MICHIGAN

OFFICE OF THE AUDITOR GENERAL

MANAGEMENT LETTER

STATE OF MICHIGAN
COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE
DEPARTMENT OF TECHNOLOGY, MANAGEMENT & BUDGET

Fiscal Year 2009-10

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

071-0010-11

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

Michigan

Office of the Auditor General

REPORT SUMMARY

Management Letter

State of Michigan Comprehensive Annual Financial Report

State Budget Office

Department of Technology, Management & Budget

Report Number:
071-0010-11

Released:
April 2011

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 2009-10 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:

Impact of Community Health Automated Medicaid Processing System (CHAMPS) Defects on the Medicaid Accrual

The Department of Community Health (DCH) did not have internal control in place to ensure that the effect of known CHAMPS defects were reviewed and included in the Medicaid accrual as necessary (Finding 1).

DCH Converted Claims

DCH did not have sufficient internal control to ensure that historical claims data was accurately converted from the Medicaid Management Information System (MMIS) data warehouse to the new CHAMPS data warehouse (Finding 2).

CHAMPS Payment Errors

DCH did not have internal control in place to prevent or detect and correct payment errors made through CHAMPS (Finding 3).

Recording and Calculation of Medicaid Accrual

DCH did not ensure that all expenditures/expenses and revenues were properly accrued for amounts due or for amounts not yet collected at September 30, 2010 for Medicaid (Finding 4).

Payments to Long-Term Care Facilities

DCH did not have sufficient internal control to ensure that proper payments were made to long-term care skilled nursing facilities (Finding 5).

Reconciliation of Pharmacy Rebates
DCH did not have sufficient internal control to ensure that pharmaceutical rebates were accurately invoiced (Finding 6).

Reconciliation of School Aid Fund Subsidiary Accounting Records
The Michigan Department of Education's year-end closing procedures did not include a comparison of its accounts receivable subsidiary detail with the "Amounts due from local units" recorded in the Michigan Administrative Information Network (MAIN) (Finding 7).

Recording of November Tax Accruals
The Department of Treasury did not adjust its estimate for the November taxes payable and receivable when actual information was available (Finding 8).

Review of Accrual Methodologies
The Office of Financial Management (OFM), in conjunction with other State agencies, should review its process to track accrual methodologies and modify the methodologies as necessary to ensure that accounting estimates are reliable (Finding 9).

General Controls Over State Information Systems
The Department of Technology, Management & Budget (DTMB), in conjunction with other State departments, should continue to improve information technology general controls for significant financial related information systems (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 (Finding 11).

Consistency in Use of Single Business Tax (SBT) Historical Data
The Department of Treasury did not have internal control in place to ensure that it consistently applied its methodology related to the use of SBT historical data to estimate Michigan Business Tax (MBT) receivables (Finding 12).

On-Behalf Payments for Other Postemployment Benefits (OPEB)
DTMB did not have internal control in place to fully recognize expenditures and revenue associated with on-behalf payments made by the federal government related to OPEB (Finding 13).

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Agency Response:
Our management letter includes 13 findings and 13 corresponding recommendations. DTMB's preliminary response indicates that OFM agrees with 9 of the recommendations, disagrees with 3 recommendations, and partially agrees with 1 recommendation.

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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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AUDITOR GENERAL

John E. Nixon, C.P.A., State Budget Director
State Budget Office
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Lansing, Michigan

Dear Mr. Nixon:

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, 2010, 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.

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 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 was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses as defined in the preceding paragraph. However, we identified certain deficiencies in internal control, as described in Findings 1 through 13, that we consider to be significant deficiencies. 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.

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 & 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

April 25, 2011

TABLE OF CONTENTS

MANAGEMENT LETTER

STATE OF MICHIGAN COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE

DEPARTMENT OF TECHNOLOGY, MANAGEMENT & BUDGET

Fiscal Year 2009-10
Findings, Recommendations, and
Agency Preliminary Responses

This section contains 10 new and rewritten findings and 10 corresponding recommendations identified in our fiscal year 2009-10 *State of Michigan Comprehensive Annual Financial Report* (*SOMCAFR*) audit.

FINDING

1. Impact of Community Health Automated Medicaid Processing System (CHAMPS) Defects on the Medicaid Accrual

The Department of Community Health (DCH) did not have internal control* in place to ensure that the effect of known CHAMPS defects were reviewed and included in the Medicaid accrual as necessary. As a result, DCH could not ensure that the accrued payables of $853.5 million and the accrued receivables of $331.0 million related to the Medicaid accrual were complete in the State's financial statements for fiscal year 2009-10.

In March 2006, the State of Michigan contracted to replace its existing Medicaid Management Information System (MMIS). Effective September 18, 2009, provider-submitted Medicaid claims were processed through CHAMPS. DCH's contract states that there were approximately 480 known CHAMPS defects at the time that CHAMPS went live. In addition, it anticipated additional defects once the system was operational. Examples of defects related to edit logic are reported in Finding 3, parts d. and f.; Finding 4, part d.; and Finding 5.

At the time that DCH prepared the fiscal year 2009-10 Medicaid accrual estimates, it continued to address known CHAMPS defects with the assistance of its contractor. DCH stated that considerable ongoing efforts had been made to prioritize CHAMPS defects for significance and impact on program expenditures so that significant defects were identified and corrected as quickly as possible. However, DCH did not analyze known CHAMPS defects to determine if the correction of such defects would warrant an accrued asset or liability in the fiscal year 2009-10 financial statements. Also, DCH was unable to provide documentation to support that it had prioritized the significant CHAMPS defects.

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

RECOMMENDATION

We recommend that DCH implement internal control to ensure that the effect of known CHAMPS defects are reviewed and included in the Medicaid accrual as necessary.

AGENCY PRELIMINARY RESPONSE

The Office of Financial Management (OFM) and DCH agree that CHAMPS defects should be corrected. DCH informed us that it will continue its ongoing efforts to prioritize and correct defects as resources allow. In addition, DCH informed us that it will evaluate the feasibility of adjusting the Medicaid accrual to reflect the impact of known defects.

FINDING

2. DCH Converted Claims

DCH did not have sufficient internal control to ensure that historical claims data was accurately converted from the MMIS data warehouse to the new CHAMPS data warehouse. As a result, DCH could not ensure that historical claims data used to estimate $160.8 million in payables and $18.2 million in receivables related to the long-term care and health plan services accrual components of the Medicaid accrual was accurate.

During August 2009, DCH converted historical paid claims data for fiscal years 2006-07, 2007-08, and 2008-09 from the existing MMIS data warehouse to the new CHAMPS data warehouse. During the August 2009 conversion process, DCH converted fee-for-service paid claims data totaling $8.5 billion dollars and managed care paid claims data totaling $9.1 billion dollars.

According to DCH's approved Medicaid accrual methodologies, historical paid claims data is often queried to estimate total cumulative claims for services provided at year-end but not yet paid. For the fiscal year 2009-10 Medicaid accrual, DCH used this methodology; however, the historical data was queried from the CHAMPS data warehouse and included paid claims amounts converted from MMIS even though DCH had not validated that the conversion was complete and accurate.

Although DCH was unable to provide us with supporting documentation for the accuracy of the converted paid claims amounts, we were able to validate their reasonableness using audited historical data from prior year audits. However, the impact of using the converted data in the accrual will continue in the future until these years are no longer considered in the accrual methodology. Therefore, it is important that DCH validate the completeness and accuracy of the converted data.

RECOMMENDATION

We recommend that DCH improve its internal control to ensure that historical claims data is accurately converted from the MMIS data warehouse to the new CHAMPS data warehouse.

AGENCY PRELIMINARY RESPONSE

OFM and DCH disagree with the recommendation. OFM and DCH informed us that they believe that the conversion and data validation methods used by DCH were sufficient to ensure the accuracy of the data converted from the MMIS data warehouse to the CHAMPS data warehouse.

FINDING

3. CHAMPS Payment Errors

DCH did not have internal control in place to prevent or detect and correct payment errors made through CHAMPS. As a result, we estimated that fiscal year 2009-10 General Fund expenditures were likely understated by $35.0 million.

Section 1600.119 of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by the Governmental Accounting Standards Board* (GASB), states that governmental fund liabilities and expenditures that should be accrued include liabilities that, once incurred, normally are paid in a timely manner and in full from current resources. To the extent not paid, such liabilities generally represent claims against current financial resources and should be reported as governmental fund liabilities.

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

In March 2006, the State of Michigan contracted to replace its existing MMIS. Effective September 18, 2009, provider-submitted Medicaid claims were processed through CHAMPS. Total fiscal year 2009-10 CHAMPS payments totaled $10.4 billion.

We reviewed a sample of 71 CHAMPS payments to determine whether DCH issued the payment in accordance with established Medicaid payment rates. We noted that DCH issued incorrect payments for 9 (12.7%) of the 71 payments reviewed. As discussed in detail below, the 9 individual errors are small dollar values. DCH chose to process necessary correcting entries for 5 of the errors but considered the remaining errors immaterial in comparison to total CHAMPS payments of $10.4 billion. During our review of the 71 CHAMPS payments, it became clear that DCH regularly made payment correction decisions based on the materiality of the individual defect noted rather than considering the likelihood that other similar claims may also be in error and that, ultimately, the total error could be significant.

