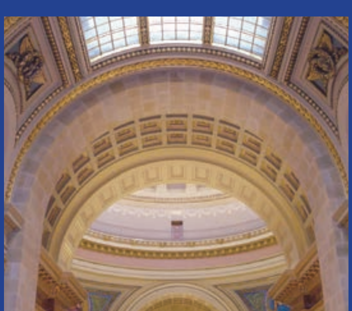
Report 16-1
January 2016

Department of Employee Trust Funds
Calendar Year 2014

State of Wisconsin


Legislative Audit Bureau

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OPINIONS PUBLISHED SEPARATELY

The financial statements and our opinions on them are found in the Department of Employee Trust Funds' *2014 Comprehensive Annual Financial Report*

STATE OF WISCONSIN
Legislative Audit Bureau

Celebrating 50 Years of Service 1966-2016

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Joe Chrisman
State Auditor

January 20, 2016

Senator Robert Cowles and
Representative Samantha Kerkman, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Cowles and Representative Kerkman:

We have completed an audit of the Department of Employee Trust Funds (ETF), as required by s. 13.94 (1) (dd), Wis. Stats., and as requested by ETF. ETF's financial statements present 14 separate funds used to account for the financial position and activity of the various benefit programs available to state and local public employees. These programs include the Wisconsin Retirement System (WRS) and health and life insurance programs for active and retired employees of the State and participating local governments. The statements, and our unmodified opinions on them, are included in ETF's *2014 Comprehensive Annual Financial Report*, which can be found on its website.

The largest program administered by ETF is the WRS. ETF implemented the provisions of new pension accounting standards for its 2014 WRS financial statements. In report 15-11, we reported on ETF's implementation of the new pension accounting standards, including the calculation of a net pension asset for the WRS of $2.5 billion. Under the new pension accounting standards, the WRS is 102.7 percent funded. The new pension accounting standards require each participating employer in the WRS to report its proportionate share of the net pension asset on its financial statements prepared on the basis of generally accepted accounting principles. We described this allocation process in greater detail in report 15-12.

ETF contracts with various actuarial firms to perform actuarial calculations for several benefit programs administered by ETF. Although the role of the actuary for each program varies due to the different program requirements, the duties generally include performing calculations to project future benefit payments, determining a liability for costs that have been incurred but not reported, and comparing these liabilities against projected assets that will be available. In addition, the actuaries may recommend changes to contribution rates intended to increase or decrease contribution revenues that would provide future assets to fund the projected liabilities.

Due to recommendations by the actuaries, contribution levels were changed during 2014 for the Long-Term Disability Insurance fund, which provides disability coverage to some WRS participants, and the Duty Disability Insurance fund, which pays special disability benefits to protective service participants in the WRS. For the Long-Term Disability Insurance fund, contributions that were last collected in 1998 were reinstated and totaled $42.3 million in 2014. For the Duty Disability Insurance fund, contribution rates were reduced in 2014 and revenue declined from $53.9 million in 2013 to $9.3 million in 2014, or by 83.0 percent.

Investment income is a significant source of revenue for many of the funds administered by ETF and is taken into consideration by the actuaries when assessing the program assets that may be available to meet future benefits. During 2014, declines in investment returns realized by the Core and Variable Retirement Investment Trust funds resulted in a decrease in investment income for the WRS and the other benefit programs invested in the Core and Variable funds. For example, investment income for the WRS declined from $11.3 billion in 2013 to $4.9 billion in 2014, or by 57.0 percent. Investment income of the Accumulated Sick Leave Conversion Credits fund declined from $280.4 million in 2013 to $125.4 million in 2014, or by 55.0 percent.

ETF also contracts with third-party administrators to manage several of the benefit programs. These third-party administrators perform administrative functions for the programs, such as determining participant eligibility, processing participant claims, and making benefit payments to participants. For instance, ETF has contracted with a third-party administrator to determine eligibility for and to pay benefits to participants in the Income Continuation Insurance fund. ETF regularly assesses the performance of third-party administrators and completes a procurement process to seek new administrators. ETF contracted with a new third-party administrator to begin managing the Employee Reimbursement Accounts and the Commuter Benefits programs beginning in calendar year 2015.

We reported a significant deficiency in internal control over financial reporting as a result of errors we identified during our audit of the 2013 financial statements and related notes. We continued to identify errors made by ETF in preparing the 2014 financial statements and related notes, and we again report a significant deficiency in internal control over financial reporting. We recommend ETF take steps to assess its current process for financial reporting and implement additional or changed processes that would prevent, or detect in a timely manner, errors in the financial statements and notes.

