OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

State Board of Investment

Fiscal Year Ended June 30, 1999

FEBRUARY 10, 2000 **00-02**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota State government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately fifty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year and one best practices review.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of Representatives and Senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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If you have comments about our work, or you want to suggest an audit, investigation, evaluation, or best practices review, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

Office of the Legislative Auditor
State of Minnesota • **James Nobles, Legislative Auditor**

Report Summary

Minnesota State Board of Investment
Fiscal Year Ended June 30, 1999

Key Finding and Recommendation:

- The statutory basis SBI has used to calculate participation in the Post Retirement Investment Fund (Post Fund) should not be used as a basis for allocating retirement fund assets to participants for financial reporting purposes. Using fair value (market value) to allocate the Post Fund investments to participants at June 30, 1999, could have resulted in a reallocation of retirement fund assets of up to $30 million for certain retirement funds. We recommended that SBI work with the Department of Finance and the state's retirement fund administrators to develop a method of calculating participation in the Post Fund for financial reporting purposes that uses fair value accounting as a basis for the allocation. (Finding 1, page 3)

Agency Response:

- SBI agreed to work with the Department of Finance and retirement fund administrators to develop the methodology required to allocate the Post Fund investments to participants based on fair value.

Background Information:

- The Minnesota State Board of Investment (SBI) administers the investment of state funds and retirement fund assets of the Minnesota State Retirement System, Teachers Retirement Association, and the Public Employees Retirement Association. SBI also administers investments for other state agencies, including invested treasurer's cash, which is the idle cash in state accounts. At June 30, 1999, SBI administered over $50 billion in state assets.

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Minnesota State Board of Investment

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Jack Hirschfeld, CPA	Audit Director
Patrick Phillips, CPA	Auditor
Scott Tsjomsland, CPA	Auditor
Charlie Gill	Auditor
April Snyder	Auditor
Natalie Steen	Intern

Exit Conference

We discussed this report and other issues involving the internal control structure with the following State Board of Investment staff at an exit conference on January 19, 2000:

Howard Bicker	Executive Director
L. Michael Schmitt	Administrative Director

Report on Compliance and Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Representative Dan McElroy, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Board of Investment

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

We have audited the statement of net assets of the Supplemental Investment Fund and the Post Retirement Investment Fund of the Minnesota State Board of Investment for the year ended June 30, 1999, and the related statements of operations, and have issued our report thereon dated December 1, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance
As part of obtaining reasonable assurance about whether the Minnesota State Board of Investment's financial statements are free of material misstatement, we performed tests of its 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 that are required to be reported under *Government Auditing Standards*.

Internal Control over Financial Reporting
In planning and performing our audit, we considered the Minnesota State Board of Investment's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control financial reporting. However, we noted certain matters involving the internal control structure over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters

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coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect SBI's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Finding 1 describes a reportable condition.

A material weakness is a condition in which the design or operation of one or more internal control components does not reduce, to a relatively low level, the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control structure over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is not a material weakness.

This report is intended solely for the information and use of the Legislative Audit Commission and the Minnesota State Board of Investment, and is not intended to be and should not be used by anyone other than these specified parties.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 1, 1999

Report Signed On: February 7, 2000

Current Finding and Recommendation

1. The statutory basis the Minnesota State Board of Investment (SBI) has used to calculate participation in the Post Retirement Investment Fund (Post Fund) should not be used as a basis for allocating retirement fund assets to participants for financial reporting purposes.

SBI has calculated the individual retirement systems' (Minnesota State Retirement System, Public Employees Retirement Association, and Teachers Retirement Association) participation in the Post Fund at June 30 each year as specified in statute. SBI's formula for determining participation in the Post Fund accounts for each retirement fund's contributions and withdrawals on a cost basis, and adds the statutorily required six percent earnings increase and the annual Post Fund benefit increase. SBI has correctly calculated participation in the Post Fund according to statute and the Post Fund financial statements have been presented fairly, in all material respects, in accordance with generally accepted accounting principles. However, the retirement fund administrators have also used the information to report each retirement fund's share of Post Fund assets in the state's financial statements. The cost basis was acceptable for both statutory reporting and for external financial reporting purposes until fiscal year 1998. At that time, established accounting principles for financial reporting changed. The change in accounting principles will require a new method of calculating participation in the Post Fund for financial reporting purposes.

