53A, organizations should develop, document, and maintain a current baseline configuration of the information system. In addition, NIST states that organizations should routinely monitor the baseline configuration and analyze changes that potentially impact security.

d. State agencies and DTMB did not periodically test DTMB's ability to restore the operating system, application programs, and data from backup. Without effective backup and recovery controls, State agencies and DTMB cannot ensure that critical applications and data are recovered in the event of a disruption. According to NIST Special Publication 800-53A, organizations should periodically use backup information in the restoration of information system functions as part of contingency planning and to verify the reliability and integrity of information.

OFM and MDIT indicated in their response to the fiscal year 2007-08 *SOMCAFR* management letter that OFM would evaluate the general controls for significant financial related information systems and would continue to improve those general controls where it was feasible and supported long-term business strategies of the State of Michigan. However, DTMB had not implemented any significant improvements to general controls during our audit period.

RECOMMENDATION

WE AGAIN RECOMMEND THAT DTMB, IN CONJUNCTION WITH OTHER STATE DEPARTMENTS, IMPROVE INFORMATION TECHNOLOGY GENERAL CONTROLS FOR SIGNIFICANT FINANCIAL RELATED INFORMATION SYSTEMS.

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

AGENCY PRELIMINARY RESPONSE

OFM did not express agreement or disagreement with the recommendation. OFM informed us that, in conjunction with DTMB, it will continue to evaluate the general controls for significant financial related information systems and will improve those general controls when feasible and supported by long-term business strategies.

FINDING

10. Recording of Net Pension Obligations (NPOs) and Net Other Postemployment Benefits Obligations (NOPEBOs)

OFM did not estimate the long-term obligations for NPOs and NOPEBOs for non-State employees. As a result, OFM overstated the noncurrent portion of other long-term obligations by $14.1 million, overstated expenses by $4.4 million, and understated net assets by $14.1 million.

GASB Codification Section N50 provides guidance on contributions made to pension plans for which the employer government is not responsible. Section N50.135 indicates that the unfunded portion of the liability related to these individuals should be considered on-behalf payments and the expenditures classified as other than pension expenditures. Also, Section N50.134 requires a note disclosure related to these on-behalf payments. In addition, GASB Statement No. 45 now requires the employer to recognize the NOPEBO in its financial statements. The NOPEBO is the cumulative portion of the yearly amortized amount based on the actuarial valuation at the beginning of fiscal year 2008-09 and the amount of the actuarially required contribution not paid by the employer for the current year.

State statute permits non-State agencies to participate in SERS. However, the State does not have a legal responsibility to provide contributions to SERS on behalf of these non-State agency participants to fund their pension and other postemployment benefits.

The amount of contributions required for participants of these non-State agencies is based on a contribution rate determined by the Office of Retirement Services (ORS). In fiscal year 2008-09, the contribution rate was not equal to the actuarially required contribution calculated by the actuary for SERS, resulting in an NPO equal to the difference between the contribution rates paid and the actuarially required contribution.

Because the actuarial study does not segregate the State employee and non-State employee populations, OFM recognized the full NPO and NOPEBO in the State's financial statements even though the liability associated with non-State agency participants is not a liability or expense of the State. OFM indicated that an actuarial study would have to be performed to determine the current balance of the NPO and the NOPEBO for these non-State employees. However, we used current membership data and estimated that 0.6% of the amount of the NPO and the NOPEBO for fiscal year 2008-09 related to non-State employees. Based on this estimate, $4.5 million of the $488.6 million NPO liability and $9.6 million of the $1.1 billion NOPEBO liability for SERS is the responsibility of the non-State agencies and, therefore, should not be reflected in the State's financial statements.

In its response to the fiscal year 2007-08 *SOMCAFR* management letter, OFM informed us that it would work with ORS to determine whether the annually required contribution rate could be segregated for the non-State agencies at a reasonable cost. In addition, if the portion attributable to non-State agencies was considered material, OFM and ORS would consider whether the plan should be classified as a cost-sharing multi-employer plan instead of a single employer.

During the fiscal year 2008-09 *SOMCAFR* audit, OFM, based on information provided by ORS, concluded that the State would ultimately assume responsibility for all unfunded or underfunded benefits owed by the plan (SERS) to the non-State agency employees. Therefore, OFM contends that the entire NPO and NOPEBO of the plan should continue to be recorded as a liability in the State's government-wide statement of net assets. However, it remains our position that the State is not legally responsible for the contributions for non-State agency employees within the plan. Therefore, the liability for the portions of the NPO and the NOPEBO related to those employees is not a liability of the State of Michigan and should not be reflected in the State's financial statements.

RECOMMENDATION

WE AGAIN RECOMMEND THAT OFM ESTIMATE THE LONG-TERM OBLIGATIONS FOR NPOs AND NOPEBOs FOR NON-STATE EMPLOYEES.

AGENCY PRELIMINARY RESPONSE

OFM and ORS disagree with the recommendation. OFM and ORS informed us that they will continue to calculate the liability based on current policy and methodology.

Codification	*Codification of Governmental Accounting and Financial Reporting Standards.*
control deficiency	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.
DCH	Department of Community Health.
DELEG	Department of Energy, Labor & Economic Growth.
DHS	Department of Human Services.
DOC	Department of Corrections.
DTMB	Department of Technology, Management and Budget.
GEAR UP	Gaining Early Awareness and Readiness for Undergraduate Programs.
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.
IT	information technology.

LRS	Legislative Retirement System.
material weakness	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/of financial statements will not be prevented or detected.
MBT	Michigan Business Tax.
MDIT	Michigan Department of Information Technology.
National Institute of Standards and Technology (NIST)	An agency of the Technology Administration, U.S. Department of Commerce. NIST's Computer Security Division develops standards, security metrics, and minimum security requirements for federal programs.
NOPEBO	net other postemployment benefits obligation.
NPO	net pension obligation.
OFM	Office of Financial Management.
OPEB	other postemployment benefits.
ORS	Office of Retirement Services.
SBT	Single Business Tax.
SERS	State Employees' Retirement System.
significant deficiency	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.

SMC	Service Management Center.
SOMCAFR	*State of Michigan Comprehensive Annual Financial Report.*
SPRS	State Police Retirement System.
SSA	Social Security Administration.
SSI	Supplemental Security Income.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL