OLA **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Board of Investment

Financial Statement Audit

Year Ended June 30, 2010

June 16, 2011 **Report 11-16**

FINANCIAL AUDIT DIVISION
Centennial Building – Suite 140
658 Cedar Street – Saint Paul, MN 55155
Telephone: 651-296-4708 • Fax: 651-296-4712
E-mail: auditor@state.mn.us • Web site: http://www.auditor.leg.state.mn.us
Through Minnesota Relay: 1-800-627-3529 or 7-1-1

Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Board of Investment Board of Trustees

Mr. Howard J. Bicker, Executive Director
Minnesota State Board of Investment

In auditing the Minnesota State Board of Investment's basic financial statements for the year ended June 30, 2010, we considered internal controls over financial reporting. We also tested compliance with significant legal provisions impacting the basic financial statements. This report contains our findings and recommendations on internal control and compliance over financial reporting. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the State Board of Investment's internal controls or compliance. In addition, our work may not have identified all significant control deficiencies or instances of noncompliance with legal requirements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. This report meets the audit standard requirements of the American Institute of Certified Public Accountants and the Government Accountability Office to communicate internal control matters identified in a financial statement audit. The audit was conducted by Jim Riebe, CPA, (Audit Manager) and Carl Otto, CPA, (Audit Coordinator), and assisted by auditors Lat Anantaphong, CPA, Chau Nguyen, CPA, Tracia Polden, Kevin Schoenrock, Lindsay Tietze, CPA, Alex Weber, and Zach Yzermans, CPA.

We consider the deficiencies described in Findings 1 through 3 to be material weaknesses. A material weakness is a deficiency, or 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 discussed the results of the audit with the State Board of Investment on June 3, 2011. Management's response to our findings and recommendations is presented in the accompanying section of this report titled, *Agency Response.* We did not audit the response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the State Board of Investment's management and the Legislative Audit Commission and is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit the distribution of this report, which was released as a public document on June 16, 2011.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: March 4, 2011

Report Signed On: June 13, 2011

Table of Contents

Report Summary

Conclusion

The Minnesota State Board of Investment's (SBI) statement of net assets was fairly presented in all material respects. However, SBI had material weaknesses in its internal controls over financial reporting, including a prior audit finding that had not been resolved, as noted below. As a result, we limited the scope of our audit opinion to the statement of net assets and did not cover the statement of changes in net assets for fiscal year 2010.

Findings

- Prior Finding Not Resolved:[1] The State Board of Investment did not sufficiently identify, analyze, and document internal controls related to financial reporting and business operations. (Finding 1, page 3)

- The State Board of Investment had significant delays in preparing its financial statements for fiscal year 2010, and the financial statements required numerous material audit adjustments. (Finding 2, page 4)

- The State Board of Investment initially provided some inaccurate and inconsistent derivative information to the state's retirement systems for their financial statement footnote disclosures. (Finding 3, page 5)

Audit Scope

We audited SBI's balance sheet for the fiscal year ended June 30, 2010.

[1] Office of the Legislative Auditor's Financial Audit Division Report 10-13, *State Board of Investment*, issued April 6, 2010.

Findings and Recommendations

Finding 1

Prior Finding Not Resolved:[2] The State Board of Investment did not sufficiently identify, analyze, and document internal controls related to financial reporting and business operations.

SBI made only limited progress in fiscal year 2010 documenting key risks associated with financial reporting and business operations. We first reported this weakness related to our fiscal year 2008 audit of SBI's financial reporting process. SBI had not specifically identified controls to address the risks or monitoring activities to ensure the controls were effective, as required by the Department of Management and Budget's policy.[3] As a result of this material weakness, and other material weaknesses in SBI's controls reported in Findings 2 and 3, we limited the scope of our audit opinion for fiscal year 2010 to the *Statement of Net Assets* and did not provide an opinion on the *Statement of Changes in Net Assets*.

The Department of Management and Budget's policy states that each agency head has the responsibility to identify, analyze, and manage business risks that impact an entity's ability to maintain its financial strength and the overall quality of its products and government services. This policy requires communication of the internal control policies and procedures to all staff so they understand what is expected of them and the scope of their freedom to act. The policy also requires follow-up procedures that, at a minimum, should include mechanisms for monitoring results and reporting significant control deficiencies to individuals responsible for the process or activity involved, including executive management and those individuals in a position to take corrective action.

SBI was aware of certain risks, had some control activities in place, and performed selected internal control monitoring functions; however, it had not comprehensively identified and analyzed risks in its financial reporting process, designed its controls to address significant risks, or developed monitoring procedures to ensure controls are in place and are effective to reduce the significant risks identified. Training of employees is a key element of control. Also operational changes and turnover are two key risk examples that may affect financial reporting and business operations. Until SBI designs and implements a comprehensive risk assessment, it has an increased likelihood of additional financial reporting errors and control deficiencies.

