MICHIGAN

OFFICE OF THE AUDITOR GENERAL

REPORT ON INTERNAL CONTROL, COMPLIANCE, AND OTHER MATTERS

STATE OF MICHIGAN
COMPREHENSIVE ANNUAL FINANCIAL REPORT

STATE BUDGET OFFICE
DEPARTMENT OF TECHNOLOGY, MANAGEMENT, AND BUDGET

Fiscal Year Ended September 30, 2013

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

071-0010-14M

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:
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Michigan

Office of the Auditor General

REPORT SUMMARY

Report on Internal Control, Compliance, and Other Matters
State of Michigan Comprehensive Annual Financial Report
State Budget Office
Department of Technology, Management, and Budget
Fiscal Year Ended September 30, 2013

Report Number:
071-0010-14M

Released:
March 2014

Generally accepted government auditing standards require an auditor to report on internal control over financial reporting; compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements; and other matters coming to the attention of the auditor during the completion of a financial audit. This report is being issued in conjunction with our financial audit of the State of Michigan Comprehensive Annual Financial Report (SOMCAFR).

Financial Statements:

Auditor's Report Issued

We have audited the *SOMCAFR* principally as of and for the fiscal year ended September 30, 2013 and have issued a separate report thereon dated December 21, 2013. We issued unmodified opinions 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 of the State of Michigan.

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Internal Control Over Financial Reporting

In planning and performing our audit of the basic financial statements, we considered the State's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, we did not identify any deficiencies in internal control that we consider to be material weaknesses; however, material weaknesses may exist that have not been identified. We did identify significant deficiencies (Findings 1 through 3). 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.

Tax Accruals
The Department of Treasury (Treasury) and the Office of Financial Management (OFM), within the Department of Technology, Management, and Budget (DTMB), should improve internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals. Treasury's accrual methodologies were used to record payables of $698.7 million and receivables of $2.9 billion for fiscal year 2012-13 (Finding 1).

Monitoring of Payables and Receivables
OFM, in conjunction with other State departments, should continue to improve internal control to ensure the validity and reasonableness of payable and receivable amounts reflected within year-end balances reported within the *SOMCAFR* (Finding 2).

MDOT Contractor Payments
The Michigan Department of Transportation (MDOT), in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates. Consequently, construction expenditures may have been recorded in the wrong fiscal year (Finding 3).

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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 basic financial statements that are required to be reported under *Government Auditing Standards*.

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Agency Response:
This report includes 3 findings and 3 corresponding recommendations. OFM's preliminary response indicates that it agrees with 2 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

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
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

March 10, 2014

Mr. John S. Roberts, State Budget Director
State Budget Office
Department of Technology, Management, and Budget
George W. Romney Building
Lansing, Michigan

Dear Mr. Roberts:

We have audited 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 of the State of Michigan principally as of and for the fiscal year ended September 30, 2013, which collectively comprise the State's basic financial statements, and have issued a separate report thereon dated December 21, 2013. In planning and performing our audit of the financial statements, we considered the State's internal control over financial reporting and compliance and other matters. This report on internal control, compliance, and other matters is being issued in conjunction with our financial audit of the *State of Michigan Comprehensive Annual Financial Report* for the fiscal year ended September 30, 2013.

This report 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 our prior year report follow-up; and a glossary of abbreviations and terms.

Certain findings included in this report specifically relate to other departments. Although the Office of Financial Management, State Budget Office, Department of Technology, Management, and Budget, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your Department's responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The agency preliminary responses were taken from the Department's response at the end of 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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GLOSSARY

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

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

John E. Nixon, C.P.A., State Budget Director
State Budget Office
Department of Technology, Management, and Budget
George W. Romney Building
Lansing, Michigan

Dear Mr. Nixon:

