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STATE OF WISCONSIN
Legislative Audit Bureau

Janice Mueller
State Auditor

November 26, 2008

Mr. David Stella, Secretary
Department of Employee Trust Funds
801 West Badger Road
Madison, Wisconsin 53702

Dear Mr. Stella:

We have completed the financial audit of the State of Wisconsin Department of Employee Trust Funds (ETF) as of and for the year ended December 31, 2006. We have issued an unqualified auditor's report on the fair presentation of ETF's financial statements. The financial statements and related opinion are included in ETF's Comprehensive Annual Financial Report.

As required by *Government Auditing Standards,* we also are furnishing you with the auditor's report on internal control over financial reporting, compliance with laws and regulations, and other matters. We identified new and continuing concerns related to planning for a new accounting standard, oversight of the financial reporting process, cash reconciliations, and compliance with a federal tax law provision. We are pleased to note that ETF has adequately addressed past concerns with the use of clearing accounts and the administration of the Badger Rx Gold Program.

ETF's responses and corrective action plans to implement recommended improvements are included in the text so that readers may see your intended resolution of the matters discussed. In future audits, the Audit Bureau will determine the extent to which the concerns discussed in this letter have been resolved.

We appreciate the courtesy and cooperation extended to us by ETF staff during the audit.

Sincerely,

Janice Mueller

Janice Mueller
State Auditor

JM/DA/kc

Enclosures

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

We have audited the financial statements of the State of Wisconsin Department of Employee Trust Funds (ETF) as of and for the year ended December 31, 2006, and have issued our report thereon dated November 19, 2008. The financial statements and related auditor's opinion have been included in ETF's Comprehensive Annual Financial Report for 2006. 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

In planning and performing our audit, we considered ETF's internal control over financial reporting in order to determine 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 ETF's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ETF's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered material weaknesses. However, as discussed in the subsequent paragraph, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control deficiency* 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 misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles, such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider deficiencies pertaining to planning for a new accounting standard, oversight of the financial reporting process, and cash reconciliations, which are further discussed in the accompanying narrative, to be significant deficiencies in internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. Of the significant deficiencies described in the preceding paragraph, we consider the deficiencies pertaining to planning for a new accounting standard and oversight of the financial reporting process to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ETF's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, 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 an instance of noncompliance that is required to be reported under *Government Auditing Standards*. As further discussed in the accompanying narrative, we found a concern with ETF's compliance with a federal tax law provision.

ETF's written responses to findings identified are described in the accompanying narrative. We did not audit ETF's responses and, accordingly, express no opinion on them.

This independent auditor's report is intended for the information and use of ETF's management and governing boards, and the Wisconsin Legislature. This independent auditor's report, upon submission to the Joint Legislative Audit Committee, is a matter of public record and its distribution is not limited. However, because we do not express an opinion on the effectiveness of ETF's internal control over financial reporting or on compliance, this report is not intended to be used by anyone other than these specified parties.

LEGISLATIVE AUDIT BUREAU

November 19, 2008 by

Diann Allsen
Audit Director

Department of Employee Trust Funds

The Department of Employee Trust Funds (ETF) is responsible for administering the Wisconsin Retirement System (WRS) and several other programs that provide retirement, disability, health, and other benefits to participants who are current and retired employees of state and local government employers.

As part of our annual financial audits, we review and consider ETF's internal controls and compliance issues for the purpose of determining the audit work necessary to express an opinion on its financial statements. During our audit of ETF's 2006 financial statements, we noted new and continuing concerns related to planning for a new accounting standard, oversight of the financial reporting process, cash reconciliations, and compliance with a federal tax law provision.

We also note that ETF has adequately addressed past audit concerns with the use of clearing accounts and the administration of the Badger Rx Gold Program. ETF reviewed and eliminated balances in its clearing accounts and is taking steps to more closely monitor the clearing account balances. ETF also obtained a signed written agreement with the third-party administrator for the Badger Rx Gold Program.

