



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

State Board of Investment
Financial Statement Report
Year Ended June 30, 2008

April 2, 2009

Report 09-15

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

April 2, 2009

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Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Board of Investment

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

In auditing the State Board of Investment's basic financial statements for the Supplemental Investment Fund and the Post Retirement Investment Fund for the year ended June 30, 2008, we considered internal controls over financial reporting. We also tested compliance with significant legal provisions impacting the basic financial statements. We identified one instance of noncompliance with legal provisions related to the Permanent School Fund, as detailed in Finding 1. This report contains our findings and recommendations on internal control 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 non compliance 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 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 Amy Jorgenson, CPA, (Audit Manager) and Carl Otto, CPA, CISA, (Auditor-in-Charge), assisted by auditors Lat Anantaphong, Kathy Rootham, and Alex Weber.

We consider the internal control deficiency described in Finding 1 related to the preparation of the basic financial statements to be a material weakness. 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 did not note any findings we consider to be significant deficiencies. A significant deficiency is a deficiency, or 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.

We discussed the results of the audit with the State Board of Investment's management on January 13, 2009. Management's response to our finding 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 April 2, 2009.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: February 4, 2009

Report Signed on: March 27, 2009

Table of Contents

	<u>Page</u>
Report Summary	1
Finding and Recommendations.....	3
1. The State Board of Investment did not identify, analyze, and document internal controls related to financial reporting and business operations	3
Agency Response.....	7

Report Summary

Conclusion

The Minnesota State Board of Investment's financial statements for the Supplemental Investment Fund and the Post Retirement Investment Fund were fairly presented in all material respects. However, the board had some weaknesses in internal control over financial reporting as noted below.

Finding

- The State Board of Investment did not identify, analyze, and document internal controls related to financial reporting and business operations.

Audit Scope

We audited the State Board of Investment's basic financial statements for the Supplemental Investment Fund and the Post Retirement Investment Fund for the fiscal year ended June 30, 2008.

Background

The State Board of Investment (the board) manages the investment of retirement fund assets of the Minnesota State Retirement System, Teachers Retirement Association, and the Public Employees Retirement Association. The board also invests funds for other state agencies, including invested treasurer's cash, which is the idle cash in state accounts. At June 30, 2008, the board administered approximately \$58 billion in state assets. The board uses both internal staff and external money managers to fulfill its responsibilities. The external firms invest and manage the assets of the retirement funds and the assigned risk plan, while internal staff manage the other state investments.

Finding and Recommendations

The State Board of Investment did not identify, analyze, and document internal controls related to financial reporting and business operations.

Finding 1

The board did not have a comprehensive risk assessment for its financial reporting and business operations. The board has an increased likelihood of control deficiencies and financial misstatement if it does not clearly communicate to all staff its risk, control activity, and monitoring policies and procedures.

State policy details 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.¹ This policy also 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. This 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.

The board is aware of certain risks, has many control activities in place, and performs selected internal control monitoring functions. However, the board has not comprehensively identified and analyzed the risks in its financial reporting process, designed its controls to address significant risks, or developed monitoring procedures to ensure that the controls are in place and are effective to reduce the significant risks identified.

The board had the following deficiencies in its internal controls:

- The board's fiscal year 2008 preliminary financial statements submitted for audit required three material adjustments. These adjustments stemmed from a lack of sufficient mitigating controls to address the weaknesses in its internal controls over financial reporting. The board had the following errors in its preliminary financial statements:
 - The board did not report \$4,250,000 of undistributed earnings for the Post Retirement Investment Fund on its Schedule of Participation because of a data entry error.

¹ Department of Finance Policy 0102-01.

- The board inappropriately included in a loan securities note to the financial statements nearly \$12 million of unrelated financial activity.
- The amounts listed in the Minnesota Supplemental Investment Fund Schedule of Participation did not correctly total.
- The board and the Department of Finance² did not have internal controls to ensure that the Permanent School Fund received investment income as required by statute.³ For six months, some Permanent School Fund assets were not invested in a way that would credit the earnings appropriately. We estimated the lost interest at approximately \$7,000 per month or \$42,000 for the six-month period. Neither the board nor the Department of Finance had controls in place to monitor the financial activity of the Permanent School Fund and to ensure that all funds earned interest. *Minnesota Statutes*⁴ require the Department of Finance to manage the Permanent School Fund and the State Board of Investment to invest the funds.
- The board did not accurately calculate an amount reported to the actuary for the Teachers Retirement Association for fiscal year 2008. The board understated the value by \$15 million. The actuary uses this amount to help determine the Post Retirement Investment Fund's required reserves. The Teachers Retirement Association's staff noticed the error and contacted the board to resolve the discrepancy.

