



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:
071-0151-13M

Michigan State Employees' Retirement System

*Fiscal Years Ended September 30, 2012 and
September 30, 2011*

Released:
April 2013

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, 2012 and September 30, 2011 and have issued a separate report thereon dated January 29, 2013. 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 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 recorded MSERS's financial activity (Finding 1).

ORS and Financial Services did not adhere to established deadlines to ensure that they recorded MSERS's financial activity and prepared drafts of MSERS's statements, notes, and *Comprehensive Annual Financial Report* timely and accurately (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*. However, we noted an instance of other noncompliance (Finding 2).

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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 the recommendations.

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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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obtained by calling 517.334.8050
or by visiting our Web site at:
<http://audgen.michigan.gov>



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

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

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



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

April 24, 2013

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, 2012 and September 30, 2011 and have issued a separate report thereon dated January 29, 2013. In planning and performing our audit of the financial statements, 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 MSERS for the fiscal years ended September 30, 2012 and September 30, 2011.

This management letter contains our report summary; our independent auditor's report on internal control over financial reporting and on compliance and other matters; our findings, our recommendations, and the agency preliminary responses; and 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,

A handwritten signature in black ink that reads "Thomas H. McTavish".

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

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
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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, 2012 and September 30, 2011 and have issued our report thereon dated January 29, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the 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 certain 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.

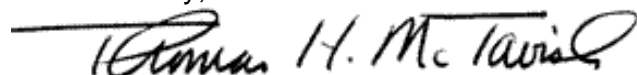
Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Michigan State 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*. However, we noted an instance of other noncompliance as described in Finding 2.

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 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,

A handwritten signature in black ink, appearing to read "Thomas H. McTavish", is written over a horizontal line.

Thomas H. McTavish, C.P.A.
Auditor General
January 29, 2013

FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

FINDING

1. Properly Recording Financial Activity

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 recorded the Michigan State Employees' Retirement System's (MSERS's) financial activity. As a result, they could not ensure the accuracy of the accounting records and MSERS's draft financial statements.

Governmental Accounting Standards Board* (GASB) Statement No. 25 establishes financial reporting standards for defined benefit pension plans; GASB Statement No. 43 establishes uniform financial reporting standards for other postemployment benefits (OPEB) plans. In accordance with these standards, ORS and Financial Services are required to account for and report MSERS's pension plan separate from its OPEB plan.

Our audit procedures identified the following internal control weaknesses and financial statement errors:

- a. Financial Services did not use the unique account coding established in the accounting system to properly classify certain transactions and did not record the necessary manual adjustment for the transactions related to vendor overpayments. As a result, the "amount due from other" in the OPEB plan was understated and the "amounts due from employer" in the OPEB plan was overstated by \$14.4 million as of September 30, 2012. We noted similar errors in the prior two audits.
- b. ORS and Financial Services did not verify the accuracy of the underlying data provided by the State of Michigan 401K Plan's third party administrator (TPA). Data provided by the TPA indicated that MSERS owed \$4.7 million to the State of Michigan 401K Plan. However, our review of the underlying data indicated that this data was erroneous and that no liability existed. As a result, "amounts due to other funds" and "transfers to other systems/funds" were overstated by \$4.7 million as of September 30, 2012.

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

- c. Financial Services did not verify revisions to its account coding. Financial Services revised its account coding structure to specifically identify OPEB plan financial activity during fiscal year 2011-12; however, it did not verify that the revised account coding was accurate. As a result, "employer contributions" was overstated in the pension plan and "employer contributions" was understated in the OPEB plan by \$0.8 million.

Prior to publishing MSERS's *Comprehensive Annual Financial Report (CAFR)*, ORS and Financial Services corrected the preceding errors in the accounting records and made the appropriate revisions to MSERS's *CAFR* for the fiscal year ended September 30, 2012.

We noted a similar condition in our prior audit. Financial Services indicated that it would revise existing financial statement preparation and review processes to enhance existing controls for calculating and recording activity related to programs and incentives. We noted that Financial Services modified its preparation and review processes; however, our review disclosed that its modifications were not sufficient to prevent the deficiencies identified in this finding.

RECOMMENDATION

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

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation but notes that all initial misclassifications in the draft financial statements were corrected in the State's accounting records and the published financial statements were accurate. DTMB informed us that Financial Services will revisit existing financial statement preparation and review processes to enhance existing controls and will update the MSERS's *CAFR* procedures as needed.

FINDING

2. Adhering to Established Deadlines

ORS and Financial Services did not adhere to established deadlines to ensure that they recorded MSERS's financial activity and prepared drafts of MSERS's

statements, notes, and *CAFR* timely and accurately. As a result, MSERS's audited financial statements were not finalized until January 29, 2013, a month after the statutory deadline.

Section 18.1492 of the *Michigan Compiled Laws* requires MSERS's financial statements to be audited and submitted to DTMB's Office of Financial Management (OFM) for inclusion in the *State of Michigan Comprehensive Annual Financial Report* within 90 days of the close of the State's fiscal year. Also, to help ensure compliance with this requirement, OFM and Financial Services agreed on deadlines for recording accounting entries and submitting the draft financial statements to OFM. To accomplish this, Financial Services developed a detailed year-end calendar identifying specific completion dates for performing reconciliations and other various procedures necessary to finalize accounting entries; prepare financial statements, note disclosures, and other information included in the *CAFR*; and provide draft statements and other necessary information to the auditors.

