State of Wisconsin
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

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Correspondence Memorandum

Date: March 13, 2015

To: Audit Committee

From: Robert C. Willett, CPA
Chief Trust Finance Officer

Subject: 2013 Financial Statement Audit

This memo is for informational purposes only. No Committee action is required.

In December 2014, the Legislative Audit Bureau (LAB) issued an unqualified opinion on the Employee Trust Fund's financial statements for the year ended December 31, 2013, and the statements were published in the ETF Comprehensive Annual Financial Report. The delay of almost a year before publication of statements is longer than usual and is the result of the department's implementation of the PeopleSoft financial management system during this period.

The department's benefit plans are reported in the financial statements in 14 separate funds.

Fiduciary Funds (used to report resources held by a government but belonging to individuals)

- Wisconsin Retirement System
- Duty Disability Insurance
- Accumulated Sick Leave Conversion Credits
- State Retiree Life Insurance
- Local Retiree Life Insurance
- Employee Reimbursement Accounts
- Commuter Benefits
- Milwaukee Retirement Systems

Agency Funds (a special type of Fiduciary Fund used to account for resources held in a purely custodial capacity)

- State Retiree Health Insurance
- Local Retiree Health Insurance

Reviewed and approved by Robert J. Conlin, Secretary

Electronically signed 3/18/15

Board	Mtg Date	Item #
AUD	4.2.15	4

Proprietary Funds (used to report on “business type” activities financed primarily by revenues generated by the activities themselves)

- Long Term Disability Insurance
- Health Insurance
- Income Continuation Insurance
- Life Insurance

With reserves approaching $90 billion, the WRS is by far the largest of benefit plans. The WRS is funded at over 99.9 percent of liabilities, with an unfunded actuarial accrued liability of only $54 million. If the new accounting standards (which will be used for 2014 financial reporting) were in effect in 2013, the plan would be funded at over 108%.

Among the other fiduciary funds, the retiree life insurance programs are each funded at approximately 71% of liabilities. The funding ratio dropped significantly in 2013 when the investment return assumption was reduced in recognition of the low interest rates available on the predominantly fixed income portfolio. Premiums have been adjusted to begin restoring the plans funding.

The only proprietary fund with a deficit is the Long Term Disability Insurance Program. This program has been on a premium holiday since 1999 to amortize a significant funding surplus. Premiums have been reinstated effective in 2014 and we expect the deficit to be eliminated over the next three years.

All other benefit plans are appropriately funded.

In the audit memo, the LAB identified a misstatement in the financial statements that was corrected prior to publication. This misstatement involved health insurance premiums for January 2014 coverage which were paid to insurers on the last day of 2013. Since the premiums were not due to the insurers until January 1, the payment was correctly reported as a prepayment rather than an expense. However, the prepayment was reported only in the active member health insurance statement rather than being allocated between active members, state retirees and local retirees. This omission resulted in a material misstatement of the state retiree and local retiree programs.

Enhanced internal controls have been applied to year-end adjustments and accruals to reduce the risk of similar errors in the future. These include additional levels of review of adjusting entries as well as trend reviews of individual elements of the financial statements.

I will be at your April 2 committee meeting to answer any questions related to the financial statement audit.

Attachments: A. LAB Report of Internal Control over Financial Statement
B. LAB Letter to ETF Board and Secretary Conlin dated December 17, 2014

STATE OF WISCONSIN
Legislative Audit Bureau

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Joe Chrisman
State Auditor

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, 2013, and have issued our report thereon dated December 16, 2014. 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 2013 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 opinions 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.

Department of Employee Trust Fund's Response to Findings

The Department's written response to the findings identified in our audit is described above. 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

December 16, 2014

STATE OF WISCONSIN
Legislative Audit Bureau

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Joe Chrisman
State Auditor

December 17, 2014

Members of the Employee Trust Funds Board, and
Mr. Robert J. Conlin, Secretary
Department of Employee Trust Funds
801 West Badger Road
Madison, Wisconsin 53707

Dear Members of the Employee Trust Funds Board and Mr. Conlin:

We have completed our audit of the financial statements, which include the related notes, of the programs presented in the financial statements of the Department of Employee Trust Funds as of and for the year ended December 31, 2013. These financial statements and related auditor's report are included in the Department's 2013 Comprehensive Annual Financial Report. We are required by professional auditing standards to ensure that certain matters related to the conduct of the audit are communicated to those charged with governance such as the Employee Trust Funds Board, which has responsibility for oversight of the financial reporting process. As part of the required communication, the rest of this document discusses our audit authority and responsibility, the audit results, and other required auditor communications. Although this document is a matter of public record, it is intended solely for the information and use of the Employee Trust Funds Board members and the Department's management.

Audit Authority, Responsibility, and Scope

As required by s. 13.94(1)(dd), Wis. Stats., and as requested by the Department, the Audit Bureau conducted a financial audit of the Department for calendar year 2013. We conducted the financial audit in accordance with generally accepted auditing standards issued by the American Institute of Certified Public Accountants and *Government Auditing Standards*, which is issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

As required by auditing standards, the Audit Bureau obtained an understanding of the Department and its environment, including its internal control, for the purpose of assessing the risks of material misstatement of the financial statements and establishing a basis for determining the nature, timing, and extent of further auditing procedures necessary for expressing an opinion on the financial statements. The Audit Bureau also tested the Department's compliance with provisions of applicable laws, regulations, and contracts determined to have a direct and material effect on the determination of financial statement amounts as part of obtaining reasonable assurance about whether the financial statements are free from material misstatement. However, consideration of the Department's internal control and its compliance is solely for the purpose of determining our audit procedures and not to provide any assurances.

Audit procedures are designed to provide reasonable assurance about whether the financial statements are free from material misstatement. However, the inherent limitations of an audit, together with the inherent limitations of internal control, result in an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with generally accepted auditing standards and *Government Auditing Standards.*

In performing this audit, we assessed the possibility that fraud may have occurred; noncompliance with the provisions of laws, regulations, and contracts may have occurred; or abuse may have occurred, and designed audit tests accordingly. However, it should be recognized that the audit provides no assurance that fraud or instances of noncompliance other than those having a material effect on the financial statements will be detected. Further, because the determination of abuse is subjective, the audit provides no assurances that abuse will be detected.

The Department retains responsibility for the preparation and fair presentation of the financial statements, related notes, and required supplementary information in accordance with accounting principles generally accepted in the United States of America; the preparation and fair presentation of other supplementary information contained in the report; the design, implementation, and maintenance of adequate internal control; and compliance with provisions of applicable laws, regulations, and contracts. At the conclusion of an audit, management will provide certain representations about the aforementioned responsibilities. Included with this letter is a copy of the written representations obtained from management during the audit. The Audit Bureau may advise the Department about appropriate accounting principles and their application. However, the selection and method of application are responsibilities solely of the Department.

The financial statements and related notes included in the Department's 2013 Comprehensive Annual Financial Report have been audited. As noted in the independent auditor's report on the financial statements, we express no opinion on the required supplementary information included on pages 81 through 88. In addition, we express no opinion on the supplementary information included in the Introduction and the sections entitled Statistics, Actuarial, Investments, and Contributions Paid and Employer Unfunded Liability Balances.

Audit Results

We have issued unmodified opinions on the financial statements for the programs presented in the Department's 2013 Comprehensive Annual Financial Report. We have also issued the Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is attached. In this report, we discuss a deficiency in internal control over financial reporting that is required to be reported under *Government Auditing Standards.*

Other Auditor Communications

The following areas of required communication are intended to assist you in further understanding the Department's financial statements and the audit process.

Significant Accounting Policies and Financial Statement Disclosures

The financial statements were prepared by the Department's management with the oversight of the Employee Trust Funds Board following accounting principles generally accepted in the United States of America. The significant accounting policies used in the preparation of the Department's financial statements are discussed in the related notes to the financial statements. Auditing standards require the auditor to communicate our views about the qualitative aspects of the entity's significant accounting policies and financial statement disclosures, including instances in which we consider a significant accounting practice used by management not to be the most appropriate to the particular circumstances of the entity. We noted no such significant matters that require disclosure.

Accounting Estimates

Accounting estimates are an integral part of the financial statements and required supplementary information and are based on management's current judgments. Estimated values reported in the financial statements and required supplementary information may differ from the values that would have been used had actual amounts been known. Auditing standards require the auditor to communicate the process used by management to formulate particularly sensitive accounting estimates, including fair value estimates, and the basis for our conclusion on the reasonableness of those estimates. The following are the more significant accounting estimates presented in the financial statements and required supplementary information.

- The actuarially accrued liabilities for the Wisconsin Retirement System (WRS), the Duty Disability Insurance, the Accumulated Sick Leave Conversion Credits, the State Retiree Life Insurance, the Local Retiree Life Insurance, the Long-Term Disability Insurance, the Health Insurance, and Income Continuation Insurance programs are estimated. As more fully discussed in Notes 5, 6, 8, and 9 to the financial statements, management's process to estimate these liabilities includes the hiring of qualified actuaries who estimate liabilities based on assumptions that include, but are not limited to, investment returns, salary projections, service periods, and mortality rates. We based our conclusion regarding the reasonableness of these estimates on, among other things, the qualifications and reputation of the actuary, the accuracy of information provided to the actuary, the consistency of information in the actuarial valuation with other available information, and the results of previous estimates. Additionally, we periodically hire independent actuaries to audit the estimates for the WRS and assumptions developed by management's actuaries.

- The value of investments held in the Core, Variable, and State Investment Funds are generally reported at fair value based on various sources of pricing information, as more fully discussed in Note 3 to the financial statements. Depending on the type of investment, management has to make assumptions regarding the accuracy of the pricing information. The types of pricing information include, but are not limited to: quoted market prices on a publicly traded exchange; third-party pricing methods, such as independent appraisals; reports from asset managers and custodial banks; independent auditors' reports; a pricing matrix system that estimates discounted cash flows; and historical cost, if no other reliable information is available. We based our conclusion regarding the reasonableness of these estimates on, among other things, the quality and independence of the source of information, the qualifications and reputation of any specialists who provide pricing information, the effectiveness of controls in place at the State of Wisconsin Investment Board to obtain and review pricing information, the ability of management to override such controls, the effectiveness of controls in place at the external managers or custodial banks to generate and provide pricing information, general market conditions during and subsequent to our audit period, and the results of previous estimates.

Significant Difficulties

For purposes of this communication, auditing standards define a significant difficulty as a significant delay in management providing required information, an unnecessarily brief time within which to complete the audit, extensive unexpected effort required to obtain sufficient appropriate audit evidence, the unavailability of expected information, restrictions imposed on the auditors by management, or management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern. We are pleased to report that no such significant difficulties arose during our audit.

Audit Adjustments and Uncorrected Misstatements

For purposes of this communication, auditing standards define an audit adjustment as a correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. Our thresholds for reporting were developed in accordance with generally accepted auditing standards.

During the course of our work, we recommended several adjustments to the Department's financial statements, related notes, required supplementary information, and program highlights. The more significant adjustments resulting from our audit procedures that we discussed with the Department include:

- a $11.1 million overstatement of prepaid expense in the Statement of Net Position for the Health Insurance fund, and an understatement of prepaid expense of $9.8 million and $1.3 million in the Statement of Fiduciary Net Position for the State Retiree Health Insurance Fund and the Local Retiree Health Insurance Fund, respectively;

- a $97.9 million misclassification between the change reported for prepaid expenses and miscellaneous payables in the Reconciliation of Operating Income to Net Cash Provided by Operating Activities in the Cash Flow Statement for the Health Insurance Fund; and

- a misclassification of $5.8 million between additions and deductions for the Cash account in the Local Retiree Health Insurance Fund Statement of Changes.

After discussions with management, the financial statements and related notes were corrected.

Based upon the adjustments identified, specifically the adjustment related to the allocation of the prepaid expense, we reported an internal control concern in the internal control and compliance report. We recommend the Department improve the oversight of its financial reporting process. We will review the Department's continued efforts during our 2014 audit.

We did not identify any unadjusted errors in excess of our thresholds for reporting.

Disagreements with Management

For purposes of this communication, auditing standards define a disagreement with management as a matter concerning financial accounting, reporting, or auditing that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during our audit.

Significant Issues Discussed or Subject to Correspondence with Management

Auditing standards require the auditor to communicate with those charged with governance any significant issues that were discussed or were the subject of correspondence with management.

In addition to the audit adjustments, we had a significant amount of discussion related to plans for the implementation of GASB Statement Number 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25,* and GASB Statement Number 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*. GASB Statement Number 67, which will make significant changes in the accounting and reporting for the WRS, is effective for the calendar year (CY) 2014 financial statements. GASB Statement Number 68, which will make significant changes to the accounting and reporting for both state and local governmental employers participating in the WRS, is effective for fiscal periods ending in 2015.

The new standards require WRS participating employers to report their share of the net pension liability or asset and other amounts in their individual employer financial statements. The Department will calculate the net pension liability or asset and provide information through employer schedules for each participating employer to calculate its proportionate share of the liability and related amounts. Audit standards require the Audit Bureau, as the plan's auditor for the WRS, to provide an opinion on these employer schedules so that employers and their auditors can rely on the information being reported by the Department.

We had significant discussions with management regarding the timeline for preparation of the CY 2014 financial statements and required employer schedules, determination of the pension liability valuation date, implications of audit guidance on assessing materiality for the employer schedules, and requirements for plan auditor testing of the underlying census data used by the actuary to calculate the total pension liability.

In order for the Department to meet the needs of employers, Department management will need to prioritize timely preparation of the 2014 WRS financial statements and the required employer schedules. Department management has actively worked with the Audit Bureau staff over the summer and fall of 2014 as it plans for the implementation of these new standards. Continued cooperative discussions will be essential to meeting the required timelines.

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

Sincerely,

Carolyn Stittleburg

Carolyn Stittleburg
Financial Audit Director

CS/LK/lw

Enclosures

cc: Mr. John A. Voelker, Deputy Secretary
Department of Employee Trust Funds

Mr. Robert Willett, Controller
Chief Trust Finance Officer
Office of Budget and Trust Finance
Department of Employee Trust Funds