Report 17-7
April 2017

Department of Employee Trust Funds
Calendar Year 2015

STATE OF WISCONSIN



Legislative Audit Bureau

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From the Department of Employee Trust Funds

OPINIONS PUBLISHED SEPARATELY

The financial statements and our opinions on them are found in the Department of Employee Trust Funds' *2015 Comprehensive Annual Financial Report*

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Joe Chrisman
State Auditor

April 19, 2017

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 13 separate funds used to account for the financial position and activity of the various benefit programs available to state and local government 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 *2015 Comprehensive Annual Financial Report*, which can be found on its website.

The WRS is the largest program administered by ETF. In report 16-10, we reported that the WRS fiduciary net position, which represents resources available to pay pension benefits, decreased from $92.2 billion as of December 31, 2014, to $88.5 billion as of December 31, 2015, or by 4.0 percent. This decline is primarily attributable to the decline in net investment income from $4.9 billion in 2014 to a loss of $675.0 million in 2015, or a decline of 113.8 percent. This decline further resulted in the reporting of a net pension liability of $1.6 billion as of December 31, 2015. Each of the almost 1,500 participating employers in the WRS is required to report its proportionate share of this net pension liability on its financial statements if prepared on the basis of generally accepted accounting principles.

ETF contracts with third-party administrators to manage several of the benefit programs it administers. We found ETF does not use available service organization audit reports to assess the controls employed by these administrators. We recommend ETF require service organization audits of its third-party administrators and review and assess controls based on the reports. In addition, we report on the declining balance in the State Income Continuation Insurance (ICI) program, which is one of two programs that make up the ICI program. We recommend ETF closely monitor the financial status of the ICI program and work with the ICI program actuary in improving the fund balance for each program.

We report a significant deficiency in ETF's internal controls over financial reporting. In addition, we identified a significant deficiency in the Department of Administration's centralized cash reconciliations, which are relied upon by ETF. Both significant deficiencies are reported in the Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which begins on page 25. These significant deficiencies were also included in report 16-10, our audit report on the WRS financial statements.

We appreciate the courtesy and cooperation extended to us by staff of ETF during the audit. A response from ETF follows the appendices.

Respectfully submitted,

Joe Chrisman
State Auditor

JC/CS/ss

Introduction ▪

ETF manages employee benefit programs for participating state and local government employees.

The Department of Employee Trust Funds (ETF) was created to manage employee benefit programs for participating state and local government 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. ETF reports the financial activity of programs it administers in financial statements that are included in its separately issued Comprehensive Annual Financial Report (CAFR). The financial statements are prepared by ETF using generally accepted accounting principles (GAAP) prescribed by the Governmental Accounting Standards Board (GASB). Nine benefit programs are reported in ETF's CAFR:

- The WRS provides post-retirement financial benefits to participating employees, as well as disability and death benefits to participants and their beneficiaries. The WRS includes over 256,000 active members and 1,487 participating employers as of December 31, 2015, with a total membership, including inactive members and annuitants, of nearly 614,000.

- The Duty Disability Insurance program offers special disability benefits to the 22,035 active protective occupation members in the WRS, such as police officers, firefighters, and correctional officers, and provided benefits to approximately

1,000 disabled members or their beneficiaries, as of December 31, 2015.

- The Long-Term Disability Insurance (LTDI) program provides disability benefits to members of the WRS. Those who were members in the WRS prior to October 15, 1992, have the option to select disability benefits, at the time of disability, from the LTDI or a disability retirement benefit from the WRS. During 2015, approximately 2,300 members received benefits under the LTDI program.

- The Accumulated Sick Leave Conversion Credits program provides for the conversion of the value of unused sick leave at the time of retirement into an account to be used to pay for post-retirement health insurance for retired employees of the State, the University of Wisconsin (UW) Hospitals and Clinics Authority, and other state authorities. There were approximately 15,800 retired employees and others using these credits as of December 31, 2015.

- The Group Life Insurance program offers group life insurance coverage for active and retired employees of the State and 734 local governments participating as of December 31, 2015. The financial activity of this program is separated into three funds for financial reporting: Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance.

- The Employee Reimbursement Accounts (ERA) and Commuter Benefits program offers employees of the State pre-tax payroll deductions that are credited to an account for the reimbursement of qualifying medical costs, dependent care costs, and transportation expenses, such as bus passes, parking, and other transit costs. In 2015, approximately 14,500 employees used the medical account, 3,000 employees used the dependent care account, and 1,800 employers used the commuter benefit account.

- The Group Health Insurance program offers health insurance coverage, including pharmacy benefits, to active and retired employees of the State, the UW Hospitals and Clinics Authority, other state authorities, and 362 local governments participating as of December 31, 2015.

Approximately 82,000 active employees and 27,000 retired employees participated in the program as of December 31, 2015. The financial activity of this program is separated into three funds for financial reporting: Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance.

- The Income Continuation Insurance (ICI) program offers short-term and long-term disability benefits for employees of the State and 211 local governments participating as of December 31, 2015. During 2015, approximately 58,300 employees participated in this program, and benefits were provided to approximately 2,680 participants.

- The Milwaukee Retirement Systems program allows other retirement systems to have funds invested with the assets of the WRS. Currently, only the Milwaukee Public Schools Supplemental Retirement Program participates in this fund.

ETF Administration

The administration of the programs reported in ETF's CAFR is overseen by boards that are responsible for establishing policies and providing oversight of the programs. The programs are administered by multiple entities, including ETF staff, third-party administrators, actuaries, and the State of Wisconsin Investment Board (SWIB).

The ETF Board is responsible for the overall direction and supervision of ETF.

Under s. 40.03, Wis. Stats., the 13-member ETF Board is responsible for the overall direction and supervision of ETF. Statutes specifically identify that, among other items, the ETF Board is responsible for:

- appointing the Secretary of ETF;

- selecting and retaining an actuary to perform all necessary actuarial services for benefit programs administered by ETF; and

- approving the contribution rates and actuarial assumptions determined by the actuary.