Lack of Adequate Planning for a New Accounting Standard

During our audit of the State's fiscal year (FY) 2006-07 Comprehensive Annual Financial Report (CAFR), we reported on concerns that ETF did not adequately plan for the implementation of Government Accounting Standards Board (GASB) Statement 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, issued in April 2004, and it had not fully understood or considered the implications of the new standard on its programs. As we communicated in the December 14, 2007 management letter for the State's CAFR, ETF was late in submitting its financial information and several audit adjustments were necessary to make ETF's other postemployment benefits (OPEB) statements acceptable for the State's CAFR.

These concerns are also applicable to our audit of ETF's financial statements for calendar year 2006, which is the first year that Statement 43 was required to be implemented. As a result of its lack of planning and understanding of the new standard, ETF was late in completing its 2006 financial statements. We also identified additional audit adjustments that needed to be made to ETF's 2006 OPEB financial statements and notes. For example, we recommended adjustments to more accurately present the year's activity in the Statement of Changes for the Retiree Health Insurance Funds. Required information on contributions was also initially excluded from the OPEB note for the Retiree Life Insurance Funds.

ETF agreed with the concerns we communicated as part of the State's FY 2006-07 CAFR audit. It indicated that it would implement steps to resolve outstanding issues associated with implementing Statement 43 and improve its planning process for implementing future accounting standard changes. Given ETF's response and subsequent actions taken since December 2007, we will not repeat our recommendation for the 2006 audit. However, we will continue to monitor the adequacy of steps ETF takes in response to new accounting standards in the future.

Department Response and Corrective Action Plan: We appreciate your acknowledgement of ETF's response and efforts to improve the planning process for implementing future accounting standards. We continue to be committed to pursuing and providing the necessary personnel, resources, and training to appropriately implement current and future accounting standards and we will continue to work with the Audit Bureau to ensure that expectations and understandings of new accounting standards are clearly, timely, and professionally communicated.

Lack of Adequate Oversight of the Financial Reporting Process

In addition to the issues we identified in ETF's implementation of Statement 43, we identified several errors in the financial statements and notes that resulted because ETF does not have adequate procedures and does not provide sufficient attention and oversight to ensure the accuracy of its financial reporting process. Specifically, we found two instances where significant or material errors occurred because some of the prior year numbers in underlying calculations had not been updated:

- The estimate of the current and non-current liability allocation for the Income Continuation Insurance program is based upon the expense history for the current and previous two years. The 2006 analysis incorrectly continued to use 2003 through 2005 activity and required a $1.5 million correction between the current and non-current liability accounts.

- Similarly, five of the six amounts on one of the 2006 Core Fund earnings allocation lines had not been changed from 2005 and required a $4.5 million correction that affected several of ETF's programs.

We also identified several inconsistencies between the financial statements, notes, and required supplementary information that could have been avoided if ETF had completed simple reconciliations and comparisons. For instance, we noted the following:

- The schedule of employer contributions in the required supplementary information correctly reported $2.1 million in employer contributions for the Local Retiree Life Insurance Fund. However, the employer contributions were incorrectly reported as $1.6 million in the financial statements until we requested a correction.

- The actuarial reserve table in Note 1 of the February 28, 2008 version of the notes continued to present the amounts from the July 19, 2007 version of the financial statements although there had been changes to the statements subsequent to that date.

- The unpaid claims liability table in Note 8 presented information that was not consistent with the 2006 financial statements because the table was based on information presented in the State's FY 2006-07 CAFR and was not amended for additional adjustments for the calendar year statements.

Lastly, ETF did not include investment disclosures required under GASB Statement 40, *Deposit and Investment Risk Disclosures*, for the Retiree Life Insurance Funds. In the past, investments had not been reported for any aspect of the life insurance programs based on ETF's original belief that insurance risk for these programs had been transferred to a life insurance company. However, after analysis of the life insurance program under Statement 43, ETF accounted for life insurance benefits provided to retirees as OPEB plans and determined that investments and other assets being accumulated by the life insurance company for the retiree benefits should be reported on the financial statements for the Retiree Life Insurance Funds.

