

Office of the Auditor General
Report on Internal Control, Compliance, and Other Matters

State of Michigan
Comprehensive Annual Financial Report
State Budget Office

Fiscal Year Ended September 30, 2017

State of Michigan Auditor General
Doug A. Ringler, CPA, CIA

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



OAG

Office of the Auditor General

Report Summary

*Report on Internal Control, Compliance, and
Other Matters
State of Michigan Comprehensive Annual
Financial Report (SOMCAFR)
State Budget Office
Fiscal Year Ended September 30, 2017*

**Report Number:
071-0010-18**

**Released:
March 2018**

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. We are issuing this report in conjunction with our independent auditor's report on the SOMCAFR dated January 5, 2018.

Findings Related to Internal Control, Compliance, and Other Matters	Material Weakness	Significant Deficiency	Agency Preliminary Response
The Michigan Department of Health and Human Services (MDHHS) did not ensure that sufficient internal control and procedures existed for the preparation and approval of accounting transactions primarily involving year-end accruals. This resulted in numerous misstatements in its accounting entries and was a factor in MDHHS missing the State's financial closing deadline (Finding #1).	X		Agree
MDHHS did not always ensure that accounts receivable and accounts payable transactions were derived using approved methodologies and that it maintained sufficient documentation to support year-end accruals (Finding #2).		X	Agree
The Department of Treasury (Treasury) and the Office of Financial Management (OFM) should continue to enhance internal control to prevent, or detect and correct, misstatements and ensure the reasonableness and accuracy of tax accruals (Finding #3).		X	Agree

Findings Related to Internal Control, Compliance, and Other Matters (Continued)	Material Weakness	Significant Deficiency	Agency Preliminary Response
Treasury should improve internal control over the offset fund to ensure that balances are accurate and complete (<u>Finding #4</u>).		X	Agree
The Michigan Department of Transportation, in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing payments and liquidating prior year accounts payable estimates (<u>Finding #5</u>).		X	Agree
The Department of Technology, Management, and Budget did not have sufficient internal control in place to ensure the accuracy and completeness of accounting information recorded in the <i>SOMCAFR</i> related to intangible and capital assets (<u>Finding #6</u>).		X	Agree

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Doug A. Ringler, CPA, CIA
Auditor General

March 16, 2018

Mr. John J. Walsh, State Budget Director
State Budget Office
George W. Romney Building
Lansing, Michigan

Dear Mr. Walsh:

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, 2017.

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

The Office of Financial Management provided preliminary responses to the recommendations at the end of our fieldwork. The *Michigan Compiled Laws* and administrative procedures require an audited agency to develop a plan to comply with the recommendations and to submit it within 60 days of the date above 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 "Doug Ringler". The signature is written in a cursive style.

Doug Ringler
Auditor General

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



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Doug A. Ringler, CPA, CIA
Auditor General

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

Mr. John J. Walsh, State Budget Director
State Budget Office
George W. Romney Building
Lansing, Michigan

Dear Mr. Walsh:

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, 2017 and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated January 5, 2018. 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 Finance Authority
- Michigan State Housing Development Authority
- Farm Produce Insurance Authority
- Mackinac Bridge Authority
- Mackinac Island State Park Commission
- Michigan Early Childhood Investment Corporation
- Michigan Education Trust
- State Bar of Michigan
- Venture Michigan Fund
- Western Michigan University
- Central Michigan University
- Eastern Michigan University
- Ferris State University
- Grand Valley State University
- Lake Superior State University
- Michigan Technological University
- Northern Michigan University
- Oakland University
- 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.

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 and, therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as described in the body of our report, we identified a deficiency in internal control that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

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. We consider the deficiency described in Finding #1 to be a material weakness.

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. We consider the deficiencies described in Findings #2 through #6 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*.

Office of Financial Management's Response to Findings

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

The Office of Financial Management's preliminary responses to the findings identified in our audit are included in the body of our report. The 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,



Doug Ringler
Auditor General
January 5, 2018

FISCAL YEAR 2017
FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

FINDING #1

Significant improvement needed to MDHHS financial accounting practices.

The Michigan Department of Health and Human Services (MDHHS) did not ensure that sufficient internal control* and procedures existed for the preparation and approval of accounting transactions primarily involving year-end accruals. Consequently, MDHHS could not ensure that its processes would prevent, or detect and correct, misstatements in its accounting transactions in a timely manner. These issues were a factor in MDHHS missing the State's financial closing deadlines.

