



FINANCIAL AUDIT DIVISION REPORT

Teachers Retirement Association
Financial Statement Audit
Fiscal Year 2010

February 18, 2011

Report 11-03

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



OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Teachers Retirement Association Board of Trustees

Ms. Laurie Hacking, Executive Director
Teachers Retirement Association of Minnesota

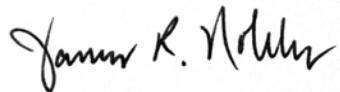
In auditing the Teachers Retirement Association's basic financial statements for the year ended June 30, 2010, we considered internal controls over financial reporting. We also tested compliance with significant legal provisions impacting the basic financial statements. We did not identify any instances of noncompliance with legal provisions material to the financial statements. This report contains our findings and recommendations on internal controls over financial reporting. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the Teachers Retirement Association'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), Carl Otto, CPA, (Audit Coordinator), Chau Nguyen, CPA, (Auditor-in-Charge), assisted by auditors Kevin Schoenrock and Alex Weber.

We consider the internal control deficiency described in Finding 1 to be a material weakness. A material weakness is a significant deficiency, or combination of significant 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. 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 consider Finding 2 a significant deficiency. Finding 3 is not a significant deficiency, and it does not have a direct or material effect on the financial statements; however, it addresses noncompliance with state statutes.

We discussed the results of the audit with the Teachers Retirement Association on February 8, 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 Teachers Retirement Association'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 February 18, 2011.



James R. Nobles
Legislative Auditor



Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: December 20, 2010

Report Signed On: February 14, 2011

Table of Contents

	<u>Page</u>
Report Summary	1
Findings and Recommendations	3
1. TRA did not accurately report derivatives in its draft financial statement footnote disclosures.....	3
2. TRA did not have sufficient controls to ensure that it had accurate date of birth data for its members	4
3. Prior Finding Partially Resolved: TRA did not receive the correct amount of direct appropriation aid contributions from the City of Minneapolis	4
Agency Response	7

Report Summary

Conclusion

The Teachers Retirement Association's (TRA) financial statements were fairly presented in all material respects. However, TRA had some weaknesses in internal control over financial reporting, as noted below.

Key Findings

- TRA did not accurately report derivatives in its draft financial statement footnote disclosures. ([Finding 1, page 3](#))
- TRA did not have sufficient controls to ensure that it had accurate date of birth data for its members. ([Finding 2, page 4](#))

Audit Scope

We audited TRA's basic financial statements for the fiscal year ended June 30, 2010.

Findings and Recommendations

TRA did not properly report derivative information in its draft financial statement footnote disclosures.

Finding 1

TRA did not properly disclose in the notes to the financial statements information related to certain types of derivatives, including TBA mortgage-backed securities,¹ and futures securities.² A number of factors contributed to the errors, including the implementation of a new accounting principle on derivative disclosures,³ and the extremely technical and complex nature of derivatives. Despite some coordinated effort among TRA, the State Board of Investment, and the state's master custodian, TRA's footnote initially included the following errors:

- TRA erroneously reported its TBA mortgage-backed securities as currency futures, including changes in fair value of \$20.24 million, a fair value at June 30, 2010, of \$2.64 million, and a notional amount of \$326.85 million. The State Board of Investment provided the derivative schedule to TRA that correctly classified the investments as TBA mortgage-backed securities; however, TRA used the currency futures classification in its draft disclosure.
- TRA incorrectly disclosed the fair value of futures at negative \$3.24 million. The futures should have been valued at zero dollars for reporting purposes because futures trades settle daily. TRA relied on the State Board of Investment to provide the information included in the derivative disclosure since the board invests the pension's funds. The State Board of Investment also consulted with the state's master custodian to furnish the derivative disclosures. The derivative schedule that TRA received from the State Board of Investment incorrectly presented the fair value of futures, because the master custodian had not updated the initial information based on subsequent discussions with Governmental Accounting Standards Board staff. However, TRA is ultimately responsible for the accuracy of its financial statements and footnote disclosures.

¹ TBA derivatives relate to mortgage-backed securities trades. The term TBA, which stands for "to be announced," is used because the actual mortgage-backed security that will be delivered to fulfill a TBA trade is not designated at the time the trade is made.

² A futures security is a financial contract obligating the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price.

³ Government Accounting Standards Board Statement 53: *Accounting and Financial Reporting for Derivative Instruments*, paragraph. 69.

Government accounting principles require derivative disclosures be aggregated by type and presented at fair value as of the end of the reporting period. In all of the instances noted above, TRA did not confirm the accuracy of the information it presented. Uncorrected, the inaccuracies in the derivative disclosure may have been misleading to users of TRA's financial statements.

Recommendation

- *TRA should work with the State Board of Investment and the state's master custodian to ensure the accuracy of the derivative disclosures reported in TRA's footnotes to the financial statements.*

Finding 2

TRA did not have sufficient controls to ensure that it had accurate date of birth data for its members.

TRA did not require members to provide evidence of date of birth when applying for retirement benefits. Instead, TRA relied on the accuracy of date of birth data that employers provided to TRA when members enrolled in the retirement plan. TRA staff told us they do require validation of date of birth when they note discrepancies in that information at the time members apply for benefits. Additionally, eight TRA staff had access in the agency's subsystem to change members' date of birth information, including their own, without a validation of the change by an independent staff person. Date of birth is an important part of the determination of a member's eligibility to receive retirement benefits and the benefit amount. Without adequate controls in place to ensure accurate date of birth information, members could receive improper retirement benefit payments.