Financial Services did not adhere to key completion dates as follows:

- a. Financial Services did not perform the reconciliation of contributions between the State's accounting system and the State's payroll system by the October 31, 2012 due date. This reconciliation was not completed until late November 2012.
- b. Financial Services did not complete the analytical review of the tax deferred receivables by the November 16, 2012 due date. This analytical review was not completed until December 5, 2012.
- c. Financial Services did not have all accounting entries recorded by the November 16, 2012 due date. Approximately 30 accounting entries were recorded between November 28, 2012 and January 3, 2013, up to 48 days past the due date, including the following significant entries:
 - (1) An adjustment to reallocate \$165.9 million of contributions from the pension plan to the OPEB plan was recorded on November 28, 2012, representing 23.7% of total contributions for the OPEB plan for fiscal year 2011-12.

- (2) An entry to decrease employer contributions by \$107.1 million was recorded on November 28, 2012.
 - (3) An entry to adjust \$17.2 million of tax deferred receivables was recorded on December 5, 2012, and an entry to correct the account coding used for this entry was recorded on December 11, 2012.
 - (4) Numerous entries to allocate \$9.6 million of unallocated cash to the proper contribution line item were recorded between November 28, 2012 and December 19, 2012.
 - (5) A \$4.7 million account payable was recorded on December 21, 2012, 35 days past the due date, and an entry to delete the \$4.7 million account payable was recorded on January 3, 2013, 48 days past the due date.
- d. Financial Services did not prepare the draft statement of plan net assets and the statement of changes in plan net assets, and provide them to the auditors, by the November 7, 2012 due date. Financial Services prepared the first draft of these financial statements and provided them to the auditors on December 7, 2012, 30 days past the due date. Also, as a result of the errors noted in Finding 1, this draft was not accurate.
 - e. Financial Services did not prepare the draft financial statements and note disclosures required for the *State of Michigan Comprehensive Annual Financial Report*, and provide them to OFM, by the November 26, 2012 due date. Financial Services provided the draft financial statements and note disclosures on December 7, 2012, 11 days past the deadline. Also, as a result of the errors noted in Finding 1, this draft was not accurate.
 - f. Financial Services did not prepare the complete draft of MSERS's *CAFR*, and provide it to the auditors, by the November 19, 2012 due date. Financial Services prepared the first complete draft of MSERS's *CAFR*, and provided it to the auditors, on December 11, 2012, 22 days past the due date. Also, our initial review of the draft MSERS's *CAFR* noted more than 200 follow-up questions and comments. The following significant examples reflect the

inadequacy of the draft MSERS's *CAFR* that required numerous revisions before Financial Services completed a final *CAFR*:

- (1) Investments of \$14.5 million were misclassified between the pension plan and the OPEB plan as of September 30, 2011, even though they were accurately classified in the prior year audited financial statements.
- (2) The pension plan's amortization of the unfunded actuarial accrued liability, disclosed in the notes, was understated by \$78.0 million for fiscal year 2011-12.
- (3) The OPEB plan's percentage of actual employer contributions to annual covered payroll, disclosed in the notes, was overstated by 17.6% for fiscal year 2010-11.
- (4) The OPEB plan's actuarial valuation of assets, disclosed in the notes, was overstated by \$10.2 million for fiscal year 2010-11.
- (5) The OPEB plan's unfunded actuarial accrued liability, disclosed in the notes, was understated by \$8.9 billion for fiscal year 2010-11.

Financial Services provided the auditors with four subsequent drafts of MSERS's *CAFR*, with the final version being provided on February 19, 2013.

We noted that one staff person is primarily responsible for MSERS's year-end closing process and recognize that the unexpected absence of this staff person contributed to some of the preceding delays. Because adherence to established completion dates is essential, Financial Services management could consider reallocating staffing resources to ensure that unexpected situations do not adversely affect the timely completion of the year-end closing process.

RECOMMENDATION

We recommend that ORS and Financial Services adhere to established deadlines to ensure that they record MSERS's financial activity and prepare drafts of MSERS's statements, notes, and *CAFR* timely and accurately.

AGENCY PRELIMINARY RESPONSE

DTMB agrees with the recommendation but notes that all items listed in the finding were related to timeliness and providing a draft *CAFR* prior to a thorough review, and not errors in the State's accounting records. As DTMB stated previously, the published financial statements were accurate. DTMB informed us that Financial Services will, however, revisit existing financial statement preparation and review processes to enhance existing controls and will update MSERS's *CAFR* time lines to ensure that the audited *CAFR* will be submitted by the deadline required by State law.

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 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 statements that causes the statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.

material weakness in internal control over financial reporting	A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis.
MSERS	Michigan State Employees' Retirement System.
OFM	Office of Financial Management.
OPEB	other postemployment benefits.
ORS	Office of Retirement Services.
other noncompliance	Violations of contracts or grant agreements that are not material to the financial statements but should be communicated to management in accordance with <i>Government Auditing Standards</i> . Other noncompliance also includes violations of laws, regulations, contracts, or grant agreements; fraud; abuse; or other internal control deficiencies that may be communicated to management in accordance with <i>Government Accounting Standards</i> .
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.
TPA	third party administrator.
unqualified opinion	An auditor's opinion in which the auditor states that the financial statements presenting the basic financial information of the audited entity are fairly presented in conformity with the disclosed basis of accounting.