We have audited, in accordance with the 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, 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 of the State of Michigan principally as of and for the fiscal year ended September 30, 2013 and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated December 21, 2013. Our report includes a reference to other auditors who audited the financial statements of the State Lottery Fund (a major fund), Michigan Unemployment Compensation Funds (a major fund), Michigan Employment Security Act - Administration Fund, Unemployment Obligation Trust Fund, State Building Authority - Debt Service Fund, State Building Authority - Capital Projects Fund, Attorney Discipline System, State Sponsored Group Insurance Fund, Michigan Education Savings Program, Michigan State Housing Development Authority, Farm Produce Insurance Authority, Mackinac Bridge Authority, Mackinac Island State Park Commission, State Bar of Michigan, Central Michigan University, Western Michigan University, Eastern Michigan University, Ferris State University, Grand Valley State University, Lake Superior State University, Michigan Technological University, Northern Michigan University, Oakland University, and Saginaw Valley State University. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit of the basic financial statements, we considered the State's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's 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 a material misstatement of the entity's basic financial statements will not be prevented, or detected and corrected, on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, as described in Findings 1 through 3, that we consider to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State's basic financial statements are free from 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*.

Department's Response to Findings

Certain findings included in this report specifically relate to other departments. Although the Office of Financial Management, State Budget Office, Department of Technology, Management, and Budget, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your Department's responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The Department's preliminary responses to the findings identified in our audit are included in the body of our report. The Department's preliminary responses were not subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Sincerely,

Thomas H. McTavish

Thomas H. McTavish, C.P.A.
Auditor General
December 21, 2013

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FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES AND PRIOR YEAR REPORT FOLLOW-UP

Fiscal Year 2012-13
Findings, Recommendations, and
Agency Preliminary Responses

FINDING

1. Tax Accruals

The Department of Treasury (Treasury) and the Office of Financial Management (OFM), within the Department of Technology, Management, and Budget (DTMB), should improve internal control* to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals. Treasury's accrual methodologies were used to record payables of $698.7 million and receivables of $2.9 billion for fiscal year 2012-13.

The deficiencies in internal control resulted in the following misstatements:

	Net Known Misstatement (in millions)	Net Known and Likely Misstatement (in millions)
General Fund:		
Assets	Overstated $44.3	Overstated $60.8
Liabilities	Overstated $ 7.8	Overstated $ 8.2
Revenues	Overstated $36.5	Overstated $52.5
Fund Balance	Overstated $36.5	Overstated $52.5
School Aid Fund:		
Assets	Overstated $ 4.4	Overstated $ 5.9
Liabilities	$ 0.0	Overstated $ 0.4
Revenues	Overstated $ 3.2	Overstated $ 4.4
Expenditures	Understated $ 1.1	Understated $ 1.1
Fund Balance	Overstated $ 4.3	Overstated $ 5.5
Michigan Transportation Fund:		
Assets	Overstated $ 1.6	Overstated $ 1.6
Liabilities	Overstated $ 0.8	Overstated $ 0.8
Revenues	Overstated $ 0.9	Overstated $ 0.9
Fund Balance	Overstated $ 0.9	Overstated $ 0.9

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

	Net Known Misstatement (in millions)	Net Known and Likely Misstatement (in millions)
Governmental Activities of the Government-wide Financial Statements:		
Assets	Overstated $50.3	Overstated $68.3
Liabilities	Understated $ 3.2	Understated $ 3.2
Revenues	Overstated $52.4	Overstated $70.4
Expenses	Understated $ 1.1	Understated $ 1.1
Net Position	Overstated $53.5	Overstated $71.5

Subsequent to our review and prior to the issuance of the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*, Treasury, in conjunction with OFM, recorded adjusting entries to correct most of the known misstatements. Although Treasury made the correcting entries and the financial statements were materially correct, the internal control weaknesses should be corrected to help ensure the accuracy of the tax accruals in subsequent fiscal years.

Section 18.1141 of the *Michigan Compiled Laws* (Section 141, Act 431, P.A. 1984, as amended) provides that DTMB shall establish a comprehensive system of internal controls in the management of the State's financial affairs and record transactions in accordance with generally accepted accounting principles*. In addition, Section 18.1485 of the *Michigan Compiled Laws* (Section 485, Act 431, P.A. 1984, as amended) provides that the department head of each principal department shall establish and maintain an internal accounting and administrative control system within that principal department using generally accepted accounting principles and in conformance with directives issued pursuant to Section 18.1141(d) of the *Michigan Compiled Laws*.

We issued a total of 13 audit memorandums related to tax accruals. Following are five examples of the significant misstatements and internal control weaknesses noted during our review of the tax accruals:

a. Treasury and OFM did not ensure that delinquent tax assessments included within estimated receivable calculations represented valid amounts owed to the State. As a result, assets were overstated by $29.7 million, deferred revenues were overstated by $2.2 million, and revenues and fund balance

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

were overstated by $27.5 million in the General Fund and assets, revenues, and net position were overstated by $29.7 million in the governmental activities of the government-wide financial statements.

We noted an exceptionally high dollar amount for an individual taxpayer included by Treasury in its calculation of tax assessments to record as taxes, interest, and penalties receivable. Because of the dollar value of this single tax assessment, we requested that Treasury reexamine its validity. Treasury concluded that the taxpayer actually overpaid the tax liability by $2.6 million. We noted a similar issue involving a different taxpayer in the prior audit. Subsequent to our review and prior to issuance of the *SOMCAFR,* Treasury, in conjunction with OFM, recorded adjusting entries to correct the misstatements.

b. Treasury and OFM did not use an available set of collectibility percentages for assessments exceeding $20,000 to estimate and record taxes receivable in relation to receivables to be assessed. As a result, we estimated that assets were likely overstated by $16.5 million, liabilities were likely overstated by $0.5 million, and revenues and fund balance were likely overstated by $16.0 million in the General Fund. In addition, we estimated that assets were likely overstated by $1.5 million, liabilities were likely overstated by $0.3 million, and revenues and fund balance were likely overstated by $1.2 million in the School Aid Fund and that assets, revenues, and net position were likely overstated by $18.0 million in the governmental activities of the government-wide financial statements.

At the end of each fiscal year, Treasury identifies tax assessments that it intends to assess against taxpayers in the months of October and November. The assessment totals are grouped by type of tax and whether the individual assessment amounts are less than or greater than $20,000. An automated program is run within the State Treasury Accounts Receivable System that determines the estimated collectibility percentages that should be applied to the gross assessment amounts in determining the total receivable amounts to recognize within the *SOMCAFR*. The collectibility percentage ultimately applied to the gross assessment amount is actually a three-year average of the percentage determined for the current fiscal year and the prior two fiscal years.

Although Treasury determines separate collectibility percentages for assessments greater than $20,000, it applies the percentages associated with assessments less than $20,000 to all assessments regardless of amounts in calculating the amounts recognized within the *SOMCAFR*. The collectibility percentages for assessments less than $20,000 are typically greater than the percentages for assessments greater than $20,000. As a result, the methodology likely inflated the estimated receivable, deferred revenue, and revenue amounts recorded at the fund level for assessments greater than $20,000.

We initially identified this issue during the fiscal year 2011-12 *SOMCAFR* audit. Treasury and OFM neither agreed nor disagreed with the finding. OFM believes that sufficient historical data was not available to determine whether it was appropriate to revise the estimation methodology and indicated that Treasury and OFM would reevaluate the issue in fiscal year 2013-14.

c. Treasury and OFM did not recognize a liability at year-end relating to sales, use, and withholding (SUW) tax returns received but not yet processed as of November 30, 2013. As a result, liabilities were understated by $2.8 million and revenues and fund balance were overstated by $2.8 million in the General Fund. Also, liabilities were understated by $1.1 million and revenues and fund balance were overstated by $1.1 million in the School Aid Fund. In addition, liabilities were understated and revenues and net position were overstated by $4.0 million in the governmental activities of the government-wide financial statements.

Treasury accrues a liability at year-end for tax refunds issued during October and November. Also, Treasury records an estimated liability at the end of the fiscal year in relation to tax returns claiming a refund that it received but had not processed as of November 30 for individual income tax, corporate income tax, Michigan business tax, and flow-through withholding tax. However, based on its accrual methodologies, Treasury does not record an estimated liability in relation to SUW tax returns.

We determined that a backlog of unprocessed SUW tax returns claiming a refund existed at the end of fiscal year 2012-13. We analyzed the backlog of returns and judgmentally selected 14 for more detailed review. Based on our review and information provided by Treasury, we determined that 5 of the selected returns represented an outstanding valid claim by the taxpayer for a refund and should be recognized as a liability within the fiscal year 2012-13 *SOMCAFR*. The refund amount claimed by the taxpayers on these five returns totaled $4.0 million. Subsequent to our review and prior to issuance of the *SOMCAFR*, Treasury, in conjunction with OFM, recorded adjusting entries to recognize the $4.0 million liability.

d. Treasury and OFM did not ensure that Treasury's Office of Accounting Services obtained the correct data set of tax assessments for use in recognizing estimated taxes receivable at year-end.

During the fiscal year-end closing process, Treasury's Office of Collections identifies tax assessments that it intends to assess against taxpayers in the months of October and November. The assessments are identified by querying the State Treasury Accounts Receivable System based on the selected date parameters. Treasury's Office of Collections staff provide the assessment data to Treasury's Office of Accounting Services staff, who further calculate and record the accrual.

Our examination of the data set obtained by Treasury's Office of Accounting Services for the November 2013 calculation determined that the date range used in the query by Treasury's Office of Collections was incorrect. Treasury erroneously used November 1 through November 30, 2012 instead of November 1 through November 30, 2013. The date range mistake was not readily identifiable from the data provided to Treasury's Office of Accounting Services staff as it does not include the individual assessment dates and is not accompanied by an output report from the State Treasury Accounts Receivable System showing the applicable date range used in the query.

We brought the issue to Treasury's attention prior to the calculation and recording of the accrual by Treasury's Office of Accounting Services staff. After we notified Treasury of the error, Treasury reran the assessment data and ultimately recorded taxes receivable of $21.7 million. If Treasury had used the initial assessment data, it would have understated the recorded taxes receivable by $11.7 million.

e. As noted in Finding 2, part a.(1), Treasury and OFM should improve internal control and implement a comprehensive tracking process to ensure that the methodologies and processes used to develop the tax accrual estimates are reliable.

RECOMMENDATION

We recommend that Treasury and OFM improve internal control to prevent, or detect and correct, misstatements and ensure the reasonableness of the tax accruals.

AGENCY PRELIMINARY RESPONSE

Treasury and OFM agree that internal control over tax accruals can be improved. OFM reiterated that most of the known misstatements were corrected prior to the issuance of the *SOMCAFR*. Regarding specific items within the finding:

- Treasury and OFM agree with parts a., c., d., and e. of the finding. OFM informed us that, as part of the annual review of tax accrual and tracking methodologies, Treasury and OFM will determine if changes are needed to minimize the risk of similar types of errors in the future.

- Treasury and OFM neither agree nor disagree with part b. of the finding. Treasury and OFM will reevaluate whether it is appropriate to revise the estimation methodology when sufficient historical data becomes available.

FINDING

2. Monitoring of Payables and Receivables

OFM, in conjunction with other State departments, should continue to improve internal control to ensure the validity and reasonableness of payable and receivable amounts reflected within year-end balances reported within the *SOMCAFR*.

Section 18.1141 of the *Michigan Compiled Laws* (Section 141, Act 431, P.A. 1984, as amended) provides that DTMB shall establish a comprehensive system of internal controls in the management of the State's financial affairs and record transactions in accordance with generally accepted accounting principles. In addition, Section 18.1485 of the *Michigan Compiled Laws* (Section 485, Act 431, P.A. 1984, as amended) provides that the department head of each principal department shall establish and maintain an internal accounting and administrative control system within that principal department using generally accepted accounting principles and in conformance with directives issued pursuant to Section 18.1141(d) of the *Michigan Compiled Laws*.

Our review of payables and receivables disclosed:

a. For payables and receivables established at year-end based on estimation methodologies, the respective State departments, in conjunction with OFM, should improve internal control to appropriately track the estimated accrual amounts with actual results.

   Effective internal control over accrued payables and receivables should include a comparison of the accounting estimates with subsequent activity to assess the reliability of the processes used to develop the estimates. In its approval of accrual methodologies, OFM instructs the State departments that it is important to evaluate the reliability of the estimated accruals in the subsequent year and adjust the estimation methodology accordingly.

   Two significant accruals established annually based on estimation methodologies are taxes payable and receivable within Treasury and Medicaid accruals within the Department of Community Health (DCH):

   (1) Our review of tax accruals for fiscal year 2012-13 disclosed that Treasury had not developed a process that would provide for a comparison of significant accounting estimates with subsequent activity for several components of the accruals. We noted that the estimates for the assessed taxes receivable, receivables to be assessed, business taxes backlog, and individual income tax backlog of the year-end tax accruals are not compared to subsequent activity to assess the reliability of the

process used to develop the estimates. A Treasury comparison of the accounting estimates with subsequent activity would help provide assurance regarding the reliability of the processes used to develop the estimates.

(2) Our review of Medicaid accruals for fiscal year 2012-13 again noted continued progress in DCH's efforts to improve the tracking process. DCH had made considerable efforts to compile subsequent activity data and document a comparison of the prior estimates to subsequent activity for all 12 of the components that we reviewed. However, while considerable efforts were made, we noted that the comparison was not fully complete or accurate for 4 of the 12 components. For example, we noted that DCH did not properly calculate the variance between the estimate and subsequent activity in 2 of the 4 instances because of formula errors within DCH's comparison. We also noted that there were significant variations between the prior estimates and subsequent activity for 3 of the 4 components, but DCH had not adequately documented why the processes used to develop the estimates for those 3 components were still reliable and acceptable for future estimates. In addition, for 1 of the 4 components, DCH indicated that it was not feasible to identify all subsequent activity and had not developed an alternative tracking process to evaluate the reasonableness of the estimate for the component.

A DCH comparison of the accounting estimates with subsequent activity would help provide assurance regarding the reliability of the processes used to develop the estimates.

We initially identified this issue during the fiscal year 2009-10 *SOMCAFR* audit. In the fiscal year 2011-12 report on internal control, compliance, and other matters, we reported that DCH had improved its tracking process from the prior year but had not fully and accurately implemented tracking and validation processes for 8 of the 13 components we reviewed during that period. OFM informed us that DCH would continue to track the various components of the Medicaid accrual and that changes to approved accrual methodologies would be considered when sufficient tracking data provided assurances that an alternative methodology would provide a better estimate in a cost-effective manner.

b. For payables and receivables not based on estimation methodologies and for those based on estimates that are not completely reversed and reestablished in the subsequent fiscal year, OFM could enhance internal control by fully implementing a centralized process to monitor payables and receivables established in a prior fiscal year. A centralized process would help ensure that the balances are properly liquidated by the individual State departments in subsequent years.

Prior to the end of the fiscal year, OFM compiles a list of outstanding payable and receivable balances, by individual State department, which it then provides to the applicable department. OFM instructs the department to review the information and record any necessary adjustments. However, OFM does not analyze the information or subsequently follow up with the departments to ensure that appropriate adjustments were recorded. In the absence of a centralized monitoring control, the risk increases that established balances may improperly carry over from one fiscal year to the next, leading to the misstatement of the aggregate year-end payable and receivable balances reported within the *SOMCAFR*.

RECOMMENDATION

We recommend that OFM, in conjunction with other State departments, continue to improve internal control to ensure the validity and reasonableness of payable and receivable amounts reflected within year-end balances reported within the *SOMCAFR*.

AGENCY PRELIMINARY RESPONSE

OFM, Treasury, and DCH agree with part a. of the finding. OFM informed us that, as part of the annual review of accrual and tracking methodologies, OFM, in conjunction with Treasury and DCH, will evaluate existing monitoring and tracking methodologies and procedures to determine if adjustments are necessary.

OFM disagrees with part b. of the finding. OFM informed us that it has delegated the responsibility for ensuring the proper liquidation of balances in subsequent fiscal years to the individual State departments. OFM believes that the policies and procedures implemented as part of that delegation provide sufficient internal control to ensure that payable and receivable balances are validated or written off as appropriate.

FINDING

3. MDOT Contractor Payments

The Michigan Department of Transportation (MDOT), in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates. Consequently, construction expenditures may have been recorded in the wrong fiscal year.

The State of Michigan Financial Management Guide (Part II, Chapter 14, Section 100) requires agencies to record payables for goods and services received by September 30.

MDOT project managers submit estimated accounts payable work sheets to MDOT's Contract Services Division for each outstanding project at the end of the fiscal year. The estimated payables are compiled by MDOT's Contract Services Division staff and recorded by MDOT's Accounting Services Division.

MDOT's practice is to apply all payments made during the current fiscal year against the estimated payable established at the end of the prior fiscal year until the payable balance is reduced to zero. The actual date that the work was completed is not taken into consideration. If payments in the current year for a project are less than the estimated payable established in relation to that project at the end of the prior fiscal year, the remaining payable balance is written off. On average, MDOT wrote off 12.2% of the estimated payables established for fiscal years 2011-12, 2010-11, and 2009-10. The write-off percentage is most likely understated because of MDOT's practice of applying all payments made during the current fiscal year against the estimated payable regardless of the date that work was completed.

MDOT project managers use inspector's daily reports (IDRs) to track the daily activity of a project. IDRs are then used to upload completed work into the Field

Manager System for payment processing. A project manager may decide to withhold an entire IDR, or certain items within an IDR, from payment processing until the project manager is satisfied that the work is complete or until the contract modification has been finalized to include the activity performed. Because of this, payments can include IDRs related to work performed during that pay period or weeks before, or even months before, the IDR item is submitted for payment processing. The information related to the dates of service is available from the IDRs but not in the Field Manager System from which contractor payments are processed.

We initially identified this issue during the fiscal year 2011-12 *SOMCAFR* audit. MDOT and OFM agreed with our recommendation and OFM informed us that MDOT would implement process changes in fiscal year 2013-14 to evaluate dates of service when processing contractor payments and liquidating prior year accounts payable estimates.

RECOMMENDATION

We recommend that MDOT, in conjunction with OFM, improve internal control to evaluate the dates of service when processing contractor payments and liquidating prior year accounts payable estimates.

AGENCY PRELIMINARY RESPONSE

MDOT and OFM agree with the recommendation. OFM informed us that MDOT will implement the necessary process changes to evaluate dates of service when processing contractor payments and liquidating prior year accounts payable estimates.

Fiscal Year 2011-12
Report on Internal Control, Compliance, and Other Matters Follow-Up

In the follow-up of our fiscal year 2011-12 *SOMCAFR* report on internal control, compliance, and other matters, we noted that OFM and State agencies had complied with 3 of the 5 recommendations (Findings 2 through 4 of that report). We repeated the other 2 prior audit recommendations in Findings 1 and 3 of this report.

GLOSSARY

Glossary of Abbreviations and Terms

DCH	Department of Community Health.
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 basic financial statements of an audited entity are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
generally accepted accounting principles (GAAP)	A technical accounting term that encompasses the conventions, rules, guidelines, and procedures necessary to define accepted accounting practice at a particular time; also cited as "accounting principles generally accepted in the United States of America."
IDR	inspector's daily report.
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 basic financial statements that causes the statements to not present fairly the financial position or the changes in financial position, and, where applicable, cash flows thereof, in accordance with the applicable financial reporting framework.

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.
MDOT	Michigan Department of Transportation.
OFM	Office of Financial Management.
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.
SOMCAFR	*State of Michigan Comprehensive Annual Financial Report.*
SUW	sales, use, and withholding.
Treasury	Department of Treasury.
unmodified opinion	The opinion expressed by the auditor when the auditor, having obtained sufficient appropriate audit evidence, concludes that the basic financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

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STATE OF MICHIGAN

OFFICE of the AUDITOR GENERAL