Recommendation

- *TRA should strengthen its internal controls to ensure that it has accurate date of birth data for its members, including requiring that members provide evidence of their date of birth, restricting the ability for employees to change date of birth data without independent verification and eliminating an employee's ability to change their own date of birth data.*

Finding 3

Prior Finding Partially Resolved:⁴ TRA did not receive the correct amount of direct appropriation aid contributions from the City of Minneapolis.

TRA did not collect the correct amount of payments from the City of Minneapolis, as required by two state statutes.⁵ One statute governs the reallocation of amortization

⁴ Office of the Legislative Auditor's Financial Audit Division Report 10-07, *Teachers Retirement Association Financial Statement Report*, issued March 12, 2010.

⁵ Minnesota Statutes 2010, 354A.12, subd. 3(b), and Minnesota Statutes 2010, 423A.02 subd.3(c).

or supplementary amortization of state aid for unfunded actuarial liabilities of local police and fire fighters relief associations. The other statute pertains to the merger of the Minneapolis Teachers Retirement Fund into the state retirement fund. Despite TRA's efforts to achieve statutory compliance, TRA and the City of Minneapolis continued to interpret the statutes differently. TRA believes, and the statutes require, that the City of Minneapolis should remit \$2.25 million annually, while the city believes that only the money collected through a tax levy should be remitted to TRA, regardless of whether the collected amount is less than \$2.25 million.

For the fiscal year ending June 30, 2010, the City of Minneapolis underpaid its direct aids by approximately \$6,300. However, the total amount in dispute, based on TRA's records is, \$727,070; \$675,222 pertains to the reallocation of state aid dating back to 1998, and \$51,848 pertains to payments since 2006 related to the merger.

Recommendation

- *TRA should resolve the conflicting interpretation of Minnesota Statutes to ensure that it collects the correct amount from the City of Minneapolis and reaches agreement on a settlement of the past due amount.*



February 11, 2011

Mr. James R. Nobles
Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
Saint Paul, MN 55155-1603

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to your report on TRA's internal controls over financial reporting for the fiscal year ended June 30, 2010.

Finding #1- TRA did not properly report derivative information in its draft financial statement footnote disclosures.

Recommendation:

TRA should work with the State Board of Investment and the state's master custodian to ensure the accuracy of the derivative disclosures reported in TRA's footnotes to the financial statements.

TRA Response:

As your report described, the Notes to the Financial Statements that TRA first delivered to the OLA for their review contained classification and amount errors. The derivative instrument reporting disclosure was new for the fiscal year 2010 report and very detailed and complex to implement. Ultimately, the schedule and disclosure were corrected prior to issuance of TRA's Comprehensive Annual Financial Report.

In future presentations, TRA will improve communications and work collaboratively with the State Board of Investment and State Street Bank, the master custodian of TRA investments, to improve process documentation, risk assessment, timeliness and accuracy of the required disclosures.

TRA Responsibility: John Wicklund, Asst. Exec. Director- Administration
Robert Johnson, Accounting Director

Resolution Date: June 30, 2011 for risk assessment and documentation of process for June 30, 2011 financial statement presentations

Finding #2 – TRA did not have sufficient controls to ensure that it had accurate date of birth data for its members.

Recommendation:

TRA should strengthen its internal controls to ensure that it has accurate date of birth data for its members, including requiring that members provide evidence of their date of birth, restricting the ability for employees to change date of birth data without independent verification and eliminating an employee's ability to change their own date of birth data.

TRA Response:

TRA will initiate a thorough review of current internal controls and evidentiary documentation over the date of birth verification as part of its ongoing internal control and risk assessment function. Current systems controls greatly limit the number of employees who have security access to modify the member date of birth data field. Systems access controls over the date of birth field will also be reassessed. We will provide you our updated documentation when you begin your next audit.

We have already implemented a systems enhancement which further restricts TRA employee access to modify the date of birth field of TRA employees.

TRA Responsibility: Karen Williamson, Asst. Exec. Director- Operations
Connie Gunderson, Member Benefits Manager
Various Operational Managers

Resolution Date: August 31, 2011, with monitoring and testing ongoing

Finding #3: Prior Finding Partially Resolved: TRA did not receive the correct amount of direct appropriation aid contributions from the City of Minneapolis.

Recommendation:

TRA should resolve the conflicting interpretation of Minnesota Statutes to ensure that it collects the correct amount from the City of Minneapolis and reaches agreement on a settlement of past due amounts.

TRA Response:

TRA began receiving direct aid from the City of Minneapolis effective with the June 30, 2006 merger with the Minneapolis Teachers Retirement Fund Association (MTRFA). In fiscal year 2010, the City of Minneapolis paid about 99.7 percent of the \$2.25 million of direct aid TRA annually expects from the City.

Mr. James R. Nobles

February 11, 2011

Page 3

TRA management has unsuccessfully attempted to resolve this issue with the City of Minneapolis over the past two years. As your finding explains, the City of Minneapolis Board of Estimate and Taxation believes that the amount of the direct aid should be based on tax levies actually paid by taxpayers to the City of Minneapolis.

We acknowledge that there is a conflict in the statutory provisions (Minn. Stat. Sec. 354A.12 subd. 3b, paragraphs (a) and (b)), and the clarification of legislative intent would help resolve the conflict. At this point, TRA is not planning to seek legislation during the 2011 session, but will be alert to the potential to address the issue should this section of statute come up for legislative review.

TRA Responsibility: John Wicklund, Asst. Exec. Director- Administration
Robert Johnson, Accounting Director

Resolution Date: June 30, 2012, should no legislative activity occur during the 2011 session

Thank you for the courtesy your staff extended to TRA employees during the audit. Please contact me if you have any further questions.

Sincerely,



Laurie Fiori Hacking
Executive Director