Our review of 71 randomly sampled CHAMPS payments disclosed:

a. Two (2.8%) of the 71 CHAMPS payments were not properly adjusted to reflect rate reductions enacted by Act 131, P.A. 2009. Upon our request, DCH estimated that the error for these claim types totaled $791,208. DCH processed the necessary correcting entries for this amount.

b. Two (2.8%) of the 71 CHAMPS payments were not adjusted to reflect retroactive Medicare rate changes. DCH did not estimate the total impact of the error and did not process the necessary correcting entries.

c. Two (2.8%) of the 71 CHAMPS payments were not properly adjusted for Medicaid copayment amounts. Upon our request, DCH estimated that the error for these claim types totaled $25,387. DCH adjusted payments to providers for these claims in fiscal year 2010-11 but did not calculate or process the necessary correcting entries in fiscal year 2009-10.

d. One (1.4%) of the 71 CHAMPS payments was not paid in accordance with established Medicaid rates because of a defect in the CHAMPS edit logic. As a result of this error, DCH identified and corrected all impacted claims. During fiscal year 2010-11, DCH paid an additional $1.1 million on claims processed during fiscal year 2009-10. However, DCH did not accrue for the liability in the fiscal year 2009-10 financial statements (see Finding 4, part d.).

e. One (1.4%) of the 71 CHAMPS payments was not paid in accordance with the rate established in DCH's executed contracts with county health plans for the MICHILD Program. We estimated that this error totaled approximately $7,000.

f. One (1.4%) of the 71 CHAMPS payments was paid using the established Medicaid payment rate, which was higher than the billed amount, causing an $11.15 overpayment. DCH stated that it was aware of this CHAMPS edit defect and was in the process of correcting the defect. However, DCH did not provide an estimate of how many claims were impacted or the total incorrect payments.

If the errors identified in our nonstatistical random samples are representative of those in the estimated population of errors, we estimate that DCH understated the fiscal year 2009-10 Medicaid accrual by $35.0 million. We calculated this estimate by dividing the total value of errors reported for the 71 randomly sampled items by the dollar value of the items in the samples. We multiplied this quotient by the total dollar value of transactions in the population to estimate the total understatement. Although nonstatistical sampling does not provide an explicit level of confidence for the projection of test results to a population, it is a commonly used and industry-accepted audit sampling methodology. Our nonstatistical sampling methodology utilized random samples from claims paid during fiscal year 2009-10, thus attempting to ensure that the items tested provided true representations of the entire population.

RECOMMENDATION

We recommend that DCH implement internal control to prevent or detect and correct payment errors made through CHAMPS.

AGENCY PRELIMINARY RESPONSE

OFM and DCH agree that system changes are needed to improve the prevention and detection of payment errors. DCH informed us that it will continue its ongoing efforts to correct and improve the CHAMPS system edits.

FINDING

4. Recording and Calculation of Medicaid Accrual

DCH did not ensure that all expenditures/expenses and revenues were properly accrued for amounts due or for amounts not yet collected at September 30, 2010 for Medicaid. As a result, net understatements of $2.9 million were noted in liabilities, $12.9 million in expenditures/expenses, and $7.1 million in revenues and net overstatements of $2.9 million were noted in assets and $5.8 million in fund balance/net assets in the General Fund financial 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.

Medicaid provides medical assistance to individuals and families who meet the Medicaid financial and nonfinancial eligibility factors. Medicaid's goal 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.

Our review of the Medicaid accrual during the *SOMCAFR* audit disclosed:

a. DCH did not properly estimate payables and receivables related to the full cost clinic component of the Medicaid accrual. As a result, expenditures/expenses were understated by $11.0 million, current liabilities were understated by $1.0 million, and federal revenue/program revenue was understated by $7.8 million. In addition, current assets were overstated by $2.1 million and fund balance/net assets were overstated by $3.2 million in the General Fund statements and the governmental activities of the government-wide statements.

   The full cost clinic component of the Medicaid accrual includes payments to federally qualified health centers, rural health clinics, and local public health departments. Various regulations and statutes require that Medicaid pay these clinics a prospective rate per encounter for services to Medicaid patients.

During our review of DCH's estimate for accrued payables of $79.3 million and receivables of $26.6 million related to full cost clinics, we noted that it included an inaccurate third party payment in the accrual calculation, which caused the established receivable to be overstated. After adjusting the third party payment, the accrual was calculated to be a payable instead of a receivable.

b. DCH's inpatient hospital capital cost component of the Medical accrual methodology did not include an accrued liability for all inpatient hospital capital costs incurred. As a result, liabilities and expenditures/expenses were understated by $8.1 million, federal revenue/program revenue and current assets were understated by $5.8 million, and fund balance/net assets were overstated by $2.3 million for fiscal year 2009-10.