In implementing these changes for the State's FY 2006-07 CAFR, the State Controller's Office obtained and reported the investment disclosures required under Statement 40 for the Retiree Life Insurance Funds. Although ETF was aware of these changes to the State's CAFR, it failed to include the necessary investment risk disclosures in its 2006 notes.

☑ ***Recommendation***

We recommend that the Department of Employee Trust Funds take steps to improve the attention and oversight given to its financial reporting process, including reconciling key balances between the financial statements, notes, and required supplementary information, and increasing the overall level of care applied to completing this information.

Department Response and Corrective Action Plan: We agree with your recommendations and will improve the attention and oversight we give to our financial reporting process. In the short term, we will use existing staff resources in the Office of Internal Audit to provide additional quality assurance reviews to make sure that statistics and financial information are consistently presented across sections of ETF's CAFR. In addition, we are exploring the possibility of reallocating existing staff within the Office of Trust Finance and Data Analysis to assist with the development of financial statements and related schedules. Finally, ETF's 2009-2011 biennial budget request seeks additional staff positions for the department. Depending on the resources received, ETF will consider adding an additional accountant position.

Cash Reconciliations

ETF uses WiSMART, the State's official accounting system, to process financial transactions and Helmsman, a financial reporting software package, to create financial statements for its programs. Section 16.41, Wis. Stats., requires all agencies to keep their accounts and other financial records in the form as prescribed by the Department of Administration (DOA) under s. 16.40, Wis. Stats. As a state agency, ETF is responsible for ensuring its information on WiSMART is complete and accurate. An important step in ensuring the accuracy of the financial information on WiSMART is to reconcile it to ETF's internal financial records and systems. Further, regular reconciliations between the systems better ensure that information reported by ETF in its financial report is complete and accurate.

ETF is not able to fully reconcile its cash balances between the systems. While ETF has made some attempts to reconcile cash balances at a fund level, varying amounts of unreconciled differences exist at the end of each year. Further, it has made only limited attempts to reconcile cash balances on a program level, which is the level on which it reports and on which we opine on the financial statements in its annual financial report.

While, to date, we have accepted the cash balances reported by ETF in its financial reports as materially correct, larger unreconciled variances could affect our ability to issue unqualified auditor's opinions in the future. Further, as a state agency, ETF has a responsibility to ensure the accuracy of its information on the State's official accounting system and records. Consequently, we had recommended in our 2004 and 2005 audits that ETF take steps to reconcile the cash balances for each program.

In response to our past audit recommendations, ETF agreed that it would be desirable for the State's official accounting system to have the most accurate balances for ETF's programs, although it indicated it may not be possible to fully reconcile the systems given the amount of time that has passed since WiSMART was implemented. ETF contacted the State Controller's Office, which agreed to help work on the reconciliation of cash balances between the two systems.

☑ ***Recommendation***

We recommend the Department of Employee Trust Funds continue its efforts to reconcile the cash balances for each program and to take steps to correct any inaccuracies identified in the beginning cash balances on the State's official accounting system or Helmsman through the reconciliation process.

Department Response and Corrective Action Plan: We agree with your recommendation and share your concern regarding the variance between the correct cash balances and the balances on the State's central accounting system. We are in the process of reviewing various balance sheet and other clearing accounts and have completed the review of various clearing accounts. The staff assigned to continue this review will be reconciling the cash account balances in an effort to assist the State Controller's Office in correcting them where necessary. We have discussed the cash balances and our related assistance with the State Controller's Office.