Respectfully submitted,

Joe Chrisman
State Auditor

JC/CS/ss

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Celebrating 50 Years of Service 1966-2016

Joe Chrisman
State Auditor

Report 16-1

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

Senator Robert Cowles and
Representative Samantha Kerkman, Co-Chairpersons
Joint Legislative Audit Committee

Members of the Employee Trust Funds Board and
Mr. Robert J. Conlin, Secretary
Department of Employee Trust Funds

We have audited the financial statements and related notes of each fiduciary fund and each proprietary fund administered by the State of Wisconsin Department of Employee Trust Funds as of and for the year ended December 31, 2014, and have issued our report thereon dated January 14, 2016. 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*, which is issued by the Comptroller General of the United States. The financial statements and related auditor's report have been included in the Department's *2014 Comprehensive Annual Financial Report*.

Internal Control over Financial Reporting

Management of the Department is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audit of the financial statements, we considered the Department's internal control to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department'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 misstatements, or to 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 Department's financial statements will not be prevented, or that a material misstatement will not be 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 have not been identified. Given these limitations, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we identified a deficiency in internal control, described below, that we consider to be a significant deficiency.

The Department has implemented procedures for preparing the financial statements, including oversight and review by management. However, as part of our audit of the financial statements for the funds administered by the Department, we identified several errors that required adjustment to the financial statements and notes, and that were not detected and corrected by the Department as part of the review process. For example:

- The Equity in Pooled Cash and Cash Equivalents account and the Core Investment Due Other Programs account for the Wisconsin Retirement System were overstated by $201.3 million due to errors in posting two adjusting journal entries. For example, one entry was posted incorrectly, resulting in the Equity in Pooled Cash and Cash Equivalents account being increased by $52.4 million when it should have been decreased.

- Net Investment Income was understated by $25.9 million for the Wisconsin Retirement System on the Statement of Changes in Fiduciary Net Position due to numerous errors made in the calculations used to allocate earnings from the Core Retirement Investment Trust Fund (Core Fund). For instance, amounts were added to a certain calculation rather than being subtracted, amounts in the calculation were from the incorrect year, and all relevant items were not included in the amounts used in the calculations.

- Net Investment Income was overstated by $8.3 million for the Wisconsin Retirement System on the Statement of Changes in Fiduciary Net Position due to errors in the allocation of the change in the Market Recognition Account, which is the account that accumulates the difference between actual and expected earnings of the Core Fund. These errors resulted from the errors in allocating Core Fund earnings noted above.

- A $96.6 million loan between the Health Insurance fund and the State Retiree Health Insurance fund and Local Retiree Health Insurance fund was inappropriately classified as Cash Flows from Operating Activities, when it should have been reported as Cash Flows from Noncapital Financing Activities on the Statement of Cash Flows.

In addition, among the notes provided for our review, the Department did not include all notes required under the Governmental Accounting Standards Board (GASB) Statement Number 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*. For example, some required notes related to the discount rate used in the calculation of the total pension liability were not included. In addition, we identified errors in the statutory reserve balances note. For example, the balance initially reported for the employee accumulation reserve was understated by $926.6 million.

Further, we identified multiple errors in the printer-ready version of the financial statements that were not identified by management. These errors were corrected prior to publication.

After we brought these concerns to its attention, the Department corrected the financial statements and notes for all identified errors. We recommend the Department take steps to assess its current process for financial reporting and implement additional or changed processes that would prevent, or detect in a timely manner, errors in the financial statements and notes.

> ***Department of Employee Trust Funds Response*:** The Department notes that this year's financial reporting process was especially challenging due to the implementation of a new accounting system, new GASB requirements, and an accelerated time frame for completion of the reports. The Department indicates it hired several new staff in the accounting area and implemented new procedures to improve the accuracy of its reports. The Department agrees with the recommendation and has taken steps to further assess its current processes for financial reporting. Based upon that assessment, the Department has put in place additional or revised processes that will prevent or detect, in a timely manner, errors in the financial statements and notes. The Department has obtained an outside consultant to work with staff to identify gaps in existing controls, and necessary process changes. Additional modifications will include:
>
> - enhancing the oversight of financial statement preparation by incorporating project management techniques throughout the process;
> - providing additional training for staff taking on new assignments in financial reporting; and
> - improving the documentation of financial reporting procedures.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free from material misstatement, we performed tests of 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Department of Employee Trust Funds' Response to the Finding

The Department's written response to the finding identified in our audit is described in the preceding paragraphs. The Department's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of This Report

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

LEGISLATIVE AUDIT BUREAU

Joe Chrisman
State Auditor

January 14, 2016