Capital costs to Medicaid are the result of sharing in capital type expenses related to buildings, equipment, etc., with inpatient hospitals that serve Medicaid recipients. The initial reimbursement for capital projects is paid by capital interim payments (CIPs). CIPs are made using a semimonthly schedule (24 payments per year). The CIP amount is set using the most recent available cost data, which includes hospital utilization information and an estimated impact of applicable limits on capital. The exact amount of capital costs are not known to DCH until the provider's cost report is received. This cost report is received five months after the close of the provider's fiscal year. The inpatient hospital capital cost component of the Medicaid accrual estimates the outstanding year-end accrual (receivable or liability) for capital outlay for the portion of the Medicaid population using hospital services on a fee-for-service basis. The capital amount is calculated by subtracting CIPs made to the hospital from the hospital's total filed capital cost reported amount. The fiscal year 2009-10 inpatient hospital capital cost accrued liability was $25.6 million.

During our review of DCH's inpatient hospital capital cost accrual, we noted that the latest inpatient hospital year included in the fiscal year 2009-10 accrual ended December 31, 2009. Depending on each inpatient hospital's year-end date, there are 9 to 20 months for which DCH did not accrue liabilities or receivables related to inpatient hospital capital costs. We estimated that these unaccrued months represent an $8.1 million liability that DCH did not accrue in the fiscal year 2009-10 financial statements.

c. DCH did not properly calculate the State's liability for the physician adjustor component of the Medicaid accrual. As a result, liabilities and expenditures/expenses were overstated by $7.3 million, federal and local revenue and current assets were overstated in total by $7.3 million, and there was no impact on fund balance/net assets for fiscal year 2009-10.

   The Physician Adjustor Program is authorized in DCH's Medicaid State plan. The Program allows authorized public universities to provide State matching funds for enhanced payments for Medicaid claims billed by their affiliated provider groups. Affiliated provider Medicaid claims are adjusted on a quarterly basis. The adjustment amounts represent the payment value of individual claims priced at a market-based commercial rate, adjusted by actual receipts (including Medicaid) for all other payment sources. The physician adjustor component of the Medicaid accrual estimates total adjustment amounts not yet paid for affiliated provider fee-for-service claims. The fiscal year 2009-10 physician adjustor component liability was $149.3 million.

   Our review disclosed that DCH incorrectly transcribed amounts from the detailed supporting documentation to the summary-level spreadsheet, and there were also errors in the summary-level data, which caused errors in the calculation. In addition, DCH increased the physician adjustor accrued liability in anticipation of an additional authorized public university and its associated affiliated providers' fee-for-service claims. However, DCH did not have documentation to support that these affiliated providers' fee-for-service claims would be subject to adjustment during fiscal year 2009-10. In addition, DCH did not have documentation to support the number of estimated affiliated providers associated with the additional authorized public university.

d. DCH did not accrue a liability related to medical supply claims that were processed incorrectly in its CHAMPS. As a result, expenditures/expenses and current liabilities were understated by $1.1 million, federal revenue/program revenue and current assets were understated by $0.7 million, and fund balance/net assets were overstated by $0.4 million in the General Fund statements and the governmental activities of the government-wide statements.

During our review of a sample of claims processed in CHAMPS, we identified a claim for a medical supply item in which the amount paid was less than the Medicaid reimbursement rate established by DCH. We were informed that this error was caused by a defect in the edit logic in CHAMPS. As a result of this error, DCH informed us that it identified and corrected all related medical supply claims and paid the additional $1.1 million in fiscal year 2010-11; however, it did not accrue for the liability in fiscal year 2009-10.

RECOMMENDATION

We recommend that DCH ensure that all expenditures/expenses and revenues are properly accrued for amounts due and for amounts not yet collected at the end of the fiscal year for Medicaid.

AGENCY PRELIMINARY RESPONSE

OFM and DCH agree that improvements are warranted with respect to parts a., c., and d. DCH informed us that it will evaluate and revise its processes to ensure that amounts are properly accrued related to these parts. However, OFM and DCH informed us that they do not believe that there is an estimation method that would be consistently reliable or cost effective to address part b.

FINDING

5. Payments to Long-Term Care Facilities

DCH did not have sufficient internal control to ensure that proper payments were made to long-term care skilled nursing facilities. As a result, it could not ensure that a portion of the approximately $814.7 million fee-for-service payments to long-term care facilities in fiscal year 2009-10 were proper.