In March 1997, the Government Accounting Standards Board (GASB) issued Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This statement required governmental entities to report investments at fair value (market value) on the balance sheet and to recognize unrealized investment gains and losses on the fair value of investments in the operating statement each year. The state implemented the fair value reporting as required by the GASB in fiscal year 1998. SBI has continued to use the cost basis to calculate statutory participation in the Post Fund. SBI then used the statutory participation percentage to allocate the fair value of investments to the fund participants. Using fair value to allocate the Post Fund investments to participants could have a material impact on the state's financial statements. Table 1 shows a simplified comparison between the cost method and the fair value method of calculating participation in the Post Fund.

Table 1
Comparison of Fair Value to Cost Basis for Computing Participation in the Post Retirement Investment Fund For Fiscal Year 1999 (1)

Retirement Fund	Cost Basis	Fair Value Basis(2)	Difference
Teachers Retirement Fund	$ 8,669,445,383	$ 8,638,394,071	($31,051,312)
MSRS State Employees Retirement Fund	$ 2,655,240,917	$ 2,664,644,562	$ 9,403,645
Public Employees Retirement Fund	$ 5,624,136,719	$ 5,656,823,857	$ 32,687,138
PERA Police and Fire Fund	$ 927,990,723	$ 909,031,354	($18,959,369)
Police and Fire Consolidation Fund	$ 869,446,198	$ 885,431,496	$ 15,985,298
State Patrol Retirement Fund	$ 290,298,723	$ 283,840,434	($ 6,458,289)
Legislative Retirement Fund	$ 34,465,694	$ 36,281,617	$ 1,815,923
Correctional Employees Retirement Fund	$ 127,997,370	$ 120,866,230	($ 7,131,140)
Judicial Retirement Fund	$ 94,434,292	$ 98,142,398	$ 3,708,106
TOTAL	$19,293,456,019	$19,293,456,019	

(1) Amounts reported in this table are based on year-end values and do not reflect changes in fair value during the year.
(2) Fair value amounts for fiscal year 1999 were calculated by using the fair value of individual retirement fund assets at June 30, 1998, adding current year contributions and withdrawals, and adding the statutorily required six percent earnings increase and the annual Post Fund benefit increase.

Source: Office of the Legislative Auditor Analysis.

Continuing to use the cost basis for determining participation in the Post Fund could distort the financial reporting of investment activity in the state's financial statements. Therefore, we think that SBI needs to work with other state agencies to develop another method of calculating participation in the Post Fund for financial reporting purposes. The new method needs to consider adjusting for fair value changes on a more frequent basis, such as monthly or quarterly.

Recommendation

- *SBI should work with the Department of Finance and the retirement fund administrators to develop a method of calculating participation in the Post Fund for financial reporting purposes that uses fair value accounting as the basis for the allocation.*

Status of Prior Audit Issues
As of December 1, 1999

Most Recent Audit

January 29, 1999, Legislative Audit Report 99-6 covered the fiscal year ended June 30, 1998, and had no reportable issues. The audit scope included the investment functions material to the State of Minnesota's financial statements and the Supplemental Investment Fund and the Post Retirement Investment Fund included in SBI's Annual Report. We audit the State Board of Investment on an annual basis.

State of Minnesota Audit Follow-up process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the Metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

MINNESOTA STATE BOARD OF INVESTMENT

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January 28, 2000

Mr. James R. Nobles
Legislative Auditor
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Dear Mr. Nobles:

The staff of the State Board of Investment (SBI) acknowledges that the retirement systems have been reporting participation in the Post Retirement Fund using a fair market value that is calculated using the percentage ownership at statutory cost. Current Government Accounting Standards Board (GASB) requirements are that governmental entities report on a fair value (market value) basis.

The staff of the SBI will work with the staff at the retirement systems and the Department of Finance to develop the methodology required to report on a fair value basis.

The responsibility for implementing this recommendation will be given to the Administrative Director.

Sincerely,

/s/ L. Michael Schmitt

L. Michael Schmitt
Administrative Director