Internal Revenue Code Compliance

ETF is required to ensure employer reported WRS earnings and contributions are in compliance with certain federal tax laws. Compliance is critical to ensuring the WRS remains a qualified benefit plan. The loss of qualified plan status could have immediate and significant tax consequences for all WRS participants as certain tax exempt benefits could become taxable for the year in which the plan is disqualified. During our audit, we found ETF had not ensured that all participants were within the correct historical annual compensation limits for the WRS.

The Internal Revenue Code limits the annual compensation on which WRS contributions can be based to be considered a qualified benefit plan (IRC 401(a)(17)). The limit applies to all WRS participants who began coverage on or after January 1, 1996, and is adjusted annually for cost of living increases. For 2006, the limit was $220,000.

The annual limit is applied to the compensation for the plan year on which benefits are based. The WRS does not expressly define its plan year. In Section 1.410(b)-9, Treasury Regulations state, "In the absence of a specifically designated plan year, the plan year is deemed to be the calendar year." Further, WRS contribution rates are effective on a calendar year basis for all participants. Therefore, one can reasonably conclude that the WRS plan year is the calendar year, which is the same conclusion reached by an ETF tax consultant in March 2006 and ETF's Chief Legal Counsel in an internal memorandum dated January 22, 2008.

The majority of employees participate in the WRS on a calendar year basis. However, K-12 teachers, professors, certain educational support personnel, and judges participate on a school year or fiscal year basis. ETF maintains employer reported compensation amounts for these participants on both a fiscal year and calendar year basis. Prior to 2006, ETF incorrectly evaluated the compensation limits for fiscal year employees based upon their fiscal year compensation. ETF correctly evaluated the compensation limits for all other employees based upon their calendar year compensation.

Upon receiving advice from its tax consultant in March 2006, ETF attempted to limit the compensation of all participants on a calendar year basis beginning in 2006. However, ETF's procedures were not designed to fully identify all participants with calendar year compensation in excess of the compensation limit. Participants with both fiscal year and calendar year compensation in excess of the limit correctly had their calendar year compensation adjusted because they were listed in a compensation exception report. However, the exception report did not fully identify participants who had fiscal year compensation in compliance with the limit, but calendar year compensation in excess of it. As a result, the calendar year compensation for those participants was not adjusted to comply with the limit.

Furthermore, ETF did not take steps to identify and correct employer reported compensation that was improperly evaluated on the fiscal year basis from 1996 to 2005. In response to our request, ETF staff generated a report identifying all participant accounts with a WRS coverage begin date on or after January 1, 1996, and calendar year compensation exceeding the IRC 401(a)(17) limits. The report identified 23 accounts from 1998 through 2006 with calendar year compensation in excess of the limit for one or more plan years. The total compensation in excess of the annual limits for these accounts was $469,402. The total contributions and interest applied and accrued to these accounts based on the excess compensation was $63,521. During our fieldwork, we requested that ETF make the necessary adjustments to these accounts.

☑ ***Recommendation***

We recommend the Department of Employee Trust Funds take steps to ensure that:

- *all participants in excess of annual Internal Revenue Code limits are identified; and*
- *corrective action is taken to address both future and past noncompliance when exceptions are noted.*

Department Response and Corrective Action Plan: We agree that steps need to be taken to ensure that ETF remains compliant with federal tax laws, and so that the WRS remains a qualified benefit plan. We have made the necessary adjustments to the accounts with calendar year compensation in excess of the limit.

We have completed a review of the computer program used to identify earnings in excess of the annual compensation limit. ETF determined that the program is accurately identifying accounts where the calendar year earnings are in excess. However, ETF did discover that any prior year adjustments made to accounts, such as late reported earnings, may create excess earnings and those accounts were not being identified. Generally, the late reported earning situations occur from the settlement of collective bargaining agreements, following protracted bargaining periods.

ETF has completed file reads to identify the accounts that exceeded annual compensation limits, and all accounts have been corrected. To make sure accounts are identified in the future ETF will complete monthly file reads and the necessary adjustments to ensure that accounts remain compliant with IRC 401(a)(17) in the future.

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