Medical Services Administration Bulletin 10-03 instructs providers to use specific coding in order to inform DCH that there was a qualifying length of stay at an inpatient hospital before the beneficiary was admitted and received skilled services from a nursing facility. CHAMPS did not have an edit in place to recognize the code used by providers to indicate that the Medicaid beneficiary had a qualifying hospital stay and, therefore, was eligible for Medicare coverage of days 1 through 20.

Skilled care is healthcare given to an individual who needs skilled nursing care or rehabilitation staff to manage, observe, and evaluate the individual's care. A skilled nursing facility could be part of a nursing home or hospital. Medicare will cover care in a skilled nursing facility for up to 100 days if the individual continues to meet Medicare's requirements. Medicare uses a period of time called a benefit period to keep track of how many days of skilled nursing facility benefits an individual uses and how many are still available. Medicare covers the beneficiaries if they have Medicare Part A (hospital insurance) and have days left in their benefit period to use, they have a qualifying hospital stay (inpatient hospital stay of three consecutive days or more), and they enter the skilled nursing facility within a short time (generally 30 days) of leaving the hospital and require skilled services related to their hospital stay.

Medicare covers the first 20 days of service if the preceding conditions are met. Between days 21 and 100, Medicaid pays the lesser of the coinsurance rate or the Medicaid established daily rate. For days over 100, Medicaid pays the facility at its DCH established daily rate.

We initially identified this issue during the prior audit. At that time, DCH informed us that it had implemented a control in CHAMPS that would correct this issue for fiscal year 2009-10. However, during our follow-up of this issue for the current audit period, DCH indicated that the CHAMPS edit implemented in January 2010 did not correct the problem and the payments were still not properly calculated. DCH informed us that another fix would go into production in January 2011 and that all impacted claims would be adjusted. DCH was unable to provide an estimate of total improper payments related to this issue. As a result, DCH did not accrue an asset or liability on the State's fiscal year 2009-10 financial statements related to improper long-term care skilled nursing facility payments.

RECOMMENDATION

We recommend that DCH improve internal control to ensure that proper payments are made to long-term care skilled nursing facilities.

AGENCY PRELIMINARY RESPONSE

OFM and DCH agree with the recommendation. OFM and DCH informed us that system modifications to correct the problem were implemented in January 2011 and impacted claims will be adjusted, as necessary.

FINDING

6. Reconciliation of Pharmacy Rebates

DCH did not have sufficient internal control to ensure that pharmaceutical rebates were accurately invoiced. As a result, DCH could not ensure that the appropriate amount of rebates was included in the pharmaceutical billings. During fiscal year 2009-10, DCH received approximately $247.7 million in rebates from pharmaceutical drug manufacturers.

Pharmaceutical drug manufacturers issue rebates to DCH because of the high volume of drug purchases for the Medicaid Drug Program. DCH contracts with a third party administrator to bill the pharmaceutical drug manufacturers for these rebates.

During our review of the rebates in the fiscal year 2009-10 audit, DCH informed us that the reconciliation between the billings from the third party administrator and the volume of drugs purchased was not performed.

In the prior audit, we reported a similar finding because we were unable to verify the appropriateness and accuracy of the rebate reconciliation that DCH performed. DCH informed us that this was because 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. DCH informed us that it would revise its reconciliation procedures to facilitate the reproduction of the reconciliation results at different points in time. However, DCH did not perform the reconciliations at all during fiscal year 2009-10.

RECOMMENDATION

We recommend that DCH improve its internal control to ensure that pharmaceutical rebates are accurately invoiced.

AGENCY PRELIMINARY RESPONSE

OFM and DCH agree with the recommendation. DCH informed us that it expects to complete the processing and loading of new rebate rate files in May 2011. Once loaded, rebate invoicing validation procedures will be implemented.

FINDING

7. Reconciliation of School Aid Fund Subsidiary Accounting Records

The Michigan Department of Education's (MDE's) year-end closing procedures did not include a comparison of its accounts receivable subsidiary detail with the "Amounts due from local units" recorded in the Michigan Administrative Information Network (MAIN). As a result, MDE did not detect that the amount recorded in MAIN exceeded the amount reflected in MDE's subsidiary records by $16.7 million. Subsequent to our review and prior to the issuance of the *SOMCAFR*, OFM recorded adjusting transactions to correct this error. However, our review of the adjusting transactions disclosed that expenditures and miscellaneous revenue were still overstated by $2.6 million.

