



MICHIGAN

OFFICE OF THE AUDITOR GENERAL



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

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

– Article IV, Section 53 of the Michigan Constitution

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Michigan Office of the Auditor General REPORT SUMMARY

Management Letter

Report Number: 071-0151-12M

Michigan State Employees' Retirement System

October 1, 2009 through September 30, 2011

Released: April 2012

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

Financial Statements:

Auditor's Report Issued

We have audited MSERS's basic financial statements as of and for the fiscal years ended September 30, 2011 and September 30, 2010 and have issued a separate report thereon dated January 19, 2012. We issued an unqualified opinion on MSERS's financial statements.

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Internal Control Over Financial Reporting

We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, we did identify a significant deficiency (Finding 1).

The Office of Retirement Services (ORS) and Financial Services, within the Department of Technology, Management, and Budget (DTMB), did not have sufficient controls to ensure that they properly classified MSERS's financial activity (Finding 1).

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Noncompliance and Other Matters Material to the Financial Statements

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

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Agency Response:

Our management letter includes 1 finding and 1 corresponding recommendation. DTMB's preliminary response indicates that it agrees with the recommendation.

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Background:

MSERS is a single-employer, Statewide, defined benefit public employee retirement plan governed by the State and operating under the provisions of Act 240, P.A. 1943, as amended. MSERS's pension plan was established by the State to provide retirement, survivor, and disability benefits to the State's government employees. In addition, MSERS's other postemployment

benefits (OPEB) plan provides all retirees with the option of receiving health, dental, and vision coverage under the Michigan State Employees' Retirement Act. By statute, employees of the following employers are also covered by this plan: American Legion, American Veterans, Veterans of Foreign Wars, Disabled American Veterans, Mackinac Island State Park, Marine Corps League, Michigan Bar Association, Business Enterprise Program, Third Circuit Court, Records Court, and 36th District Court. Although MSERS reports information for several small employers, the State is legally responsible for almost all contractually required contributions to MSERS. This level of responsibility is ongoing and is unlikely to change significantly in the foreseeable future. Therefore, the reporting requirements for a single-employer plan have been adopted.

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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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201 N. Washington Square
Lansing, Michigan 48913

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

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



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

April 3, 2012

Mr. Douglas Drake, Chair
Michigan State Employees' Retirement System Board
General Office Building
and
John E. Nixon, C.P.A., Director
Department of Technology, Management, and Budget
George W. Romney Building
and
Mr. Phillip J. Stoddard, Director
Office of Retirement Services
Department of Technology, Management, and Budget
General Office Building
Lansing, Michigan

Dear Mr. Drake, Mr. Nixon, and Mr. Stoddard:

We have audited the basic financial statements of the Michigan State Employees' Retirement System (MSERS) as of and for the fiscal years ended September 30, 2011 and September 30, 2010 and have issued a separate report thereon dated January 19, 2012. In planning and performing our audit of the financial statements of MSERS, we considered MSERS's internal control over financial reporting and compliance and other matters. This is our management letter on the internal control over financial reporting and on compliance and other matters of the Michigan State Employees' Retirement System for the period October 1, 2009 through September 30, 2011.

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

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

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

Sincerely,


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

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



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

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

Mr. Douglas Drake, Chair
Michigan State Employees' Retirement System Board
General Office Building
and
John E. Nixon, C.P.A., Director
Department of Technology, Management, and Budget
George W. Romney Building
and
Mr. Phillip J. Stoddard, Director
Office of Retirement Services
Department of Technology, Management, and Budget
General Office Building
Lansing, Michigan

Dear Mr. Drake, Mr. Nixon, and Mr. Stoddard:

We have audited the basic financial statements of the Michigan State Employees' Retirement System as of and for the fiscal years ended September 30, 2011 and September 30, 2010 and have issued our report thereon dated January 19, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined in the preceding paragraph. However, we identified a deficiency in internal control over financial reporting, as described in Finding 1, that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

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

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

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

Sincerely,



Thomas H. McTavish, C.P.A.
Auditor General
January 19, 2012

FINDING, RECOMMENDATION, AND AGENCY PRELIMINARY RESPONSE

FINDING

1. Controls Over Financial Reporting

The Office of Retirement Services (ORS) and Financial Services, within the Department of Technology, Management, and Budget (DTMB), did not have sufficient controls to ensure that they properly classified the Michigan State Employees' Retirement System's (MSERS's) financial activity. As a result, they could not ensure the accuracy of MSERS's financial statements as evidenced by several financial statement classification errors.

Governmental Accounting Standards Board* (GASB) Statement No. 25, paragraph 21, requires pension plans to report the plan assets by major category of assets, such as receivables and investments, and then by principal components of those assets. In addition, GASB Statement No. 43, paragraph 19, requires the same reporting for other postemployment benefits (OPEB) plans. Therefore, it is important that amounts due from different sources are properly classified. Our review disclosed:

- a. Financial Services did not properly classify the amounts due from federal agencies relating to the Early Retiree Reinsurance Program and the Retiree Drug Subsidy Program totaling \$23.6 million. As a result, the amounts due from other funds were overstated and amounts due from federal agencies were understated by \$23.6 million in the OPEB plan at September 30, 2011.
- b. Financial Services did not properly classify the amounts due from a vendor related to drug rebates. As a result, the amounts due from employer in the pension plan were overstated by \$13.3 million and the amounts due from other in the OPEB plan were understated by \$13.3 million as of September 30, 2011.
- c. Financial Services did not properly allocate the amounts due to a vendor related to drug claims and administrative costs to the OPEB plan. As a result, accounts payable in the pension plan were overstated and accounts payable in the OPEB plan were understated by \$8.2 million at September 30, 2011.

* See glossary at end of report for definition.

Prior to publishing MSERS's *Comprehensive Annual Financial Report (CAFR)*, ORS and Financial Services corrected the accounting records and made the appropriate revisions to MSERS's *CAFR* for the fiscal year ended September 30, 2011.

RECOMMENDATION

We recommend that ORS and Financial Services, within DTMB, implement sufficient controls to ensure that they properly classify MSERS's financial activity.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation but notes that the misclassifications were corrected in the State's accounting records and that the published financial statements were accurate. Financial Services will, however, revise existing financial statement preparation and review processes to enhance existing controls for calculating and recording activity related to programs and incentives. Financial Services will update relevant procedures as needed by August 30, 2012.

GLOSSARY

Glossary of Acronyms and Terms

<i>CAFR</i>	<i>Comprehensive Annual Financial Report.</i>
deficiency in internal control over financial reporting	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.
DTMB	Department of Technology, Management, and Budget.
financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are presented fairly in all material respects in conformity with the disclosed basis of accounting.
Governmental Accounting Standards Board (GASB)	An arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.

material weakness in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial schedules and/or financial statements will not be prevented, or detected and corrected, on a timely basis.
MSERS	Michigan State Employees' Retirement System.
OPEB	other postemployment benefits.
ORS	Office of Retirement Services.
significant deficiency in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
unqualified opinion	An auditor's opinion in which the auditor states that the financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting.

