



STATE OF MISSISSIPPI
OFFICE OF THE STATE AUDITOR
STACEY E. PICKERING
AUDITOR

February 23, 2017

Financial Audit Management Report

Honorable Lynn Fitch, State Treasurer
Office of the State Treasurer
P. O. Box 138
Jackson, MS 39205

Dear Treasurer Fitch:

Enclosed for your review are the financial audit findings for the Office of the State Treasurer for the Fiscal Year 2016. In these findings, the Auditor's Office recommends the Office of the State Treasurer:

1. Recognize revenue in the period it is realized or realizable and make appropriate accrual entries during GAAP conversion; and
2. Strengthen controls over arbitrage calculations.

Please review the recommendations and submit a plan to implement them by March 9, 2017. The enclosed findings contain more information about our recommendations.

During future engagements, we may review the findings in this management report to ensure procedures have been initiated to address these findings.

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 Office of the State Treasurer's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Office of the State Treasurer's internal control and compliance. Accordingly, this communication is not suitable for any other purpose. However, this report is a matter of public record and its distribution is not limited.

I hope you find our recommendations enable the Office of the State Treasurer to carry out its mission more efficiently. I appreciate the cooperation and courtesy extended by the officials and employees of the Office of the State Treasurer throughout the audit. If you have any questions or need more information, please contact me.

Sincerely,

A handwritten signature in blue ink that reads "Stephanie C. Palmertree".

Stephanie C. Palmertree, CPA, CGMA
Director, Financial Audit and Compliance Division
Enclosures

FINANCIAL AUDIT MANAGEMENT REPORT

The Office of the State Auditor has completed its audit of selected accounts included on the financial statements of the Office of the State Treasurer for the year ended June 30, 2016. These financial statements will be consolidated into the State of Mississippi's *Comprehensive Annual Financial Report*. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The Office of the State Auditor's staff members participating in this engagement included Thomas Wirt, CPA, Elaina Jo Smith, CPA, Derrick Garner, CPA, Kari Horn, Rick Kinnard, Katherine Landrum, CPA, Emily Mathis, Dana McMorris, Lisa Meade, Jeremy Miller, CPA, Justin Reulet, and Clayton Southerland.

Our procedures and tests cannot and do not provide absolute assurance that all state legal requirements have been met. In accordance with Section 7-7-211, Miss. Code Ann. (1972), the Office of the State Auditor, when deemed necessary, may conduct additional procedures and tests of transactions for this or other fiscal years to ensure compliance with legal requirements.

Internal Control over Financial Reporting

In planning and performing our audit of selected accounts included on the financial statements, we considered the Office of the State Treasurer's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on these accounts, but not for the purpose of expressing an opinion on the effectiveness of internal control. Accordingly, we do not express an opinion on the effectiveness of the Office of the State Treasurer's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, we identified certain deficiencies in internal controls that we consider to be material weaknesses.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency identified in this letter as item 2016-004 to be a material weakness.

In addition, we noted certain control deficiencies involving internal control that require the attention of management. These matters are listed under the heading **OTHER CONTROL DEFICIENCIES** as item 16-01.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether selected accounts included on the financial statements of the Office of the State Treasurer are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Findings and Recommendations

Material Weakness

2016-004 Revenue Should be Recognized in the Period it is Realized or Realizable and Appropriate Accrual Entries Should be Made During GAAP Conversion

Repeat Finding No

Criteria Section 27.104.4, Miss. Code Ann. (1972) requires each state agency to prepare annual financial statements at such times as determined by the State Fiscal Officer.

Section 27.103.302, Miss. Code Ann. (1972) requires all settlement funds received in connection with the Deepwater Horizon oil spill to be deposited into the Budget Contingency Fund.

Generally Accepted Accounting Principles (GAAP) requires revenue to be recognized in the accounting period it is realized or realizable and should be considered "deferred revenue" until such time that it is considered earned.

Condition The State of Mississippi was awarded a settlement agreement against British Petroleum (BP) for economic damages from the Deepwater Horizon oil spill that occurred in 2010. The settlement agreement was signed by the judiciary and effective as of April 4, 2016. The total amount awarded to the State of MS amounted to \$750,000,000, of which \$150,000,000 was to be paid within 90 days. Per Section 27.103.302, Miss. Code Ann. (1972), revenue paid from this settlement is to be deposited in the Budget Contingency Fund which is the responsibility of the Office of the State Treasurer (OST).

Proper GAAP treatment of the settlement would require immediate recognition of the initial \$150,000,000 payment to be recognized as revenue and as a receivable as of the date of the Master Settlement Agreement (April 4, 2016) with the remaining \$600,000,000 to be recognized as Deferred Revenue in fiscal year 2016. Audit review of Settlement Litigation and Claims and GAAP packet review of the Budget Contingency Fund found that the initial payment was recognized as revenue in fiscal year 2017 when it was received and was not properly accrued. Additionally, the remaining settlement revenue was not properly deferred in fiscal year 2016. Failure to recognize this revenue in fiscal year 2016 resulted in a material misstatement that was corrected by auditor via adjusting entries.

Cause Unknown

Effect Failure to properly accrue revenue in the correct accounting period according to GAAP standards resulted in material misstatement that required adjustment.

Recommendation We recommend the Office of the State Treasurer strengthen procedures regarding settlement revenue and revenue recognition.

OTHER CONTROL DEFICIENCIES

OTH 16-01 Controls Should Be Strengthened over Arbitrage Calculations

Repeat Finding Yes; OTH 15-02

Criteria Per Internal Revenue Service (IRS) guidance on the instructions for form 8038-T (arbitrage rebates), issuers must pay arbitrage rebates in installments for computation dates that occur at least once every five years. Rebate payments are due within 60 days after each computation date. The final rebate payment for an issue is due within 60 days after the issue is discharged.

Condition During testwork performed over arbitrage calculations at the Office of the State Treasurer (OST), we noted OST did not prepare calculations for seven bond issues within the timeframe specified by the Internal Revenue Service (IRS). The agency did send information to a third party in order to prepare arbitrage calculations for the bond issues; however, all seven calculations were received late ranging from five to 139 days. It should be noted that the calculations revealed there were no arbitrage payments due to the IRS.

Cause Agency personnel did not request arbitrage calculations from the third party in a timely manner.

Effect Failure to ensure arbitrage calculations are prepared and rebates are paid within the timeframe specified by the Internal Revenue Service (IRS) could result in penalties and/or loss of tax exempt status for the bond issue.

Recommendation We recommend the Office of the State Treasurer strengthen controls to ensure all bonds are monitored for the timing of arbitrage calculations and rebate submissions, and that those calculations and rebate submissions occur timely, in accordance with Internal Revenue Service regulations.

End of Report



OFFICE OF THE STATE TREASURER
LYNN FITCH
TREASURER

FINANCIAL AUDIT FINDING

March 9, 2017

The Honorable Stacey E. Pickering, State Auditor
Office of the State Auditor
State of Mississippi
P. O. Box 956
Jackson, MS 39205-0956

Dear Mr. Pickering:

In accordance with your correspondence dated February 23, 2017, the Office of the State Treasurer (OST) is providing the following response for the financial audit finding for the fiscal year ending June 30, 2016.

AUDIT FINDING:

Audit Finding Heading:
Finding Number: 2016-004

Revenue Should be Recognized in the Period it is Realized or Realizable and Appropriate Accrual Entries Should be Made During GAAP Conversion

Response:

We do not concur with the audit finding.

Simply stated, accrual cannot occur where it is not known to exist.

The Office of the Attorney General of the State of Mississippi (AGO) has managed all legal negotiations for the State of Mississippi with British Petroleum (BP) for economic damages from the Deepwater Horizon oil spill that occurred in 2010. All settlement documents, correspondence, and discussions, including those detailing all payments to be received, have been and continue to be handled through the AGO. The settlement agreement was signed by the Governor and the Attorney General on September 14, 2015. This document was considered effective when the Consent Decree was entered by the Court on April 4, 2016. This agreement states that any notices are to be provided and addressed in writing to the AGO and specifically includes the banking information for the AGO account for the wiring of funds related to the settlement agreement.

OST received no official notice from the AGO or the Governor that the settlement had been signed in September 2015. Nor did we receive any official notice that the Consent Decree had been entered by the Court in April 2016. At no point, did OST receive any official notice from any State agency of any payment plan for the settlement or of any schedule of such payments. To the contrary, informal discussions between staff of the AGO and OST indicated that any money received by the State in 2016 would not be received until after the close of the fiscal year on June 30, 2016. This same understanding is reflected in the Budget Summary, 2016 Legislative Session as prepared by the Legislative Budget Office and published on June 10, 2016. On page 10 of this official State document, the \$150,000,000 BP Litigation Settlement funds are considered FY2017 revenue.

Pursuant to SB 2898, 2012 Regular Session, the proceeds from BP for economic damages from the Deepwater Horizon oil spill are to be "deposited into the Budget Contingency Fund," which is managed by OST. By the specific language of the settlement agreement, all funds are to be received by the AGO on behalf of the State. The AGO then must transfer the funds to OST for deposit into the Budget Contingency Fund, again, pursuant to SB 2898, 2012 Regular Session. The initial payment of \$150,000,000, based on the payment schedule detailed in the settlement agreement, was received at the AGO on July 1, 2016. That initial settlement payment of \$150,000,000 was received by OST via check from the Attorney General Contingent Fund on July 7, 2016.

The funds were recorded as revenue in the Budget Contingency Fund on July 7, 2016 by OST as FY2017 revenue. Our only knowledge was that (1) the funds had been and were always expected to be received in FY2017 by the AGO, (2) the funds had been received in FY2017 by OST, (3) the funds were immediately deposited into the Budget Contingency Fund in FY2017 pursuant to our statutory duty, and (4) the LBO officially considered these funds FY2017 revenue. In the normal course of action, settlement funds go directly to the General Fund and are recorded by DFA. The procedures for the BP settlement funds were unique.

With regard to the subsequent payments to be made by BP to the State of Mississippi in calendar years 2019 thru 2033, we recognize those payments as gain contingencies. Pursuant to the terms of the settlement agreement, the remaining payments are to be made to the State of Mississippi on the anniversaries of the effective date (April 4). However, even by the terms of this agreement, there are provisions that can materially alter the actual receipt dates, and even actual receipt, of such funds.

For example, under Section 5.3 of the settlement agreement, a default by BPXP may not even occur until sixty (60) days following April 4 and pursuant to the First Guaranty Section 1(a), under such circumstances, BP Corporation North America Inc. has another sixty (60) days from

default to make good on the default, changing the fiscal year in which revenues are received. Similarly, pursuant to Section 2.1 of the Second Guaranty, B.P. p.l.c. has an additional fifteen (15) days to make good on the default, stretching the payment date 135 days past April 4, which is August.

In addition, under Sections 5.6 and 8.6 of the settlement agreement, the Primary Guaranty and/or Secondary Guaranty may be modified or replaced with a letter of credit, trust agreement, or other financial assurance. Pursuant to Section 5.7, payment dates may be accelerated if there is a change of control or act of insolvency for B.P. p.l.c. Pursuant to Section 8.6, the State of Mississippi may modify the payment schedule. Moreover, pursuant to Section 11 of the Primary Guaranty and Section 10 of the Secondary Guaranty, payment terms may at any time be amended, as well.

As the preceding two paragraphs demonstrate, there are several provisions that can materially alter the actual receipt dates, and even actual receipt, of future funds under the settlement agreement. Given these uncertainties, we recognized these payments as gain contingencies. In GASB 62, paragraph 112, the Governmental Accounting Standards Board (GASB) cautions against the recognition of a gain contingency until the underlying uncertainty is settled. To do otherwise, might result in excessively early recognition of revenue, which violates the conservatism principle, that revenues are only recognized when they are *assured* of being received. As GASB 62 notes, early recognition of revenue could be misleading to those who rely upon our financial reports.

Corrective Action Plan:

No corrective action plan is deemed necessary by the Office of the State Treasurer. OST will request that the AGO alter the payment instructions in Attachment 2 of the settlement agreement, pursuant to Section 3.2 of that agreement, to provide that payments are wired directly to the OST.

Sincerely,



Lynn Fitch
State Treasurer



**STATE OF MISSISSIPPI
OFFICE OF THE STATE AUDITOR
STACEY E. PICKERING
AUDITOR**

Auditor's note to the Response from Management

TREASURY

MATERIAL WEAKNESS

Finding Number

Finding Heading

2016-004

Revenue Should be Recognized in the Period it is Realized or Realizable and Appropriate Accrual Entries Should be Made During GAAP Conversion.

Rebuttal to Agency Response:

We have reviewed the comments made by the agency in response to the above noted finding. While the Office of the State Treasurer (OST) provided many reasons and opinions while the revenue was not appropriately recognized and accrued, none of these excuses supplant generally accepted accounting principles (GAAP). Revenues are realizable when it is reasonable to expect that cash will be received in the future, and the income from the judicial settlement is both **known** and **reasonably expected** to be received.

OSA agrees with OST that no additional corrective action is necessary as the appropriate journal entries to accrue settlement revenue were approved by OST and have been correctly reported in the CAFR for fiscal year 2016.

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OFFICE OF THE STATE TREASURER
LYNN FITCH
TREASURER

OTHER AUDIT FINDING

March 9, 2017

The Honorable Stacey E. Pickering, State Auditor
Office of the State Auditor
State of Mississippi
P. O. Box 956
Jackson, MS 39205-0956

Dear Mr. Pickering:

In accordance with your correspondence dated February 23, 2017, the Office of the State Treasurer is providing the following response for the other audit finding for the fiscal year ending June 30, 2016.

AUDIT FINDING:

Audit Finding Heading:

Controls Should Be Strengthened over Arbitrage Calculations

Response:

We concur with this audit finding; however, we would like to emphasize that no arbitrage payments or interest penalties were due on any late filings.

The Office of the State Treasurer will strengthen controls to ensure all bonds are monitored for the timing of arbitrage calculations and rebate submissions, and that those calculations and rebate submissions occur timely, in accordance with the Internal Revenue Service regulations.

Contact Person:

Yolanda Campbell

Anticipated completion

Date for corrective action:

July 1, 2017

Corrective Action Plan:

The Office of the State Treasurer plans to ensure better efficiency, maintenance, and reporting for all bond issues requiring arbitrage rebate calculations by developing a centralized database of the reporting due dates.

Sincerely,

A handwritten signature in black ink, appearing to read "Lynn Fitch". The signature is fluid and cursive, with the first name "Lynn" and last name "Fitch" clearly distinguishable.

Lynn Fitch
State Treasurer