Section 18.1485 of the *Michigan Compiled Laws* (a section of Act 431, P.A. 1984, as amended) provides that State agencies are responsible for developing and maintaining a system of controls over the preparation of financial statements in accordance with generally accepted accounting principles. Also, Part II, Chapter 11, Section 100 of the State of Michigan Financial Management Guide requires agencies to periodically and at least annually adjust the amounts recorded in MAIN to reflect the amounts in the agencies' subsidiary detail records.

Our review of fiscal year 2009-10 amounts due from local units disclosed:

a. Since fiscal year 2004-05, MDE's accounts receivable monitoring procedures have not considered the effects of the reclassification of the long-term accounts receivable to short-term accounts receivable. Therefore, MDE did not realize that it had collected these amounts through the routine State aid payment process and did not appropriately account for these amounts in the year-end closing write-off transactions. As a result, amounts due from local units and fund balance were overstated by $15.2 million, expenditures were understated by $12.7 million, and miscellaneous revenue was overstated by $2.6 million.

b. MDE recorded duplicate accounts receivable for some amounts already included in the long-term, short-term accounts receivable reclassification entry. As a result, amounts due from local units, miscellaneous revenue, and fund balance were overstated by $1.5 million.

MDE performs an annual review of the accounts receivable general ledger account. However, this review did not include a comparison of the final balance recorded in the general ledger account with MDE's subsidiary records. This review could help detect the omission of an accounting entry or an inaccurate accounting entry.

RECOMMENDATION

We recommend that MDE's year-end closing procedures include a comparison of its accounts receivable subsidiary detail with the "Amounts due from local units" recorded in MAIN.

AGENCY PRELIMINARY RESPONSE

OFM and MDE agree with the recommendation. MDE informed us that it will evaluate and revise its year-end closing procedures to ensure that the needed comparison occurs.

FINDING

8. Recording of November Tax Accruals

The Department of Treasury did not adjust its estimate for the November taxes payable and receivable when actual information was available. As a result, assets were overstated by $4.1 million, liabilities were overstated by $0.4 million, and tax revenue/general revenue and fund balance/net assets were overstated by $3.6 million in the Michigan Transportation Fund and governmental activities of the government-wide statements.

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. The Department of Treasury records the November taxes payable and receivable amounts for special revenue fund taxes based on estimates. However, when the final actual amounts pertaining to the month of November became available, the Department of Treasury did not make adjustments to the accrued amounts for the gasoline tax, diesel fuel tax, motor carrier diesel fuel tax, liquefied petroleum gas tax, and International Fuel Tax Agreement fuel receipts to reflect the actual information.

RECOMMENDATION

We recommend that the Department of Treasury adjust its estimate for the November taxes payable and receivable when actual information is available.

AGENCY PRELIMINARY RESPONSE

OFM and the Department of Treasury disagree with the recommendation. OFM and the Department of Treasury informed us that estimates are used to streamline and expedite the year-end closing process and the need to adjust to actual is evaluated on a case-by-case basis. In addition, they informed us that in this instance, OFM, the Department of Treasury, and the Michigan Department of Treasury jointly concluded that the fiscal year 2009-10 variance between estimated and actual Michigan Transportation Fund tax revenue (less than 1%) was insufficient to warrant an adjustment.

FINDING

9. Review of Accrual Methodologies

OFM, in conjunction with other State agencies, should review its process to track accrual methodologies and modify the methodologies as necessary to ensure that accounting estimates are reliable. A review of the process would help increase the accuracy of the financial statements; provide more assurance that the amounts reflect the assets and liabilities of the State; reduce the need for adjusting entries; and decrease the amount of effort required to reconcile, validate, and audit those entries during the closing process.

Effective internal control over year-end accruals should include a comparison of prior accounting estimates with subsequent activity to assess the reliability of the process used to develop the estimates.

Our review of various accrual methodologies during the *SOMCAFR* audit disclosed:

a. DCH's internal control was not sufficient to ensure that accounting estimates were reliable. As a result, DCH could not ensure the reasonableness of its established accrual methodologies which resulted in accrued payables of $853.5 million and accrued receivables of $331.0 million for fiscal year 2009-10.

   DCH has approved methodologies for accruing Medicaid payables and receivables for providers rendering services through the fiscal year-end. During our review, we requested DCH's comparison of prior accounting estimates with subsequent activity for 13 accrual components. For 7 (54%) of 13 components, DCH did not complete a comparison or the comparison that was completed did not compare prior year estimates to subsequent actual activity.