Given the complexity of its operations and the interdependencies of its processes with the Department of Finance and the retirement systems' operations, the board should have better anticipated where errors could occur and designed controls to prevent those errors or detect them within a reasonable period.

Recommendations

- *The State Board of Investment should frequently review and clearly document its risks, control activities, and internal control monitoring functions to mitigate the risk of errors in its financial statements and financial operations. Specifically, the board should:*
 - *Thoroughly review its financial statements before submitting them for audit to detect any errors.*

² Effective June 2008 the Legislature reorganized the Department of Finance to include the duties of the Department of Employee Relations. Although still identified as the Department of Finance, in October 2008, the department changed its name to Minnesota Management and Budget. The department will seek legislative approval for the name change in the 2009 legislative session.

³ *Minnesota Statutes* 11A.16, subdivision 3 – 6.

⁴ *Minnesota Statutes* 11A.16, subdivision 3 – 6.

- *Work with the Department of Finance to examine the process for investing Permanent School Fund money and put adequate internal controls in place to ensure the fund receives its full share of investment income. In addition, the board should work with the Department of Finance to ensure the Permanent School Fund recovers the lost interest.*
 - *Have the retirement systems review allocation schedules prior to submitting them to the actuary and to the OLA for audit.*
-

**MINNESOTA
STATE
BOARD OF
INVESTMENT**



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Tim Pawlenty**

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Rebecca Otto**

**Secretary of State
Mark Ritchie**

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March 25, 2009

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

Dear Mr. Nobles:

Thank you for the opportunity to respond to your report on internal control over the State Board of Investment financial reporting process.

Finding: The State Board of Investment did not identify, analyze, and document internal controls related to financial reporting and business operations.

Recommendations: The State Board of Investment should frequently review and clearly document its risks, control activities, and internal control monitoring functions to mitigate the risk of errors in its financial statements and financial operations. Specifically, the board should:

- Thoroughly review its financial statements before submitting them for audit to detect any errors.
- Work with the Department of Finance to examine the process for investing Permanent School Fund money and put adequate internal controls in place to ensure the fund receives its full share of investment income. In addition, the board should work with the Department of Finance to ensure the Permanent School Fund recovers the lost interest.
- Have the retirement systems review allocation schedules prior to submitting them to the actuary and to the OLA for audit.

Audit Response: While the State Board of Investment believes that overall the current internal controls are adequate, we do recognize that the documentation of existing controls and procedures can be improved. The State Board of Investment will work to develop and maintain an effective internal control structure in accordance with Department of Finance policy.

Specifically, the State Board of Investment will perform additional review of the financial statements before submitting them for audit.

Mr. James R. Nobles
March 25, 2009
Page 2

The State Board of Investment has added additional procedures that should ensure that all Permanent School Fund transfers occur on a timely basis. The Department of Finance has been notified of this issue and will also monitor reporting to ensure that the transfers are made on a timely basis. In addition, the State Board of Investment and the Department of Finance intend to review the Permanent School Fund process. This review will incorporate controls that will ensure that all transfers are accurate and timely.

The State Board of Investment currently sends the allocation schedules for the Post Retirement Investment Fund to the retirement systems at the same time that they are sent to the actuary. It should be noted that the Post Retirement Investment Fund will be dissolved on June 30, 2009. The State Board of Investment will be working with the retirement systems leading up to the June 30, 2009 dissolution date to ensure that the allocation schedules used for the dissolution are accurate.

Person Responsible: Steve Schugel, Administrative Director

Implementation Date: June 30, 2009

Thank you for the opportunity to respond to your report's findings and recommendations.

Sincerely,

/s/ Howard Bicker

Howard Bicker
Executive Director