OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Public Employees Retirement Association

Year Ended June 30, 2006

May 24, 2007 **07-13**

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 forty 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.

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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OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

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Audit Participation

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
Tom Donahue, CPA	Audit Manager
Rhonda Regnier, CPA	Auditor-in-Charge
Xin Wang	Auditor

Report Summary

Audit Conclusions/Finding

On December 8, 2006, we issued an unqualified opinion on the financial statements of the Public Employees Retirement Association of Minnesota (PERA) as of and for the year ended June 30, 2006.

This is a related report on internal controls over financial reporting and compliance with certain legal requirements. It contains one finding concerning supplementary information in PERA's 2006 financial report that was not presented in compliance with generally accepted accounting principles.

Background Information

PERA administers four separate funds: the Public Employees Retirement Fund (PERF); the Public Employees Police and Fire Fund (PEPFF); the Public Employees Correctional Fund (PECF); and the Public Employees Defined Contribution Plan (PEDCP). The PERF covers employees of counties, cities, and townships and employees of schools in non-certified positions. The PEPFF covers police officers and fire fighters. The PECF covers employees in county correctional institutions who have direct contact with inmates. The PEDCP covers elected local government officials (except elected county sheriffs), emergency medical service personnel employed by or providing service to any of the participating ambulance services, and physicians employed at public facilities.

PERA served approximately 2,000 units of government and had 378,174 members in its four funds as of June 30, 2006. Its net assets totaled $16.7 billion at June 30, 2006. For the year ended June 30, 2006, PERA received contributions of about $620 million and paid benefits and refunds of about $1.04 billion.

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

Representative Rick Hansen, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Public Employees Retirement Association of Minnesota Board of Trustees

Ms. Mary Most Vanek, Executive Director
Public Employees Retirement Association of Minnesota

We have audited the financial statements of the Public Employees Retirement Association of Minnesota (PERA) as of and for the year ended June 30, 2006, and have issued our report thereon dated December 8, 2006. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered PERA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether PERA's financial statements 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 the 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*.

However, we are reporting in Finding 1, an instance where PERA did not fully comply with generally accepted government accounting principles concerning the presentation of required supplementary schedules in its comprehensive annual financial report. While this instance resulted in only an explanatory paragraph in our Independent Auditor's Report, dated December 8, 2006, it should be noted that the Governmental Accounting Standards Board is currently considering changes to the presentation of the required schedules, which, if implemented, could result in an audit qualification.

This report is intended solely for the information and use of the Legislative Audit Commission and the Public Employees Retirement Association of Minnesota's management 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 May 24, 2007.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: December 8, 2006

Report Signed On: May 22, 2007

Current Finding and Recommendations

1. PERA's required supplementary information as presented in its comprehensive annual financial report did not fully comply with generally accepted accounting principles.

PERA presented certain required supplementary information according to actuarial valuations required by the Legislative Commission on Pensions and Retirement. Those actuarial valuations do not meet the requirements of the Governmental Accounting Standards Board (GASB). GASB establishes generally accepted accounting principles for government financial reporting. The schedules (the Schedule of Contributions From the Employer and Other Contributing Entities, and the Schedule of Funding Progress) included an actuarial asset valuation for part of the retirement plans' assets[1] that was not related to the market value of those assets, as required by GASB.[2]

GASB requires these schedules because they provide vital information about whether the plan is accumulating sufficient assets to meet its future pension obligations. A plan that is fully or over funded (a 100% funding ratio or greater) has sufficient funds to pay the retirement benefits promised to its retirees, provided that the expected investment returns are achieved. A plan that is under funded (a funding ratio less than 100%) may not have sufficient funds to meet its future pension obligations if expected investment returns are not achieved.

Minnesota Statutes[3] state that the annual financial reports prepared by the retirement systems, including PERA, "*must conform with generally accepted governmental accounting principles, applied on a consistent basis*." Furthermore, *Minnesota Statutes*[4] state that the "*actuarial valuation must contain those actuarial calculations that are necessary to allow the retirement plan administration . . . to prepare the pension-related portions of its annual financial reports to meet generally accepted accounting principles for the public sector*." However, the statutes and the contract with the actuary require the actuary to provide the relevant calculations in accordance with the most recent *Standards for Actuarial Work* adopted by the Legislative Commission on Pensions and Retirement. Those standards require that the assets of the Post Retirement Investment Fund "must equal the actuarial present value of projected benefits." This method of asset valuation is not in accordance with GASB requirements. Thus, the

[1] PERA's retirement assets are invested in two pools – one pool invests the funds accumulating for current employees (the active funds) and the other pool invests the funds accumulating for retirees (the Post Retirement Investment Fund). The active funds' assets were valued based on a "smoothed" market value. The Post Retirement Fund's assets were valued equal to the valuation of the Post Retirement Fund's liabilities at year end, as required by *Minnesota Statutes*. When an employee retires, PERA moves funds sufficient to fund the retirement obligation from the active funds to the Post Retirement Investment Fund. When investment returns in the Post Retirement Investment Fund are not sufficient to fund benefit obligations, a deficit in the fund occurs.
[2] GASB requires that the actuarial asset valuation be "market related," meaning that it can vary from market values to "smooth" increases and decreases in market values over a period of years. Although the active funds' assets were valued based on a "smoothed" market value, the Post Retirement Investment Fund's assets were valued equal to the valuation of the Post Retirement Investment Fund's liabilities at year end.
[3] *Minnesota Statutes* 2006, 356.20, subd. 4.
[4] *Minnesota Statutes* 2006, 356.215, subd. 10.

actuary's asset valuation calculations did not provide the retirement systems with the information needed to present appropriate disclosure information.

According to PERA's estimates, from the Management Discussion and Analysis section of its comprehensive annual financial report, using the market value of the Post Retirement Investment Fund's assets to determine the plans' funding ratios would have reduced the funding ratios as shown in Table 1.

Table 1
Estimate of Impact of Post Retirement Investment Fund's Valuation on PERA Retirement Plans' Funding Ratios at June 30, 2007

Retirement Plan	Reported Funding Ratio	Estimated Funding Ratio
Public Employees Retirement Fund	74.4%	68%
Public Employees Police and Fire Fund	95.4%	88%
Public Employees Correctional Fund	94.4%	94%

Source: PERA's Management Discussion and Analysis, 2006 Comprehensive Annual Financial Report.

The two required supplementary schedules are not a part of PERA's basic financial statements and, therefore, we are not required to express and do not express an opinion on them.

Recommendations

- *PERA should present its required supplementary schedules in compliance with generally accepted accounting principles.*

- *PERA should work with the Teachers Retirement Association, the Minnesota State Retirement System, and its actuary to determine those actuarial valuation calculations that are necessary to prepare the pension-related portions of their annual financial reports that meet generally accepted accounting principles.*

Status of Prior Audit Issues As of December 8, 2006

Most Recent Audit

January 26, 2006, Legislative Audit Report 06-01 covered the fiscal year ended June 30, 2005. The audit scope included employer and employee contributions, annuity benefits, and refunds. We audit PERA on an annual basis. There were no reportable issues in that report.

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 metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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May 21, 2007

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

Dear Mr. Nobles:

Thank you for the opportunity to respond to your written finding contained in your financial audit report of PERA for the fiscal year ended June 30, 2006.

Finding: PERA's required supplementary information as presented in its comprehensive annual financial report did not fully comply with generally accepted accounting principles.

Recommendation 1: *PERA should present its required supplementary schedules in compliance with generally accepted accounting principles.*

Recommendation 2: *PERA should work with the Teachers Retirement Association, the Minnesota State Retirement System and its actuary to determine those actuarial valuation calculations that are necessary to prepare the pension-related portions of their annual financial reports that meet generally accepted accounting principles.*

PERA agrees with your audit report finding and recommendations. As indicated in your report, the actuarial value of assets of the Minnesota Post Retirement Investment Fund (MPRIF) has been reported in PERA's supplementary information using a methodology that is not based on the market value of the assets, as is required in GASB 25. This occurred because the Legislative Commission on Pensions and Retirement (LCPR) Standards for Actuarial Work required PERA and its actuary to report the actuarial value of MPRIF assets using a now obsolete accounting methodology that was formerly, but no longer, compliant with generally accepted accounting principles (GAAP) in an attempt to keep the MPRIF separated from the Active Funds.

PERA, along with the other two statewide retirement systems, wrote to the LCPR on January 3, 2007 requesting that it change its Standards for Actuarial Work. PERA is working with the other two statewide retirement systems, the actuarial consultants, and the Legislative Commission on Pensions and Retirement (LCPR) to resolve this problem. The LCPR Chairperson has pledged that a hearing will be held before August to review the LCPR Actuarial Standards for Actuarial Reporting. We are recommending an asset valuation methodology that is market-related and would allow PERA to present its supplementary information consistent with GAAP.

Our request to the LCPR will be to implement modifications effective for the forthcoming July 1, 2007 actuarial valuations. This change would allow PERA to produce its fiscal year 2007 Comprehensive Annual Financial Report (CAFR) in compliance with GAAP and include PERA's share of the MPRIF funding deficit in the overall PERA funding ratio.

PERA Staff Responsible: Mary Vanek, Dave DeJonge

Expected Date of Resolution: December 31, 2007 upon completion of the June 30, 2007 Comprehensive Annual Financial Report.

Thank you for your work on this issue to improve the clarity and completeness of PERA's financial and actuarial reporting. If you have any further questions, please do not hesitate to contact me.

Sincerely,

/s/ Mary Most Vanek

Mary Most Vanek
Executive Director