   In addition, for one component in which DCH did compare the prior year estimates to subsequent actual activity for the health plan services accrued liability, it was determined that its prior year estimated payable was understated by $17.9 million. This amount represented 33% of the total fiscal year 2008-09 health plan services accrued liability. However, because tracking procedures were inconsistent and incomplete, DCH was unable to provide documentation to support its decision not to adjust the accrual methodology to account for the differences.

b. DCH's internal control did not identify modifications to the Adult Home Help (AHH) accrual methodology that could allow for a more reliable estimation of the State's liability to AHH providers. As a result, DCH could not ensure the reasonableness of prior and current year AHH accruals.

   DCH did not have adequate procedures in place to compare prior AHH accrual estimates with subsequent activity to assess the reliability of the established accrual methodologies. DCH's current AHH accrual methodology assumes that the majority of AHH payments in October are related to services performed in the previous month. As a result, it accrued a liability on the fiscal year 2009-10 financial statements equal to October 2010 payments only.

During our review, we estimated that approximately $3.9 million in payments made during November and December of fiscal year 2010-11 were related to fiscal year 2009-10. However, DCH had not performed an analysis, such as a historical analysis of actual AHH payments, to determine if its estimation methodology was still reliable.

c. MDE, in conjunction with OFM, should reevaluate its method used to estimate the expenditures and related accounts payable for the National School Lunch Program. Use of the current methodology could result in continued overstatement of MDE's accounts payable, expenditures, and the related federal receivable and revenue.

The methodology may need to be modified to address changes in the processing of payments for the National School Lunch Program. MDE informed us that the school districts no longer submit claims for the National School Lunch Program via a paper form. School districts now electronically submit claims to obtain reimbursement. Because the process is now fully automated, school districts may be submitting claims more timely.

In the subsequent year, MDE compares the actual payments to the prior year payable established and writes off any overstatements. Our review of the write-off transactions in the subsequent years disclosed that the accounts payable estimate has been consistently overstated:

Fiscal Year	Accounts Payable Established	Amount Written-Off in Subsequent Fiscal Year
2009-10	$ 45,462,155	$ 10,145,645
2008-09	$ 41,156,265	$ 6,773,632
2007-08	$ 40,251,245	$ 3,339,809
2006-07	$ 30,155,712	$ 0

The increase in the write-off indicates that new factors, which should be considered, may be affecting the total expenditures for the National School Lunch Program and that a revised methodology should be developed.

RECOMMENDATION

We recommend that OFM, in conjunction with other State agencies, review its process to track accrual methodologies and modify the methodologies as necessary to ensure that accounting estimates are reliable.

AGENCY PRELIMINARY RESPONSE

OFM agrees with the recommendation. OFM informed us that it will evaluate its processes for reviewing and monitoring accrual methodologies and adjust them as needed to ensure that the methodologies provide reliable estimates.

FINDING

10. General Controls Over State Information Systems

The Department of Technology, Management & Budget (DTMB), in conjunction with other State departments, should continue 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), 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.

DTMB informed us that it had made specific enterprise-wide improvements during our audit period that included implementation of enhanced file integrity monitoring and logging processes for servers holding sensitive data; establishment of a technical standard governing change control processes; use of a standard base image and baseline configuration checklist for installation of new servers; implementation of processes to track server patch levels; and initiation of an ongoing project to document and periodically test disaster recovery plans for all critical systems. However, continued improvements should be made.

RECOMMENDATION

We recommend that DTMB, in conjunction with other state departments, improve IT general controls for significant financial related information systems.

AGENCY PRELIMINARY RESPONSE

OFM and DTMB agree with the recommendation. DTMB informed us that it would continue to evaluate the general controls for significant financial related information systems and improve those general controls when feasible and supported by long-term business strategies.

Fiscal Year 2008-09
Management Letter Follow-Up

In the follow-up of our fiscal year 2008-09 *SOMCAFR* management letter, we noted that OFM and State agencies had complied with 5 of the 10 recommendations. Of the other 5 recommendations, 2 were rewritten in the previous section (Findings 6 and 10) and we have repeated 3 recommendations in this section of our fiscal year 2009-10 management letter.

FINDING

11. 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 $17.5 million, overstated expenses by $3.4 million, and understated net assets by $17.5 million.

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

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 the Michigan State Employees' Retirement System (MSERS). These agencies include the Third Circuit Court, the Recorder's Court, and the 36th District Court; the American Legion; the Mackinac Island State Park; and the Michigan Bar Association. However, the State does not have a legal responsibility to provide contributions to MSERS 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 2009-10, the contribution rate was not equal to the actuarially required contribution calculated by the actuary for MSERS, 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 0.61% of the amount of the NPO and the NOPEBO for fiscal year 2009-10 related to non-State employees. Based on this

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

estimate, $4.5 million of the $533.2 million NPO liability and $13.0 million of the $1.5 billion NOPEBO liability for MSERS 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 plan.