Section 18.1485 of the *Michigan Compiled Laws* states that each department shall establish and maintain an internal accounting and administrative control system using generally accepted accounting principles. These controls should include a system of authorization and recordkeeping procedures to control assets, liabilities, revenues, and expenditures; a system of practices to be followed in the performance of duties; qualified personnel that maintain a level of competence; and internal control techniques that are effective and efficient. Each principal department head shall document the system and ensure that the system functions as intended.

The Office of Financial Management (OFM), within the State Budget Office, is responsible for developing the State's detailed financial closing schedule and associated deadlines.

We noted:

- a. MDHHS utilized its Corrective Action Tracking System (CATS) to monitor audit requests. Although this system was intended to provide management with a way to monitor audit request status and help ensure that audit requests were fulfilled, it affects the MDHHS control environment in that it appeared to establish a tone that the MDHHS staff were not to talk to the auditors unless the requests had been entered in the system and subject to management review.

The Office of the Auditor General (OAG) communicated an issue regarding CATS to MDHHS management after the prior audit. Early in the current audit, the OAG and MDHHS discussed that it would be reasonable for the initial documentation request and any subsequent documentation requests to be submitted through CATS, but the OAG would need to discuss follow-up questions directly with the MDHHS staff responsible for the transaction. However, when we requested those meetings, we were initially asked if the request was made in CATS, and if it was not, we were asked to add the request. Also, our requests for meetings with the specific MDHHS staff responsible for preparing transactions were not always honored, which often resulted in inaccurate

* See glossary at end of report for definition.

initial information being provided, further delaying resolution. This, in turn, resulted in additional correcting entries late in the process, further delaying MDHHS's financial close.

- b. For multiple transactions without necessary supporting documentation, MDHHS management requested that we report a misstatement rather than continuing to audit the transactions in an attempt to determine an accurate transaction amount. MDHHS made these requests because it deemed the dollar value of the sampled transactions to be immaterial (see Finding #2, part h.). However, audit procedures include sampling transactions in a population and projecting any misstatements noted over the entire population. Transactions that have a small dollar value may project to a material misstatement depending on the size of the population and the amount of the misstatement. Without knowing these amounts, the results of other related testing, and the audit materiality thresholds, MDHHS would not be in a position to deem a transaction as immaterial for audit sampling and projecting purposes. Projecting these transactions to the entire population could have overstated the financial impact and possibly affected the overall audit opinion. Because we did not have enough evidence to determine whether or how much of a misstatement existed, we did not consider it prudent to simply identify the transaction amount as a misstatement and project the "error" to the entire population.
- c. MDHHS did not have documented processes and procedures for the calculation of some transactions, including the required retention of supporting documentation. When we requested support for these transactions and asked questions about the calculations, MDHHS was not always able to provide support for the calculations that it had just completed a few weeks earlier, without reperforming the work originally completed by its staff.
- d. MDHHS did not have a process in place to ensure that transactions prepared by staff were properly reviewed and approved by management. We acknowledge that MDHHS management does not have the time and resources available to review all transactions prior to the release of the financial statements. However, ongoing monitoring to ensure that established procedures were followed could help mitigate the extent of misstatements in future audits.

The combination of deficiencies identified in this finding, in conjunction with those deficiencies identified in Finding #2, increase the possibility that a material misstatement of the

basic financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the combination of these deficiencies to be a material weakness* in MDHHS's internal control. MDHHS informed us that its management is committed to improving internal control.

RECOMMENDATION

We recommend that MDHHS ensure that sufficient internal control and procedures exist for the preparation and approval of accounting transactions, primarily involving year-end accruals.

**AGENCY
PRELIMINARY
RESPONSE**

OFM provided us with the following response:

MDHHS and OFM agree that there are areas where internal control should be improved and DHHS will work to implement the needed improvements. However, MDHHS disagrees with some of the specifics cited in the finding and disagrees that the issues identified by the auditors collectively constitute a material weakness. In particular, with respect to Part a., MDHHS would like to note that it tracked, responded, and closed 273 requests between October 2017 and January 2018 related to the CAFR. The goal of CATS is to help ensure that audit requests are processed as efficiently as possible. MDHHS is committed to working with the OAG to accomplish that goal.

* See glossary at end of report for definition.

FINDING #2

Improvements needed to transaction processing and documentation retention procedures.

MDHHS did not always ensure that accounts receivable and accounts payable transactions were derived using approved methodologies and that it maintained sufficient documentation to support year-end accruals.

Section 18.1485 of the *Michigan Compiled Laws*, as cited in Finding #1, applies here as well.

We noted:

- a. MDHHS did not ensure that sufficient procedures existed for the transition and oversight of staff responsible for federal revenue, receivable, and payable transactions. Insufficient transfer of knowledge, combined with a lack of comprehensive instructions, contributed to differences in expected amounts. OFM made inquiries of MDHHS to validate recorded federal revenue, receivables, and payables. Initially, MDHHS could not provide sufficient support for many of the amounts recorded. After the OAG conducted alternative procedures, including reconciliations, calculations, and data analysis to validate the completeness of these populations, MDHHS made entries to correct a \$40.5 million overstatement of federal revenue and associated receivables prior to the *State of Michigan Comprehensive Annual Financial Report's (SOMCAFR's)* issuance.
- b. MDHHS did not ensure that two accrued Medicaid liabilities totaling \$14.6 million were recorded in the State's accounting system. Prior to the *SOMCAFR's* issuance, MDHHS recorded entries for these liabilities.
- c. MDHHS did not record a liability for Medicaid payments that were in a pended state as of September 30, 2017. During the prior audit, pended payments were estimated to be \$49.1 million and were accrued as a liability as of September 30, 2016. MDHHS informed us that it implemented a system fix during fiscal year 2017 that corrected the problem, but it could not provide the needed documentation. MDHHS informed us that the fix corrected the issue, so there was nothing to provide. We inquired if MDHHS was monitoring pended payments to ensure that the fix was working as intended but were informed that MDHHS was not monitoring for pended payments because there was no longer an issue. After numerous attempts to obtain access to the data, MDHHS finally provided us access to allow us to analyze pended payments. We estimated that there was \$8.5 million in pended payments that MDHHS did not record as a liability as of September 30, 2017.
- d. MDHHS did not maintain a detailed accrual methodology for the calculation of the Psychiatric Hospital year-end receivable. Specifically, \$2.8 million in federal expenditures that should have been reimbursed for one hospital were improperly excluded from the calculation,

resulting in a \$2.2 million understatement to the federal receivable.

- e. MDHHS did not ensure that the accrual methodology established for the Quality Assurance Assessment Tax was appropriately followed, resulting in a \$2.7 million revenue overstatement. The methodology states that if a facility had two or more months of unpaid/past due invoices, this should be considered a deferred inflow instead of current revenue.
- f. MDHHS established a \$1.7 million payable for Foster Care Relative Incentive Licensing. Upon our request for supporting documentation, MDHHS informed us that the payable was not valid and subsequently created an entry to liquidate the payable.
- g. MDHHS established a payable for the Flint Children's Health Insurance Program (CHIP) Lead Abatement Initiative based on actual invoices received during fiscal year 2017 rather than contacting other State agencies managing the initiative to determine the amount of services that had already been provided but not yet billed. We requested from another State agency the invoices paid during fiscal year 2017 and a listing of CHIP eligible households that had services provided in fiscal year 2017 but were not invoiced as of September 30 and determined that the payable amount was overstated by \$1.3 million. MDHHS corrected this overstatement prior to the *SOMCAFR*'s issuance.
- h. MDHHS established a payable and a receivable for approximately \$659,000 for a medical hospital. Although MDHHS liquidated the payable when an associated bankruptcy was settled through the courts, the receivable was not liquidated. MDHHS was unable to provide supporting documentation for either the liquidated payable or the remaining receivable balance. Also, MDHHS was not able to provide an explanation as to whether the liquidation of the payable was appropriate and whether the receivable was still valid. Later, MDHHS identified a second receivable for approximately \$303,000 for the same hospital. MDHHS could not confirm the appropriateness of either receivable.
- i. MDHHS did not maintain sufficient documentation to support reimbursement payments for the Home Help Program. Our testing of a sample of 23 payments identified 1 payment with no supporting documentation and 11 additional payments for which documentation did not support the full payment that was made. When questioned, MDHHS informed us that for 1 sample item the original documents provided were missing a page; however, the updated documentation provided had different and conflicting information from the information

previously provided. This error also impacted the Medicaid accruals.

RECOMMENDATION

We recommend that MDHHS ensure that accounts receivable and accounts payable transactions are derived using approved methodologies and that it maintains sufficient documentation to support year-end accruals.

**AGENCY
PRELIMINARY
RESPONSE**

OFM provided us with the following response:

MDHHS and OFM agree that there are areas where internal control should be improved and MDHHS will work to implement the needed improvements. However, MDHHS disagrees with some of the specifics cited in the finding. In particular, with respect to Part c., MDHHS would like to note that it did not record a separate liability for potential pended payments in fiscal year 2017 because MDHHS did not consider this a significant liability that necessitated a separate accrual as the amount of pended payments in FY 16 were related to the Healthy Michigan Plan program implementation, which reflected a onetime anomaly. MDHHS will reevaluate if a separate accrual is necessary for pended payments, document that decision and develop any accrual methodology, if necessary. Also, with respect to Part i., MDHHS agrees that sufficient documentation was not available to support some home help expenditures. However, for the majority of these items, there is a difference in interpretation of policy between the OAG and MDHHS.

FINDING #3

Continued improvements needed to processes for establishing and monitoring tax receivables and payables.

The Department of Treasury (Treasury) and OFM, within the State Budget Office, should continue to enhance internal control to prevent, or detect and correct, misstatements and ensure the reasonableness and accuracy of tax accruals.

Our review of tax accruals for fiscal year 2017 disclosed:

- a. Treasury did not sufficiently evaluate and implement necessary revisions to the Governmental Accounting Standards Board* (GASB) 34 estimated receivable calculations, resulting in significant adjustments for the corporate income tax (CIT) estimated receivable from Treasury's preliminary GASB 34 report to Treasury's final GASB 34 report.

During the year-end closing process, Treasury provides information to OFM relating to tax receivable amounts on the accrual basis of accounting. The amounts are derived from complex calculations involving estimated percentages of taxpayer liability expected to be collected by the State at some point in future fiscal years. The estimated percentages are developed using historical tax return data and collection pattern assumptions, which Treasury typically compiles for five years prior to estimating a tax's receivable amount. Fiscal year 2017 was the first year that Treasury estimated a CIT GASB 34 receivable.

During our review of Treasury's preliminary fiscal year 2017 GASB 34 report, we identified inaccuracies in how Treasury accumulated CIT information. At our suggestion, Treasury reexamined its CIT estimation methodology and ultimately increased the CIT estimated receivable from \$163.7 million to \$486.1 million.

- b. Treasury had not developed a process to compare and evaluate significant accounting estimates with subsequent activity for tax accrual payable components, in accordance with sound business practice. The estimates for the business taxes and individual income tax (IIT) payable backlogs of the year-end tax accruals are not compared with subsequent activity to assess the reliability of the process used to develop the estimates.

In its approval of accrual methodologies, OFM instructs State departments that it is important to evaluate the reliability of the estimated accruals in the subsequent year and adjust the estimation methodology accordingly.

We first commented on this issue during the fiscal year 2013 *SOMCAFR* audit. OFM and Treasury agreed with our prior audit recommendation, and Treasury began

* See glossary at end of report for definition.

evaluating assessed taxes receivable and receivables to be assessed estimates with subsequent activity during fiscal year 2017. Treasury informed us that it intends to begin evaluating the payable backlogs in fiscal year 2018.

- c. Treasury did not ensure that liabilities relating to the sales, use, and withholding (SUW) tax and CIT were properly recorded. As a result, payables were understated and revenues and fund balance were overstated by \$2.6 million in the General Fund and \$2.4 million in the School Aid Fund. Also, payables were understated and revenues and net position were overstated by \$5.0 million in the governmental activities of the government-wide financial statements. Treasury recorded correcting entries prior to the *SOMCAFR*'s issuance.

We noted:

- (1) Treasury improperly excluded four CIT returns processed and approved in late November from the year-end liability. Treasury stated that a breakdown in SAP system approval controls caused this error.
 - (2) Treasury improperly excluded one unprocessed SUW return from the year-end liability. The return's refund amount was in review status at Treasury's November 30 evaluation; however, subsequent to this evaluation and prior to the *SOMCAFR* opinion date, Treasury was able to determine the appropriate refund amount. Treasury's established methodology does not require reevaluating the recorded liability if the refund amount changes as the return is processed prior to the *SOMCAFR* opinion date.
- d. Treasury did not ensure that October and November estimated IIT collections were properly recorded in fiscal year 2017. As a result, assets, revenues, and fund balance/net position were overstated by a known amount of \$572,117 and a projected amount of \$3.6 million in the General Fund and governmental activities of the government-wide financial statements.

Treasury records a receivable at fiscal year-end for IIT collections received in October and November related to tax periods ending prior to October 1. Treasury assumes that all October and November IIT collections relate to tax periods ending prior to October 1; however, several IIT tax filers remit their calendar year fourth quarter estimated payments early, which also includes their September tax liability. When determining the amount of October and November collections to accrue for these filers, Treasury accrued the entire amount collected rather than only an estimated amount

for September. Treasury recorded a correcting entry for the known error prior to the SOMCAFR's issuance.

RECOMMENDATION

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

**AGENCY
PRELIMINARY
RESPONSE**

OFM provided us with the following response:

Treasury and OFM agree that internal control related to tax accruals should be enhanced. Treasury is in the process of continuing to improve the accuracy of the GASB report, advancing the current evaluation of accounting estimates with subsequent activity to include payables, improving the completeness of SUW and CIT liabilities recorded, and improving the process of ensuring that IIT receivables are properly recorded.

FINDING #4

**Improvements
needed to Treasury's
controls to ensure
accurate and
complete balances in
the offset fund.**

Treasury should improve internal control over the offset fund to ensure that balances are accurate and complete. Treasury records payments from vendors and income tax refunds in the offset fund until the payments are released based on a court judgment. However, reconciliations are not performed to ensure that the balance of the offset fund is accurate and complete.

Section 18.1485 of the *Michigan Compiled Laws* requires departments to establish and maintain recordkeeping procedures to control liabilities and develop internal control techniques that are effective and efficient.

In our follow-up of prior year offset fund balances, we noted that the Treasury offset fund had an ending balance (\$8.4 million) that approximated the prior year ending balance. Treasury informed us that it does not perform a reconciliation of the offset fund and could not confirm the accuracy or completeness of the offset fund balance. The total fiscal year activity in the offset fund (funds received and disbursed) approximated \$252.0 million.

RECOMMENDATION

We recommend that Treasury improve internal control over the offset fund to ensure that balances are accurate and complete.

AGENCY PRELIMINARY RESPONSE

OFM provided us with the following response:

Treasury and OFM agree that internal controls for the offset fund should be improved. Treasury plans to implement a comprehensive reconciliation process of the offset fund to ensure the balance is accurate and complete.

FINDING #5

Improvements needed to MDOT financial accounting practices.

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 payments and liquidating prior year accounts payable estimates. Consequently, 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 or services received by September 30. Local agencies, MDOT project managers, and external consultants submit estimated accounts payable work sheets for compilation by MDOT staff at the end of the fiscal year. MDOT's practice is to apply payments made during the current fiscal year against the established payable until the balance is reduced to zero. The actual work date of service is not taken into consideration. If payments in the current fiscal year are less than the estimated payable, the remaining payable balance is written off.

MDOT wrote off an average of 21% (\$29.7 million) of the estimated payables established for fiscal years 2014 through 2016. The write-off percentage is most likely understated because of MDOT's practice of applying payments made during the current fiscal year against the estimated payable regardless of the work date of service.

We evaluated service dates and noted:

- a. MDOT overstated an estimated payable by \$15.1 million for fiscal year 2017 expenditures. We randomly sampled fiscal year 2017 payments applied to the fiscal year 2016 payable and noted a 45% error rate based on dates of service (e.g., payment for services rendered in fiscal year 2017 would constitute an error). The 45% error rate was used to estimate the payable overstatement for fiscal year 2017.
- b. MDOT understated an estimated payable by \$9.8 million for fiscal year 2018 expenditures with dates of service in fiscal year 2017 that did not have an associated fiscal year 2017 payable.

In the fiscal year 2016 *SOMCAFR* report on internal control, compliance, and other matters, we reported that MDOT and OFM agreed that comprehensive consideration of the dates of service might lead to accounts payable transactions that are more accurate. However, MDOT also indicated that it did not intend to implement the recommendation because it believed that the cost of the needed system changes would significantly outweigh the benefits derived from any resulting improvements in precision.

RECOMMENDATION

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

**AGENCY
PRELIMINARY
RESPONSE**

OFM provided us with the following response:

MDOT and OFM agree that comprehensive consideration of the dates of service when processing contractor payments might lead to accounts payable transactions that are more accurate. However, the service dates mentioned in the recommendation are not readily available to central office contractor payment staff and efficient access would require system changes. MDOT will review the methodology used to estimate and track contractor payables and determine if there are opportunities for improvements where the cost to implement the improvements do not significantly exceed the benefits derived.

FINDING #6

Improvements needed to DTMB financial accounting practices.

The Department of Technology, Management, and Budget (DTMB) did not have sufficient internal control in place to ensure the accuracy and completeness of accounting information recorded in the *SOMCAFR* related to intangible and capital assets. Our audit disclosed the following errors, which DTMB corrected prior to the *SOMCAFR*'s issuance:

- a. DTMB did not properly account for maintenance expenses for intangible assets. Section 1400.150 of the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification), published by GASB, requires IT system maintenance costs to be expensed as incurred. DTMB capitalized \$43.1 million in maintenance expenses that were primarily part of multiple-year maintenance contracts and reported these costs as "Buildings, equipment, and other depreciable assets." In addition, over the life of the contract, DTMB recorded \$18.6 million in accumulated depreciation related to these maintenance contracts, with \$7.6 million in depreciation expense recorded in fiscal year 2017. These maintenance contracts should have been classified as prepaid expenses and expensed each year as they were used.
- b. DTMB did not properly classify the \$6.9 million account receivable balance for a land contract as a current asset even though it was due within the next fiscal year. GASB Codification Section 1800.109 states that receivables from other governments, customers, and vendors should be classified as current assets if they are collectible within one year. DTMB informed us that the balance was initially classified as long-term because it was not due within 60 days of the end of the fiscal year.

RECOMMENDATION

We recommend that DTMB establish sufficient internal control to ensure the accuracy and completeness of accounting information recorded in the *SOMCAFR*.

AGENCY PRELIMINARY RESPONSE

OFM provided us with the following response:

- a. *DTMB and OFM agree that maintenance agreements should be classified as prepaid expenses. In fiscal year 2017, DTMB began recording new multi-year maintenance agreements as prepaid expenses. At the time of the fiscal year 2017 closing, DTMB had not yet made adjustments for previously recorded maintenance agreements. DTMB has updated procedures to ensure that maintenance agreements are properly recorded as prepaid expenses.*
- b. *DTMB and OFM agree that the account receivable should have been reclassified from long-term to short-term. DTMB Financial Services has updated its year end procedures by including a step for staff to reach out to program areas to obtain and verify data needed to properly record accounting entries.*

FISCAL YEAR 2016
REPORT ON INTERNAL CONTROL,
COMPLIANCE, AND OTHER MATTERS
FOLLOW-UP

Below is the status of the reported findings from the 2016 *SOMCAFR* report on internal control, compliance, and other matters:

Prior Audit Finding Number	Topic Area	Current Status	Current Finding Number
1	Prevention and Resolution of Duplicate Tax Refunds	Complied	Not applicable
2a	Tax Accruals - Sales Tax Cash Collections	Complied	Not applicable
2b	Tax Accruals - SUW Tax Data Anomalies	Rewritten*	3a
2c	Tax Accruals - Monitoring of Receivables and Payables	Repeated*	3b
3	OFM Capital Asset Reporting Process	Complied	Not applicable
4	MDOT Contractor Payments and Liquidation of Accounts Payable Estimates	Repeated	5

* See glossary at end of report for definition.

GLOSSARY OF ABBREVIATIONS AND TERMS

CATS	Corrective Action Tracking System.
CHIP	Children's Health Insurance Program.
CIT	corporate income tax.
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.
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.
IIT	individual income tax.
internal control	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
IT	information technology.
material misstatement	A misstatement in the 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 basic financial statements will not be prevented, or detected and corrected, on a timely basis.
MDHHS	Michigan Department of Health and Human Services.
MDOT	Michigan Department of Transportation.
OAG	Office of the Auditor General.
OFM	Office of Financial Management.
repeated	The same problem was noted in the current audit and the wording of the current recommendation remains essentially the same as the prior audit recommendation.
rewritten	The recurrence of similar conditions reported in a prior audit in combination with current conditions that warrant the prior audit recommendation to be revised for the circumstances.
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	<i>State of Michigan Comprehensive Annual Financial Report.</i>
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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