---

[2] Office of the Legislative Auditor's Financial Audit Division Report 10-13, *State Board of Investment*, issued April 6, 2010.

[3] Department of Management and Budget Policy Number 0102-01.

Recommendation

- *The State Board of Investment should develop a comprehensive internal control structure that identifies and documents its financial reporting, business risks, and control procedures and establishes an effective monitoring function that ensures controls operate as designed.*

Finding 2

The State Board of Investment had significant delays in preparing its financial statements for fiscal year 2010, and the financial statements required numerous material audit adjustments.

SBI did not submit fiscal year 2010 financial statements to us for audit until January 14, 2011, over two months later than planned. According to SBI staff, the delays resulted from its implementation of a new accounting system. SBI also significantly changed the content and presentation of its financial statements this year.[4] As a result of the changes to the financial statements and the unique nature of SBI's investment responsibilities in contrast to typical governmental fund accounting and financial reporting principles, questions arose about which generally accepted accounting principles applied. For example, SBI did not identify the type of funds being presented, which is an important factor in determining required note disclosures. State statutes require SBI to prepare and file financial statements in accordance with generally accepted accounting principles by December 31 each year for funds managed by the board and to provide financial statements to participating public retirement plans and nonretirement funds.[5]

SBI submitted financial statements to us for audit that contained numerous errors, including the following:

- SBI understated interest, dividends, and other income by $2.9 billion and overstated unrealized gains by the same amount.
- SBI understated total retirement fund beginning net assets by about $608 million and misstated transfers by a corresponding amount.
- SBI overstated beginning net assets and understated unrealized gains by $30 million for the Assigned Risk Plan.

[4] In past years, SBI's financial statements had shown financial activity for the state's Post Retirement Investment Fund and the Supplemental Investment Funds. Because of legislative changes, the Post Retirement Investment Fund did not exist in fiscal year 2010.
[5] *Minnesota Statutes* 2010, 11A.07, subd. 4 (8) and 11A.14, subd. 14.

- SBI understated accounts receivable of $15 million in securities lending income due from its custodian bank[6] and understated nonsecurities lending investment income by the same amount.

- SBI understated investment expenses by $5.3 million, investment expense liabilities of $3 million, and investment income by $2.3 million, in part because expenses were netted from income, whereas generally accepted accounting principles require these amounts to be reported at gross.

- Prior Finding Partially Resolved:[7] SBI inaccurately disclosed a few foreign currency risks by misclassifying Canadian fixed income securities as Euro securities and overstating "other foreign fixed income securities" and "other foreign cash holdings" by several million dollars. We reported errors in foreign currency risk disclosures in our prior audit report.

Recommendations

- *SBI should strengthen its internal control procedures to prepare financial statements in a timely manner and to mitigate the risk of errors in the financial statements.*

- *SBI needs to determine the appropriate application of generally accepted accounting principles in the preparation of its financial statements.*

Finding 3

The State Board of Investment initially provided some inaccurate and inconsistent derivative information to the state's retirement systems for their financial statement footnote disclosures.

SBI did not initially provide the state's retirement systems with accurate fair values of synthetic guaranteed investment contracts[8] and the fair values of futures securities was inconsistent with how the Department of Management and Budget planned to report the information in the state's financial statements. SBI initially provided the following information to the retirement systems:

- SBI initially provided inaccurate fair values of its synthetic guaranteed investment contracts at $1.6 billion and the corresponding insurance wrap at $382 million for the Minnesota State Retirement System (MSRS). SBI

[6] A custodian bank is a specialized financial institution responsible for safeguarding financial assets and is not likely to engage in "traditional" commercial or consumer/retail banking.
[7] Office of the Legislative Auditor's Financial Audit Division Report 10-13, *State Board of Investment*, issued April 6, 2010.
[8] A synthetic guaranteed investment contract (SGIC) is an insurance contract that guarantees the owner principal repayment and a fixed or floating interest rate for a predetermined period of time. In a SGIC, the policyholder owns the assets underlying the contract.

should have valued the contract and wrap at $748 million and $38 million respectively. Although SBI later included the corrected information with other information in correspondence to MSRS, it did not clearly highlight the significance of the changes. As a result, MSRS overlooked the correction and did not adjust its preliminary financial statement disclosures until we proposed an audit adjustment.

- SBI provided fair values of futures to the retirement systems of negative $10.4 million as of June 30, 2010, while Department of Management and Budget planned to report the values of the same investments at zero in the state's financial statement disclosures. The inconsistent approach occurred for a variety of reasons, including lack of authoritative guidance about how to implement an extremely technical and complex new accounting principle on derivative disclosures.[9] After a meeting initiated by the auditors, SBI and the Department of Management and Budget agreed to consistently report the futures at zero after consulting with the state's custodian bank. Since SBI, the pension systems, and the Department of Management and Budget all operate within the state's financial reporting entity, it is important that the financial statement disclosures for each entity provide consistent information.

Government accounting principles require derivative disclosures be aggregated by type and presented at fair value as of the end of the reporting period. Uncorrected, the inaccuracies and inconsistencies in the derivative disclosures could have been misleading to users of the financial statements.

Recommendation

- *SBI should work with the state's custodian bank, retirement systems, and the Department of Management and Budget to ensure the accuracy and consistency of the derivative disclosures reported in the footnotes to the financial statements.*

[9] Government Accounting Standards Board Statement 53: *Accounting and Financial Reporting for Derivative Instruments,* paragraph 69.

MINNESOTA STATE BOARD OF INVESTMENT

60 Empire Drive
Suite 355
St. Paul, MN 55103
(651) 296-3328
FAX (651) 296-9572
E-mail:
minn.sbi@state.mn.us
www.sbi.state.mn.us

June 10, 2011

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles

Thank you for the opportunity to review and respond to your report on the results of the SBI financial audit. We take any audit finding very seriously, and have already made significant progress in corrective action, as noted below.

Finding 1 – Prior Finding Not Resolved: The State Board of Investment did not sufficiently identify, analyze, and document internal controls related to financial reporting and business operations.

We are aware of the necessity of resolving this finding and have made substantial progress on this issue. During the fiscal year we had staff turnover, and implemented a new financial system that limited our resources towards the project. We are now fully staffed and have completed implementation so we now have more resources devoted to this project. We have made significant strides in resolving this finding. We have identified and documented our greatest risks to financial reporting by flowcharting our financial reporting processes, identifying reconciliation points and control documents, reviewing separation of duties, and documenting our procedures to ensure our controls are relevant and effective.

Persons Responsible for resolution of this audit issue:

Paul Anderson	Administrative Director
Bill Nicol	Accounting Director
Kathy Leisz	Information Technology

Target Date for Resolution: June 30, 2012

Finding 2 - The State Board of Investment had significant delays in preparing its financial statements for fiscal year 2010 and the financial statements required numerous material audit adjustments.

For thirty plus years prior to 2010, the SBI prepared financial statements for the Post Fund and the Supplemental Funds. The Post Fund was merged with the Basic Fund June 30, 2009, as required by statute. As a result, a decision needed to be made on what the SBI should be reporting in the financial statements. Meetings were held with the Legislative Auditors on what should be included and a plan was developed. As the audit progressed, Legislative Auditors required the SBI to included additional items in the financial statements. In addition, for Fiscal Year 2010, a decision was made to switch from monthly valuations to daily valuations of the plans. This switch required the implementation of a new financial system which was a major project. In addition to producing new reports and implementing a new financial system, we also had turnover of a critical staff position. We believe the errors that occurred during the preparation of Fiscal Year 2010 statements were an anomaly as a result of the significant changes that occurred during the year. We have worked diligently to fully utilize our new system and develop reconciliation documents for internal controls. With the further utilization of our financial system and the development of internal controls for financial reporting, we believe errors in future financial reports will be greatly minimized.

The report notes that the SBI did not identify the type of funds being presented (which is an important factor in determining required note disclosures.) The SBI acts in a fiduciary roll for dollars that are received for investment. As a result, we treat all the revenues and expenses in a consistent manner regardless of the type of funds that generated the dollars for investment. The SBI is working with the Legislative Auditors, Minnesota Management and Budget, and outside experts, if necessary, to resolve the application of generally accepted accounting principles.

Persons Responsible for resolution of this audit issue:

Paul Anderson Administrative Director

Target Date for Resolution: December 1, 2011

Finding 3: - The State Board of Investment initially provided some inaccurate and inconsistent derivative information to the state's retirement systems for their financial statement footnote disclosures.

The footnote disclosure for derivative information was new for Fiscal Year 2010. The SBI worked with the custodian bank to develop a report. In October of 2010, the Governmental Accounting Standards Board issued a pronouncement to provide further guidance on the requirement. The pronouncement changed the reporting interpretation and the SBI reissued the report. By the time the derivative report was reissued, some of the retirement systems had already completed their financial statements. We will continue to work with our custodian bank to develop a report in a timely manner for Fiscal Year 2011 and we will meet with Minnesota Management and Budget to ensure they are in agreement with the information.

Persons Responsible for resolution of this audit issue:

Paul Anderson	Administrative Director
Bill Nicol	Accounting Director

Target Date for Resolution: December 1, 2011

We appreciate the dedicated work your staff did to identify the areas that need improvement. We are committed to making the appropriate changes to further strengthen our internal controls.

Sincerely

Howard Bicker

Howard Bicker
Executive Director