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 (MSERS) to the non-State agency employees. During our audit period, OFM continued to contend that the entire NPO and NOPEBO of the plan should 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 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

As in the response to the prior audit, 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 because they believe that they are consistent with generally accepted accounting principles.

FINDING

12. Consistency in Use of Single Business Tax (SBT) Historical Data

The Department of Treasury did not have internal control in place to ensure that it consistently applied its methodology related to the use of SBT historical data to estimate Michigan Business Tax (MBT) receivables. As a result, taxes receivable and deferred revenue were overstated by $4.2 million and tax revenue and fund balance were overstated by $18.1 million in the General Fund. In addition, taxes receivable, general revenues, and net assets were overstated by $22.3 million in the governmental activities of the government-wide statements. Subsequent to our review and prior to the issuance of the *SOMCAFR*, the Department, in conjunction with OFM, recorded adjusting transactions.

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 collectibility percentages to estimate the MBT receivables to be assessed.

RECOMMENDATION

WE AGAIN RECOMMEND THAT THE DEPARTMENT OF TREASURY IMPLEMENT INTERNAL CONTROL TO ENSURE THAT IT CONSISTENTLY APPLIES 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 and informed us that they will take steps to ensure that the approved methodology is consistently applied.

FINDING

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

DTMB did not have internal control in place to fully recognize expenditures and revenue associated with on-behalf payments made by the federal government related to OPEB. As a result, OFM understated expenditures and revenue by $8.1 million for the fiscal year ended September 30, 2010. There is no impact on ending fund balance or net assets. Subsequent to our review and prior to the issuance of the *SOMCAFR*, OFM recorded adjusting transactions.

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 expenditures and revenue for on-behalf payments for fringe benefits and salaries.

During fiscal year 2009-10, the State of Michigan administered and made contribution payments to three single-employer OPEB plans (the Michigan Legislative Retirement System [MLRS], Michigan State Police Retirement System [MSPRS], and Michigan State Employees' Retirement System [MSERS]). In addition, it made contribution payments for OPEB for life insurance. The State of Michigan is the employer for these plans. The MLRS, MSPRS, and MSERS plans also received contribution payments of $27.5 million directly from the federal government pursuant to retiree drug subsidy provisions of Medicare Part D. DTMB initially recorded $19.5 million of these on-behalf payments as expenditures and revenue in the General Fund and as expenses and program revenue in the government-wide statements.

RECOMMENDATION

WE AGAIN RECOMMEND THAT DTMB IMPLEMENT INTERNAL CONTROL TO FULLY RECOGNIZE EXPENDITURES AND REVENUE ASSOCIATED WITH ON-BEHALF PAYMENTS MADE BY THE FEDERAL GOVERNMENT RELATED TO OPEB.

AGENCY PRELIMINARY RESPONSE

OFM and DTMB agree with the recommendation. DTMB informed us that it will evaluate and revise its processes to ensure that on-behalf payments are properly recorded.

Glossary of Acronyms and Terms

AHH	Adult Home Help.
CIP	capital interim payment.
Community Health Automated Medicaid Processing System (CHAMPS)	The Department of Community Health Information System used to process and adjudicate all Medicaid claims.
Codification	*Codification of Governmental Accounting and Financial Reporting Standards.*
DCH	Department of Community Health.
deficiency in internal control	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.
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.

IT	information technology.
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	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.
MBT	Michigan Business Tax.
MDE	Michigan Department of Education.
Michigan Administrative Information Network (MAIN)	The State's automated administrative management system that supports accounting, purchasing, and other financial management activities.
MLRS	Michigan Legislative Retirement System.
MMIS	Medicaid Management Information System.
MSERS	Michigan State Employees' Retirement System.
MSPRS	Michigan State Police Retirement System.
net other postemployment benefits obligation (NOPEBO)	The cumulative difference between annual OPEB cost and an employer's contributions to a plan, including the OPEB liability (asset) at transition (if any) and excluding (a) short-term differences and (b) unpaid contributions that have been converted to OPEB-related debt.

net pension obligation (NPO)	The cumulative difference between annual pension cost and the employer's contributions to the plan, including the pension liability (asset) at transition and excluding (a) short-term differences and (b) unpaid contributions that have been converted to pension-related debt.
OFM	Office of Financial Management.
other postemployment benefits (OPEB)	Postemployment benefits other than pension benefits. OPEB includes postemployment healthcare benefits, regardless of the type of plan that provides them, and all postemployment benefits provided separately from a pension plan, excluding benefits defined as termination offers and benefits.
ORS	Office of Retirement Services.
SBT	Single Business Tax.
significant deficiency	A deficiency, or a combination of deficiencies, 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.*

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL