MICHIGAN

OFFICE OF THE AUDITOR GENERAL

MANAGEMENT LETTER

# MICHIGAN STATE POLICE RETIREMENT SYSTEM

October 1, 2009 through September 30, 2011

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

071-0154-12M

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

Audit report information can be accessed at:
*http://audgen.michigan.gov*

Michigan
*Office of the Auditor General*
# REPORT SUMMARY

*Management Letter*

*Michigan State Police Retirement System*

*October 1, 2009 through September 30, 2011*

**Report Number:**
**071-0154-12M**

**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 Police Retirement System (MSPRS).*

***Financial Statements:***

**Auditor's Report Issued**

We have audited MSPRS'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 December 30, 2011. We issued an unqualified opinion on MSPRS'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 significant deficiencies (Findings 1 and 2).

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 MSPRS's financial activity (Finding 1).

ORS and Financial Services did not record the expenses related to the Deferred Retirement Option Program (DROP) in MSPRS's financial statements when the benefits were due and payable to the participants' DROP accounts (Finding 2).

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**Noncompliance and Other Matters Material to the Financial Statements**

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

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***Agency Response:***

Our management letter includes 2 findings and 2 corresponding recommendations. DTMB's preliminary response indicates that it agrees with 1 recommendation and disagrees with 1 recommendation.

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***Background:***
MSPRS is a single-employer, Statewide, defined benefit public employee retirement plan governed by the State and operating under the provisions of Act 182, P.A. 1986, as amended. MSPRS's pension plan was established by the State to provide retirement, survivor, and disability benefits to Michigan State Police. In addition, MSPRS's other postemployment benefits (OPEB) plan provides all retirees with the option of receiving health, dental, and vision coverage under the State Police Retirement Act.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

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

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

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

April 3, 2012

Sergeant Richard Hale, Chair
Michigan State Police 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 Sergeant Hale, Mr. Nixon, and Mr. Stoddard:

We have audited the basic financial statements of the Michigan State Police Retirement System (MSPRS) as of and for the fiscal years ended September 30, 2011 and September 30, 2010 and have issued a separate report thereon dated December 30, 2011. In planning and performing our audit of the financial statements of MSPRS, we considered MSPRS'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 Police 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; findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

The agency preliminary responses were 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 recommendations and submit it within 60 days after release of the audit report to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

Thomas H. McTavish

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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AUDITOR GENERAL

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

Sergeant Richard Hale, Chair
Michigan State Police 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 Sergeant Hale, Mr. Nixon, and Mr. Stoddard:

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

Internal Control Over Financial Reporting

Management of the Michigan State Police 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 Police 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 Police Retirement System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Michigan State Police 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 deficiencies in internal control over financial reporting, as described in Findings 1 and 2, that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan State Police 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 responses to the findings identified in our audit are included in the body of our management letter. We did not audit the agency preliminary responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Governor, the Legislature, the Michigan State Police 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

Thomas H. McTavish, C.P.A.
Auditor General
December 30, 2011

# FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

## 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 Police Retirement System's (MSPRS's) financial activity. As a result, they could not ensure the accuracy of MSPRS'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 $1.9 million. As a result, amounts due from other funds were overstated and amounts due from federal agencies were understated by $1.9 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 $1.0 million and the amounts due from other in the OPEB plan were understated by $1.0 million at 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 $0.6 million at September 30, 2011.

Prior to publishing MSPRS's *Comprehensive Annual Financial Report* (*CAFR*), ORS and Financial Services corrected the accounting records and made the

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

appropriate revisions to MSPRS'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 MSPRS'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.

## FINDING

2. Deferred Retirement Option Program (DROP)

ORS and Financial Services did not record the expenses related to the Deferred Retirement Option Program (DROP) in MSPRS's financial statements when the benefits were due and payable to the participants' DROP accounts. As a result, MSPRS's net assets held in trust for pension and OPEB benefits at September 30, 2011 were overstated by $21.0 million.

GASB Statement No. 25, paragraph 26, requires pension plans to recognize liabilities for benefits when due and payable. In addition, the *Comprehensive Implementation Guide* (question 5.25.1), published by GASB, explains that a plan may have a long-term liability in situations in which benefits are due and payable but the payee has elected to receive payment over a period of more than one year.

Section 38.1624a of the *Michigan Compiled Laws* created DROP for State police officers with more than 25 years of experience. Under DROP, the officers may elect to continue working under the program for up to 6 years and have their monthly pension benefits go into their DROP accounts. The monthly pension benefits are calculated as if the officers retired the day before becoming DROP participants. The DROP participants do not receive monthly retirement allowances until completion of DROP and commencement of retirement, which can be at any time during the DROP period; however, the DROP participants vest in their account balances based on years served in the program (i.e., less than 1 year is 30% vesting, 1 year but less than 2 years is 50% vesting, and each year after that increases by 10% until the participant is 100% vested at 6 years). Upon termination from DROP and commencement of retirement, the DROP participants can elect to receive complete or partial distributions of their accounts or maintain the funds in their accounts until the calendar year in which their age is 70 years.

Financial Services did not record the pension benefit expense and related accounts payable when the benefits were due and payable to the participants' DROP accounts; rather, it recorded the expense when the DROP participants received distributions from their accounts. The distributions reflected in benefit payments during fiscal year 2010-11 totaled $14.6 million, and ORS estimated MSPRS's unrecorded DROP liability at September 30, 2011 to be $21.0 million.

## RECOMMENDATION

We recommend that ORS and Financial Services record the expenses related to DROP in MSPRS's financial statements when the benefits are due and payable to the participants' DROP accounts.

## AGENCY PRELIMINARY RESPONSE

DTMB disagrees with the assertion that its recording of expenses for DROP benefits is inconsistent with generally accepted accounting principles. GASB Statement No. 25, paragraph 26, states that "plan liabilities for benefits and refunds should be recognized when due and payable in accordance with the terms of the plan." Section 38.1624a(6) of the *Michigan Compiled Laws* states that "a DROP participant shall not have any claim to any funds in his or her deferred retirement option plan account until he or she retires at the termination of his or her deferred retirement option plan participation." DTMB believes that Section 38.1624a(6) of the *Michigan Compiled Laws* makes it clear that DROP benefits do not become due and payable until the employee ends his or her participation in DROP by retiring and electing a distribution option. Therefore, DTMB believes that recording expenses for DROP benefits in accordance with the distribution option selected at retirement is consistent with generally accepted accounting principles.

## OFFICE OF THE AUDITOR GENERAL EPILOGUE

DTMB believes that ". . . DROP benefits do not become due and payable until the employee ends his or her participation in DROP by retiring and electing a distribution option." Even though a DROP participant does not have a claim to the funds in his or her DROP account until he or she retires at the termination of his or her DROP participation, the monthly pension benefit for a participant working under the program is placed into the DROP account specific to the DROP participant. The DROP participant becomes vested in these funds based on the vesting schedule in Section 38.1624a(5) of *the Michigan Compiled Laws*. In addition, it is DTMB's practice to record the retirement benefit when the DROP participant withdraws the funds. This can be years after the participant leaves DROP as the law allows him or her to keep his or her funds in the program until he or she is 70 years old. The Office of the Auditor General believes that, as the participant becomes vested, the retirement benefit becomes due and payable and that only the actual payout is being deferred. Therefore, the retirement benefit expense and liability should be recorded in the plan as the participant vests in the benefit.

# GLOSSARY

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| *CAFR* | *Comprehensive Annual Financial Report.* |
| 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. |
| DROP | Deferred Retirement Option Program. |
| 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. |

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| 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. |
| MSPRS | Michigan State Police 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. |

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