The ETF Board members, as of December 31, 2016, are shown in Appendix 1, and include:

- the Governor, or the Governor's designee on the Group Insurance Board;

- the Administrator of the Division of Personnel Management in the Department of Administration (DOA), or designee;
- four members of the Teachers Retirement Board;
- four members of the Wisconsin Retirement Board;
- one member nominated by the Governor and appointed with the advice and consent of the Senate, as a public representative, who is not a member of the WRS but has at least five years of actuarial, insurance, or employee benefits plan experience;
- one annuitant elected by retired WRS participants; and
- one active WRS participant who must be either a technical college or school district educational support personnel employee, elected by participating employees who meet the same employment criteria.

Although the ETF Board is the overall governing body for ETF, the 13-member Teachers Retirement Board and the 9-member Wisconsin Retirement Board each serve in an advisory role on issues related to the WRS. The members of the Teachers Retirement Board and the Wisconsin Retirement Board represent state and local government employers, employees, annuitants, and the general public.

The Group Insurance Board oversees administration of the group health, group life, and income continuation insurance programs.

In addition to the ETF Board, the 11-member Group Insurance Board is responsible for setting policies and overseeing administration of the group health insurance, group life insurance, and income continuation insurance programs. The Group Insurance Board members, as of December 31, 2016, are shown in Appendix 2, and include:

- the Governor, or designee;
- the Administrator of the Division of Personnel Management in DOA, or designee;
- the Attorney General, or designee;
- the Secretary of DOA, or designee;
- the Commissioner of Insurance, or designee;
- a member appointed by the Governor;

- an insured participant in the WRS who is a teacher and is appointed by the Governor;
- an insured participant in the WRS who is not a teacher and is appointed by the Governor;
- an insured participant in the WRS who is a retired employee and is appointed by the Governor;
- an insured participant who is an employee of a local unit of government and is appointed by the Governor; and
- the chief executive or member of the governing body of a local unit of government that is a participating employer in the WRS and is appointed by the Governor.

Table 1 lists the programs that ETF administers and the board that has authority over the policies and administration of each program.

Table 1

ETF Board and Group Insurance Board Authority
As of December 31, 2015

Program	ETF Board	Group Insurance Board
Wisconsin Retirement System	✓	
Duty Disability Insurance	✓	
Long-Term Disability Insurance		✓[1]
Accumulated Sick Leave Conversion Credits	✓	
Group Life Insurance[2]		✓
Employee Reimbursement Accounts and Commuter Benefits	✓	
Group Health Insurance[3]		✓
Income Continuation Insurance		✓[1]
Milwaukee Retirement Systems	✓	

[1] At the February 8, 2017 Group Insurance Board meeting, the Group Insurance Board approved moving the authority of these programs to the ETF Board. Current statutes and administrative code must be modified to permit this change.

[2] Includes the Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance funds.

[3] Includes the Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance funds.

ETF contracts with third-party administrators to manage several of the benefit programs.

The Secretary of ETF is charged with implementing the policies approved by each of the boards, and with managing the daily operations of ETF. Each program administered by ETF has its own unique requirements related to eligibility, contributions, benefit payment determination, and reporting. As of July 1, 2016, ETF was authorized 267.20 full-time equivalent positions. In addition, ETF has contracted 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 pay benefits to participants in the Income Continuation Insurance program.

ETF contracts with actuaries to perform actuarial calculations for several benefit programs.

ETF also uses actuaries to perform actuarial calculations for several benefit programs it administers. 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 the projected assets that will be available. In addition, the actuaries may recommend changes to contribution rates intended to increase or decrease contribution revenues that provide future assets to fund projected liabilities.

Except group life insurance assets, which are held and invested by the third-party administrator, the assets of all of the programs are invested by SWIB in one or more of the following funds: Core Retirement Investment Trust Fund (Core Fund), Variable Retirement Investment Trust Fund (Variable Fund), or the State Investment Fund (SIF). The Core Fund is a fully diversified fund, or balanced fund, which provides less volatile investment returns and is invested for the long term in several types of investments. The Variable Fund is an equity fund, or stock fund, which provides returns that are typically more volatile than the Core Fund. The SIF invests the excess operating funds of the State and local governments with the objective of providing liquidity, safety of principal, and competitive rates of return. For more information about the investment performance and financial condition of the Core Fund and Variable Fund as of December 31, 2015, and the SIF as of June 30, 2016, please see reports 16-15 and 17-3, respectively.

As shown in Table 2, ETF contracts with a third-party administrator to manage five of the nine benefit programs and uses actuaries for seven of the programs.

Table 2

ETF's Use of Third-Party Administrators and Actuaries
As of December 31, 2015

Program	Third-Party Administrator	Actuary
Wisconsin Retirement System		✓
Duty Disability Insurance		✓
Long-Term Disability Insurance	✓	✓
Accumulated Sick Leave Conversion Credits		✓
Group Life Insurance[1]	✓	✓
Employee Reimbursement Accounts and Commuter Benefits	✓	
Group Health Insurance[2]	✓	✓
Income Continuation Insurance	✓	✓
Milwaukee Retirement Systems	n/a	n/a

[1] Includes the Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance funds.

[2] Includes the Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance funds.

Monitoring Third-Party Administrators

Due to the number of programs that are administered by third-party administrators and the significance of the role these administrators have in managing the programs, monitoring the activities of third-party administrators is critical for the proper administration of ETF's programs. ETF uses a variety of methods to perform this monitoring, including requiring performance reports and contracting for independent audits of the administrators. To provide assurance that the controls of a third-party administrator are effective, an independent audit of the entity's controls, completed under the American Institute of Certified Public Accountants' (AICPA) Statements on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization*, may be useful.

SSAE No. 16 provides a consistent framework for the completion of an audit of a service organization's controls. ETF's third-party administrators would be considered service organizations under these standards if they are responsible for initiating, processing, and recording transactions. These audits are intended to meet the needs of management of user entities, such as ETF, and user entities' auditors. One type of audit that may be completed under SSAE No. 16 includes an opinion on the fairness of management's description of the controls in place at a service organization, whether the auditor believes those controls are suitably designed to achieve the control objective, and whether the controls are effective at achieving the control objective.

ETF does not always include provisions in its third-party administrator contracts to require an audit of controls.

We found that ETF requires service organization audits through contract provisions for some, but not all, of its third-party administrators. For example, we found that the contract with the third-party administrator for the Employee Reimbursement Accounts and Commuter Benefits program did not include this requirement. This entity did not have a service organization audit completed for 2015 and, in order to provide assurance for our audit that the controls were in place and effective for our audit period, the third-party administrator chose to contract for a specialized audit focused specifically on the assurance we required for our audit of these programs.

When a service organization audit report is available, ETF does not consider the impact of the results of the audit on the program.

We also note that when a service organization audit report is available, ETF does not consider the impact of the results of the audit on the program. Because these reports provide an opinion on whether controls of the third-party administrator are operating effectively, ETF should use these reports as an additional tool in assessing whether third-party administrators have effective controls in place and whether any identified deficiencies should be further discussed and addressed with respect to ETF transactions being processed. In addition, these reports include a discussion of the controls that would be expected to be in place at ETF to complement the controls of the third-party administrator. ETF should use the service organization audit reports to assess whether these user controls are in place at ETF.

In early 2017, and subsequent to our audit period, ETF's Office of Internal Audit evaluated the audits of the third-party administrators. On March 31, 2017, the Office of Internal Audit made internal recommendations for it to take a lead role in overseeing these audits in the future.

☑ Recommendation

We recommend the Department of Employee Trust Funds:

- *obtain a service organization audit report from existing third-party administrators that would be considered a service organization under the American Institute of Certified Public Accountants' Statements on Standards for Attestation Engagements No. 16;*

- *review the service organization audit reports to assess the effectiveness of the controls and the impact of identified deficiencies on ETF programs;*

- *assess the user controls recommended in the service organization audit reports and, as appropriate, ensure complementary controls are present at ETF; and*

- *ensure future contracts with third-party administrators that would be considered a service organization include provisions related to the completion of an annual service organization audit.*

Audit Results

The financial statements included in ETF's separately issued CAFR include information related to the contributions, benefits paid, and investment income of each program. The contribution and benefit requirements differ between the programs and are established by statute, administrative code, and board decisions. In addition, various tax laws may impact the administration of a program and the amount of contributions that may be collected or the benefits that may be provided. As required by statutes, we have completed an audit of the financial statements and related notes of the 13 funds reported in ETF's CAFR as of and for the year ended December 31, 2015. To complete our audit of the financial statements, we reviewed ETF's internal controls over financial reporting, tested financial transactions, and reviewed the financial statements, notes, and required supplementary information that were prepared by ETF management.

We provided an unmodified opinion on the financial statements of programs administered by ETF for the year ended December 31, 2015.

In addition to providing an unmodified opinion on the financial statements and related notes as of and for the year ended December 31, 2015, we have issued our Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which begins on page 25. In that report, we describe a significant deficiency in internal control related to ETF's financial reporting process. Although we noted some improvement in ETF's process for preparing the financial statements, we again identified errors made by ETF, and we recommend ETF improve its processes. This significant deficiency was also included in report 16-10 on the WRS. We also describe a significant deficiency in DOA's cash reconciliations, which are relied upon by ETF. This significant deficiency was also included in report 17-4 on the State's fiscal year 2015-16 financial statements. Due to the pervasiveness of this deficiency and its effects on state agencies and programs, users of the financial statements should be informed of this weakness. No recommendations were made to ETF related to the concerns with the centralized controls at DOA.

The issuance of ETF's CAFR was later than anticipated due to delays in ETF's financial statement preparation process, which was affected by the State's implementation of a new enterprise resource planning system called STAR. A significant deficiency in DOA's centralized cash reconciliations caused additional delays.

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Administration
Revenues
Expenses
Net Position
Restricted for Benefits
Recommended Fund Balance
Actions Taken by ETF

Income Continuation Insurance Program ▪

The ICI program provides income replacement for eligible state and local government employees affected by disabilities.

Created in 1972, the Income Continuation Insurance program is an elective benefit program that provides income replacement for eligible State and local government employees who are unable to engage in substantial gainful activity for which they are reasonably qualified due to short-term disabilities, as well as certain disabilities that may last for extended periods. The ICI program is comprised of two programs: the State ICI program for participating state employees; and the Local ICI program, which serves local government employee participants. Although the overall ICI program ended 2015 with a surplus balance, the State ICI program ended 2015 with a deficit balance, as it has for several years. ETF contracted with an actuary to propose a redesign of its disability programs, including the ICI program. We recommend ETF closely monitor the financial status of the ICI program and work with the ICI program actuary in improving the fund balance for each program.

Administration

ETF, under direction of the ETF Secretary, is responsible for administering the ICI program with oversight by the Group Insurance Board. The Group Insurance Board contracts with a third-party administrator to perform some of the administrative requirements for the program, such as eligibility determinations and claims processing. In February 2017, the Group Insurance Board approved ETF's recommendation to transfer oversight responsibility for the ICI program to the ETF Board in order to place all disability programs under one board's authority. ETF must now seek statutory changes to accomplish this transfer of oversight.

For the State ICI program, any state employee who participates in the WRS may participate in the program. The Local ICI program is available to local government employees whose employers have elected to participate in the program and who have completed six months of service under the WRS. As of December 31, 2015, 211 local employers participated in the Local ICI program.

Revenues

The ICI program is funded through employer and employee premiums and investment earnings.

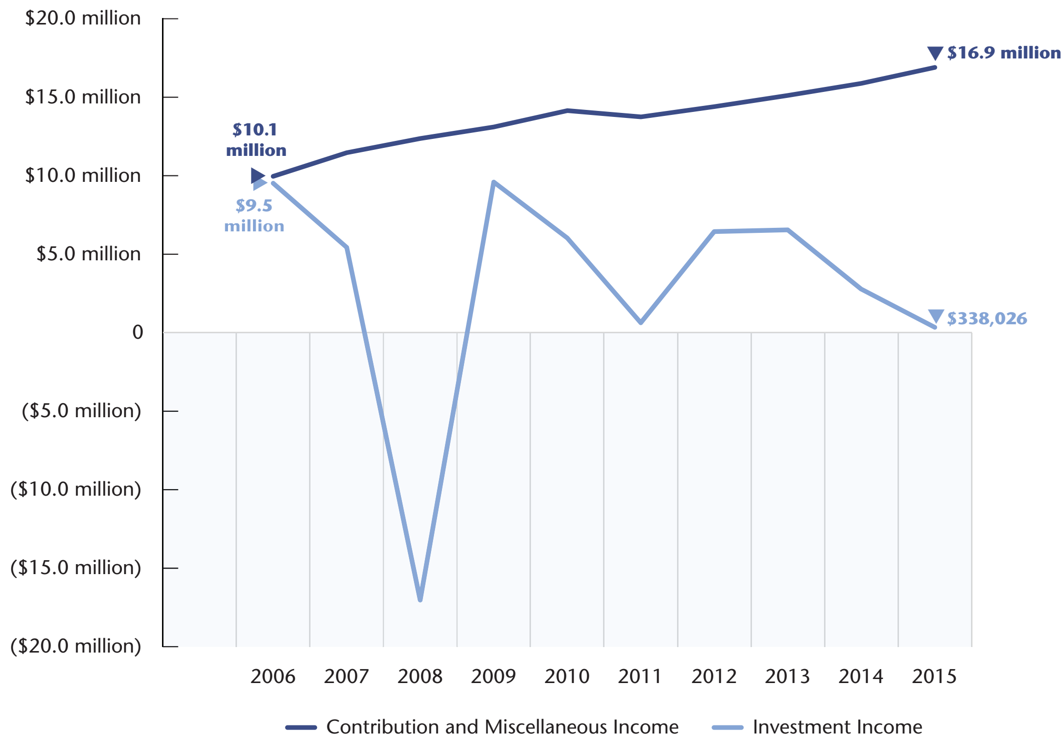
The ICI program is largely funded through premiums paid by state and local government employees and their employers as well as investment earnings. Assets of the ICI program are invested in the Core Fund, and investment earnings are allocated to the program on an annual basis. In 2015, total premium contributions were $16.8 million, and the program experienced a loss on investments of $596,000.

Although contribution revenue in the State ICI program steadily increased from 2006 to 2015, investment earnings fluctuated significantly during this time period.

As shown in Figure 1, contribution and other miscellaneous income for the State ICI program steadily increased from 2006 to 2015, with a high of $16.9 million. The increase in contribution revenue is a direct result of increases in premium rates approved by the Group Insurance Board. Investment income fluctuated significantly from 2006 to 2015, with significant declines in 2008, 2011, and 2015 as a result of downturns in the investment markets.

Figure 1

State ICI Program Revenues
(calendar year)

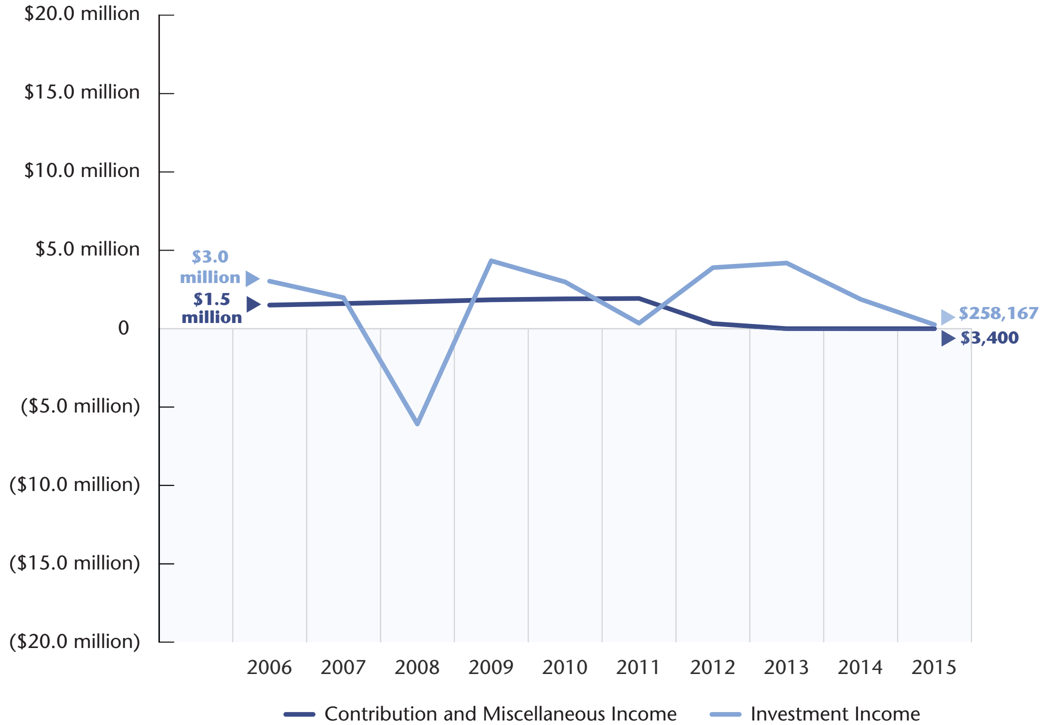


The Local ICI program has been on a premium holiday since 2012.

As shown in Figure 2, contribution and other miscellaneous income in the Local ICI program dropped from $1.5 million in 2006 to $3,400 in 2015. This decline is attributable to a premium holiday on contributions that has been in effect since 2012. Investment income fluctuated in a manner similar to the State ICI program with significant declines in 2008, 2011, and 2015.

Figure 2

Local ICI Program Revenues
(calendar year)



Expenses

ICI program expenses include benefit payments made in the current period, expenses for claims that have been incurred but not yet paid at calendar year end, and administrative expenses. Total expenses of the ICI program were $25.9 million in 2015.

Benefits were provided to approximately 2,500 State ICI program participants and 180 Local ICI program participants.

As shown in Table 3, expenses for both the State and Local ICI programs fluctuated from year to year. In 2015, benefits were provided to approximately 2,500 State ICI program participants and 180 Local ICI program participants.

Table 3

State and Local ICI Program Expenses[1]
(in millions)

Calendar Year	State ICI Program	Local ICI Program
2006	$21.3	$1.6
2007	14.5	0.5
2008	24.5	0.8
2009	12.7	0.7
2010	18.2	1.1
2011	32.7	1.9
2012	12.4	2.0
2013	28.8	0.9
2014	13.9	0.0
2015	24.3	1.6

[1] Includes benefit payments made in the current period, expenses for claims that have been incurred but not yet paid at calendar year end, and administrative expenses.

Net Position Restricted for Benefits

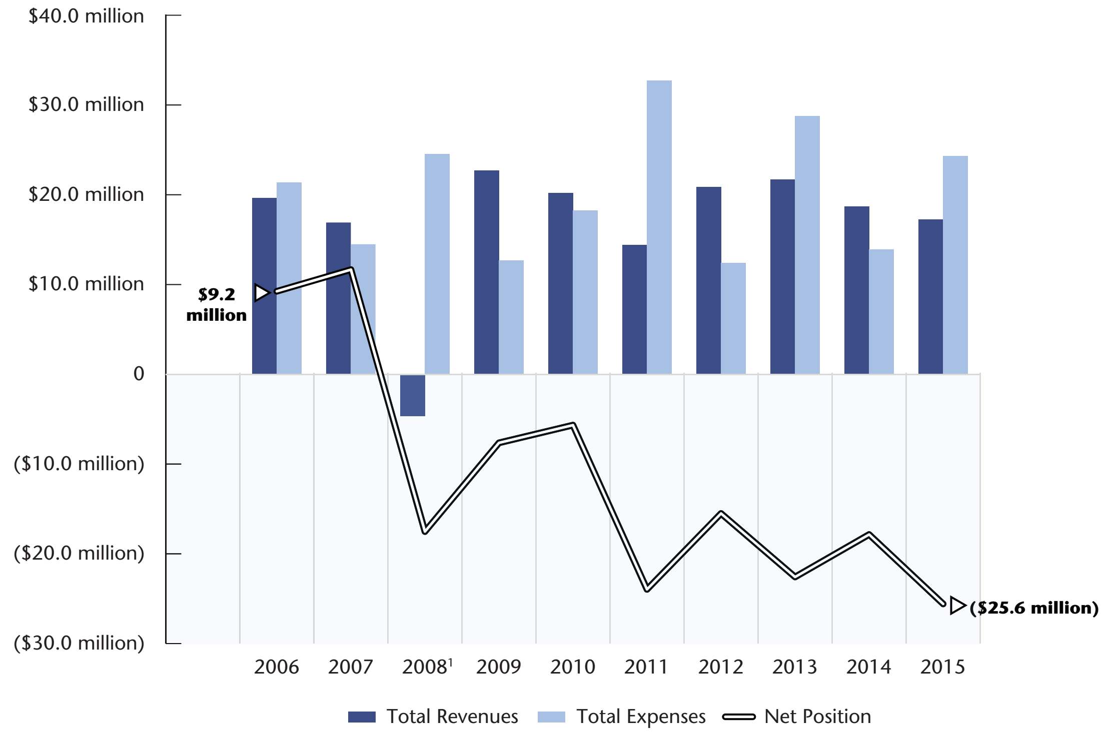
The Net Position Restricted for Benefits (net position) represents the excess of assets over liabilities and, therefore, the overall financial status of the program. When revenues exceed expenses, the net position increases. When expenses exceed revenues, the net position decreases. The net position reported for the overall ICI program was $5.1 million as of December 31, 2015. However, an evaluation of the net positions of the State ICI program and the Local ICI program raises some concerns with the financial status of each program.

The net position of the State ICI program declined from a positive $9.2 million as of December 31, 2006, to a negative $25.6 million as of December 31, 2015.

As shown in Figure 3, as a result of the changes in revenues and expenses from year to year, the net position of the State ICI program has declined from a positive $9.2 million as of December 31, 2006, to a negative $25.6 million as of December 31, 2015, or by 376.7 percent. Expenses significantly exceeded revenues in four of the ten years between 2006 and 2015, contributing to the decline in the net position for the State ICI program.

Figure 3

State ICI Net Position
As of December 31



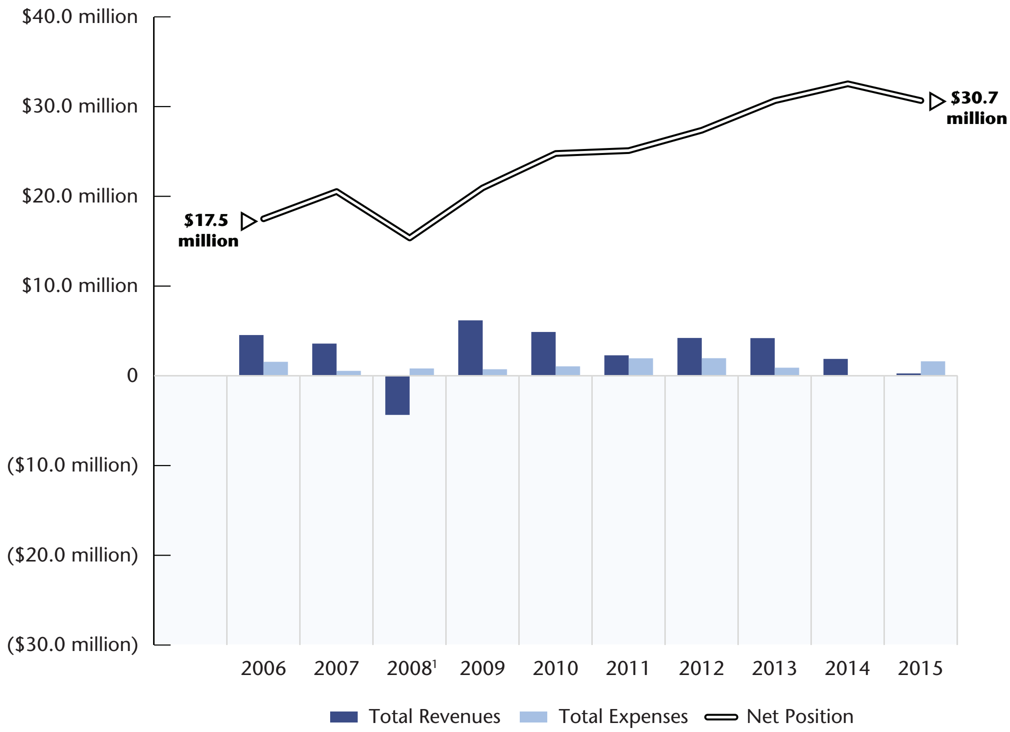
[1] Total revenue is negative due to the reporting of investment losses.

The net position of the Local ICI program increased from $17.5 million as of December 31, 2006, to $30.7 million as of December 31, 2015.

In comparison and as shown in Figure 4, the net position of the Local ICI program increased from $17.5 million as of December 31, 2006, to $30.7 million as of December 31, 2015, or by 75.3 percent. According to reports from the ICI actuary, the large net position of the Local ICI program can be traced back to at least 1996. Local ICI program expenses exceeded revenues in only two of the ten years between 2006 and 2015.

Figure 4

Local ICI Net Position
As of December 31



[1] Total revenue is negative due to the reporting of investment losses.

Recommended Fund Balance

To evaluate the financial status of the ICI program and to set premium rates, ICI actuaries compare assets to liabilities. To ensure there are sufficient assets in the program to pay benefits, ETF indicated that, based on past actuary recommendations, assets should equal or exceed liabilities by 15 to 25 percent for the State ICI program. For the Local ICI program, which has fewer participants and more volatility, ETF indicated that, based on past actuary recommendations, assets should equal or exceed liabilities by up to 100 percent for the Local ICI program.

The assets of the State ICI program were $44.6 million below the minimum recommended.

Liabilities of the State ICI program were $82.4 million as of December 31, 2015. The recommended assets would be between $94.8 million to $103.0 million. The actual assets of the State ICI program as of December 31, 2015, were $50.2 million, or $44.6 million below the minimum recommended. This is an indication that ETF may be at risk of not having adequate funds to pay State ICI benefits in the future.

In contrast, liabilities of the Local ICI program were $4.6 million as of December 31, 2015. The recommended assets would be $4.6 million to $9.3 million. The actual assets as of December 31, 2015, were $31.6 million, or $22.3 million above the maximum recommended.

Actions Taken by ETF

ETF has taken steps to address both the deficit in the State ICI program and the surplus in the Local ICI program. To address the deficit in the State ICI program, the Group Insurance Board approved premium increases for four of the nine years between 2007 and 2015. In addition, the ICI program actuary recommended, and the Group Insurance Board approved, premium increases of 20 percent for each year from 2016 to 2020. In contrast, the Local ICI program has been on a premium holiday since 2012 to address its surplus balance.

At its February 2017 meeting, the Group Insurance Board approved changes to redesign the ICI program.

Recognizing that premium increases have not been sufficient to address the deficit in the State ICI program and further premium increases could result in a continued decline in enrollment, ETF contracted with an actuary in October 2014 to propose a program redesign. At its February 2017 board meeting, the Group Insurance Board approved the changes recommended by the actuary, including:

- changing the premium structure of the State ICI program for non-UW state employees, which is currently based on prior-year salary and the employee's accumulated sick leave balance, to a structure based on prior-year salary and an elimination period, which is an employee-chosen length of time from 30 to 180 days after which the employee's ICI benefits will be paid;

- changing the premium structure of the State ICI program for UW employees, which is currently based on prior-year salary, an elimination period, and whether the employee has more than one year of State service, to a structure that does not consider length of State service;

- changing the benefit structure of the State ICI program for both non-UW and UW employees, which currently provides that benefits begin when an employee's accumulated sick leave balance is exhausted or after 30 days, whichever is longer, to beginning after the chosen elimination period;

- capping the maximum length of benefits at 18 months for both the State and Local ICI programs to address the recent growth in long-term claims;

- eliminating the $75 additional benefit that begins after one year of disability for both the State and Local ICI programs; and

- reducing the amount of the monthly benefit from 75 percent of prior-year earnings divided by 12 to 70 percent of prior-year earnings divided by 12 for both the State and Local ICI programs.

The actuary did not recommend changes to the premium structure of the Local ICI program that, prior to implementation of the premium holiday in 2012, was based on prior-year salary and an elimination period. Benefits for the Local ICI program will continue to begin after a chosen elimination period.

The actuary projects the proposed changes to the ICI program will eliminate the deficit in the State ICI program by 2022 or 2023.

If the Legislature approves ETF's proposed statutory change, ETF anticipates these changes will become effective on January 1, 2019, or January 1, 2020. Actuarial projections indicate that the deficit in the State ICI program would be eliminated by 2022 or 2023. In addition, it appears that the changes may also reduce expenses in the Local ICI program, and could further increase the surplus in the Local ICI program.

☑ Recommendation

We recommend the Department of Employee Trust Funds:

- *continue to closely monitor the financial status of both the State and Local Income Continuation Insurance programs;*

- *work with the Income Continuation Insurance program actuary to bring the actual fund balance closer to the fund balance recommended for each program; and*

- *report to the Joint Legislative Audit Committee by September 30, 2017, on the status of its fund balances and its efforts to redesign the Income Continuation Insurance program.*

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Auditor’s Report ■

STATE OF WISCONSIN | Legislative Audit Bureau
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Joe Chrisman
State Auditor

Report 17-7

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 the following fiduciary funds administered by the State of Wisconsin Department of Employee Trust Funds (ETF) as of and for the year ended December 31, 2015: the Wisconsin Retirement System (WRS), Duty Disability Insurance, Accumulated Sick Leave Conversion Credits, State Retiree Life Insurance, Local Retiree Life Insurance, Employee Reimbursement Accounts and Commuter Benefits, Milwaukee Retirement Systems, State Retiree Health Insurance, and Local Retiree Health Insurance. In addition, we have audited the following proprietary funds administered by ETF as of and for the year ended December 31, 2015: Long-Term Disability Insurance, Health Insurance, Income Continuation Insurance, and Life Insurance. We have issued our report thereon dated March 31, 2017. 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 ETF's *2015 Comprehensive Annual Financial Report.*

Internal Control over Financial Reporting

Management of ETF 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 ETF'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 ETF's internal control. Accordingly, we do not express an opinion on the effectiveness of ETF'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 ETF'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 were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we identified certain deficiencies in internal control that we consider to be a significant deficiency related to financial reporting. In addition, we identified a significant deficiency with controls over the reconciliation of cash at the Department of Administration (DOA), which we believe should be reported to the users of the financial statements.

Financial Reporting at the Department of Employee Trust Funds:

ETF is responsible for maintaining effective internal control to ensure the financial statements and related notes are fairly presented and that misstatements are prevented, or detected and corrected in a timely manner. ETF has implemented procedures for preparing the financial statements, including oversight and review by management.

In response to our findings from the calendar year (CY) 2014 audit (report 16-1), ETF hired an outside firm to review its financial reporting process. The firm made several recommendations in a report issued in spring 2016 detailing improvements ETF could make in its processes. Although efforts to implement these recommendations are ongoing, ETF indicated it has made some of the recommended improvements in 2016, such as providing additional training to staff, cross-training staff, developing a template to use in preparing spreadsheets, and developing a more formal communication process with the auditors.

During our CY 2015 audit, we noted some improvements to ETF's financial reporting process, particularly in the review process. However, we continued to identify errors that required adjustment to the financial statements and notes, which indicates that deficiencies continue to exist in the financial reporting process. For example:

- The Cash and Cash Equivalents account on the WRS's Statement of Fiduciary Net Position was understated by $90.9 million due to a receipt that was received by the bank as of December 31, 2015, but was not considered a cash receipt in the financial statements since it was not recorded in the accounting system until January 4, 2016. Although the recording of the receipt in the accounting system is the responsibility of DOA, ETF is responsible for ensuring accurate financial reporting. ETF staff reconciled contribution revenue and documented the mismatch in the date of the receipt of the contributions revenue and the date it was posted in the general ledger. However, this information was not used to adjust the recorded cash receipts in the financial statements. This error did not impact the reported fiduciary net position of the WRS.

- The employer reserve balance was reported at $19.3 billion in the notes to the financial statements, when the correct amount was $20.5 billion, resulting in an understatement of $1.2 billion in the notes.

- Net Investment Income of the WRS was understated by $6.5 million on the Statement of Changes in Fiduciary Net Position due to errors made in the calculations and entries that allocate earnings from the Core Retirement Investment Fund to the WRS, as well as other programs invested in the Core Fund. Although these errors were not material, our CY 2014 audit identified similar errors that were more significant.

After we brought these concerns to its attention, ETF corrected the financial statements and notes for all identified errors. In October 2015, the State implemented a new enterprise resource planning (ERP) system called STAR, which includes both an accounting and payroll system. The staff time devoted to resolution of various implementation issues with STAR placed additional demands on ETF staff, which increased the risk of financial reporting errors.

We recommend ETF:

- continue with efforts to improve its financial reporting process, including effective review of entries and balances;

- implement additional procedures, such as receiving additional information from the bank or DOA related to receipts at the end of the year to ensure they are properly reported; and

- assess the issues that arose during preparation of the CY 2015 financial statements and the implementation of STAR and determine what other changes should be made to improve the financial reporting process.

Department of Employee Trust Funds Response:

ETF agrees that it has made improvements to the financial reporting process. ETF believes the results of the audit support this statement as the errors cited are either immaterial to or did not affect the WRS fiduciary net position.

As noted, the $90.9 million adjustment did not impact the reported fiduciary net position. A check with DOA at year-end regarding bank deposits has already been incorporated into ETF's procedures and should mitigate the risk of this situation occurring in the future.

The adjustment related to the employer reserve balance was a disclosure note only and did not impact the financial statements. As noted, the implementation of the State's new ERP system proved to be challenging. This included the ability to generate reports. An error in a report layout was the cause of this issue. Staff have since corrected the layout and also incorporated a check against the actuarial report which will be performed each year going forward.

The correction of $6.5 million to net investment income is .007% or .7 basis points of the WRS Trust fund, and as noted is not a material finding. The allocation of earnings is a complex process and the use of spreadsheets has its risks. This past year, staff implemented controls to mitigate the risk of errors, including documentation of the process and spreadsheet, an automated way to pull in data to allow for updating of calculations when data changes, and better reviews of the calculations. ETF believes these are good controls but will continue to look for opportunities to further mitigate the risk of errors in this process.

With the recent hire of a Financial Reporting Director, staff will continue efforts to improve the financial reporting process. This will include an assessment of issues that arose during the preparation of the CY 2015 financial statements. This assessment will be completed prior to the beginning of the audit for the year ending December 31, 2016.

Cash Reconciliation at the Department of Administration:

DOA is responsible for performing certain centralized internal control functions related to cash. State agencies, including ETF, rely on these controls. As part of our separate audit of DOA, we identified a significant deficiency in the centralized controls related to cash. This weakness relates to the lack of complete and timely reconciliations of cash reported by the bank with cash balances reported in the State's central accounting system, STAR. This control is important to ensure cash balances are accurate and to ensure all receipts and disbursements have been properly recorded. Due to the pervasiveness of the deficiency and its effects on state agencies and programs, this deficiency is reported to the users of the financial statements. We communicated this weakness to DOA, which agreed with the finding. DOA's response was included in our separate report related to the State's *FY 2015-16 Comprehensive Annual Financial Report* (report 17-4). We did not request a response from the management of ETF since DOA is responsible for corrective action.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the 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 Findings

ETF's written response to the finding identified in our audit is described in the preceding paragraphs. ETF'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 ETF'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 ETF's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU

Joe Chrisman
State Auditor

March 31, 2017

Appendices

Appendix 1

Employee Trust Funds Board Membership

As of December 31, 2016

Name	Board Member Since
Wayne Koessl, Chair	1996
John David, Vice Chair	2008
Robert Niendorf, Secretary	1992
William Ford	2011
Michael Langyel	2009
Leilani Paul	2015
Roberta Rasmus	2012
Stacey Rolston	2015
Victor Shier	2013
Mary Von Ruden	2009
David Wiltgen	2011
Bob Ziegelbauer	2016
Vacant	

Appendix 2

Group Insurance Board Membership

As of December 31, 2016

Name	Board Member Since
Michael Farrell, Chair	2012
Bonnie Cygenek, Vice Chair	2012
Herschel Day, Secretary	2013
Terri Carlson	2013
Charles Grapentine	2012
Michael Heifetz	2015
Theodore Neitzke	2014
Stacey Rolston	2015
Nancy Thompson	2012
J.P. Wieske	2016
Bob Ziegelbauer	2016

Response ■

Response ■

WISCONSIN DEPARTMENT OF EMPLOYEE TRUST FUNDS

STATE OF WISCONSIN
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

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April 17, 2017

MR. JOE CHRISMAN, STATE AUDITOR
LEGISLATIVE AUDIT BUREAU
22 E. MIFFLIN ST., SUITE 500
MADISON, WI 53703

Dear Mr. Chrisman,

Thank you for the opportunity to review and comment on the 2015 financial audit of the Department of Employee Trust Funds (ETF). We appreciate the time and effort expended by the Legislative Audit Bureau in completing this audit as well as the additional areas you selected for review.

As described below, ETF agrees with your recommendations. I am pleased that your review confirms the appropriateness of actions ETF has already taken regarding monitoring of third-party administrators and the Income Continuation Insurance (ICI) Fund Balance.

Monitoring Third-Party Administrators

ETF agrees with the recommendations regarding the monitoring of third-party administrators (TPA). In early 2015, ETF identified the need for improvements in this area. Based on a risk analysis and discussions with ETF management, ETF's Office of Internal Audit (OIA) included a TPA consulting project in ETF's biennial internal audit plan for 2015-2017. This plan was presented to the ETF Board's Audit Committee on June 25, 2015. The consulting work was conducted from December 2016 to March 2017. On March 31, the OIA issued an internal memo outlining the process to be used for reviewing TPA service organization control (SOC) audit reports. Next steps include the following:

- The OIA will request and obtain the SOC audit reports from TPAs each year. To date ETF has received SOC audit reports for 2016 from most TPAs.
- The OIA, in conjunction with program staff, will review the reports as well as ensure the identified user controls are in place at ETF.
- A training session has been scheduled for April 19, 2017 to educate and train ETF's program managers on SOC audit reports and this process.
- ETF will include specific language requiring SOC audit reports in TPA contracts as existing contracts are renewed or as new ones are executed.

Income Continuation Insurance (ICI) Fund Balance

While ETF agrees with the recommendations regarding monitoring the ICI Fund Balance, we believe more must be done. ETF staff and its past and current consulting actuary have consistently monitored the financial status of the State and Local ICI programs. Starting in 2014 the ETF's governing boards responded to a deteriorating financial position of the State ICI program by taking additional steps. Those steps included:

- In 2014, a new actuary reviewed the past actuary's work and made changes to the assumptions used in actuarial valuations of the ICI program.
- As noted in the report, premium increases through 2020 have been approved by the Group Insurance Board to address the deficit in the State ICI program.
- In late 2014, ETF staff engaged with the ICI actuary to begin a redesign of the program structure in order to address the long term fund balance of the State ICI program rather than depend solely on premium increases. The redesign efforts focused on addressing declining enrollments, benefit levels that appear higher than industry norms, and simplifying the structure for program efficiency.
- In February 2017, the Group Insurance Board approved the program redesign, and recommended moving forward with legislative changes necessary to implement it. If approved by the Legislature, these changes would help to eliminate the deficit and improve the program's sustainability into the future.
- ETF will seek legislative support for the statutory changes in the coming months.

Consistent with the LAB's recommendations, we will report to the Joint Audit Committee on the status of the ICI program's financial condition and our continuing efforts to improve that condition by September 30, 2017.

Financial Reporting

We addressed the financial reporting recommendations in our response to LAB Audit Report 16-10 and in my testimony to the Joint Audit Committee in January of this year. We continue to make improvements to our internal controls and will report those improvements to the Committee in July, as directed.

Thank you again for the opportunity to comment on this report.

Sincerely,

Robert J. Conlin
Secretary