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

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Retirement System

Financial Statement Audit

Fiscal Year 2010

February 18, 2011 **Report 11-04**

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Members of the Legislative Audit Commission

Members of the Minnesota State Retirement System Board of Trustees

Mr. David Bergstrom, Executive Director
Minnesota State Retirement System of Minnesota

In auditing the Minnesota State Retirement System'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 Minnesota State Retirement System'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), Lat Anantaphong, CPA, (Auditor-in-Charge), assisted by auditors Chau Nguyen, CPA, Tracia Polden, Kevin Schoenrock, Alex Weber, and Zachary Yzermans, CPA.

We consider the internal control deficiencies described in Findings 1 and 3 to be material weaknesses. 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 4 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.

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 Minnesota State Retirement System'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	Cecile M. Ferkul, CPA, CISA
Legislative Auditor	Deputy Legislative Auditor

End of Fieldwork: December 23, 2010

Report Signed On: February 14, 2011

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Report Summary

Conclusion

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

Key Findings

- Prior Finding Not Resolved: MSRS did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis. It also did not adequately restrict access to eliminate incompatible duties or implement adequate mitigating controls over incompatible access. (Finding 1, page 3)

- Prior Finding Not Resolved - MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting. (Finding 2, page 4)

- MSRS did not properly report derivative information in its draft financial statement footnote disclosures. (Finding 3, page 5)

Audit Scope

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

Findings and Recommendations

Finding 1

Prior Finding Not Resolved:[1] MSRS did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis. It also did not adequately restrict access to eliminate incompatible duties or implement adequate mitigating controls over incompatible access.

MSRS lacked security access controls. MSRS did not provide adequate documentation to help managers make informed decisions about the level of computer access to grant its staff. Although MSRS personnel analyzed incompatible security profiles, management had not approved or implemented revised security access procedures during fiscal year 2010. MSRS also did not implement a formal process to periodically review and recertify current computer users' access.

Without adequate information describing, in non-technical terms, the access options available in the business application and any access combinations that would result in someone having incompatible access, MSRS managers often requested someone's computer access be set the same as another employee's access without explicitly defining the specific access needed. This is a high-risk practice because it can lead to employees obtaining inappropriate access without any mitigating controls.

As a result, MSRS had the following system access issues without proper controls in place to mitigate the risks:

- Fifty-nine MSRS employees had incompatible access to the MSRS business system. Based on inquiry and analysis, these employees had the ability to change an annuitant's name, address, and bank routing information.

- Seven of the fifty-nine employees with incompatible access had access to process death records and change bank or annuitant information. Five of the seven employees with access to death records also had access to update beneficiary information.

- Eight of the fifty-nine employees with incompatible access had access to process refunds. In addition, two of these eight employees also had physical access to refund checks, increasing the risk of fraud.

[1] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 10-12, *Minnesota State Retirement System*, April 12, 2010 (Finding 2) and Report 09-17 *Minnesota State Retirement System*, April 23, 2009 (Finding 2).

- Two of the fifty-nine employees with incompatible access had access to control the entire annuity process that includes entry, preparation, computation, review, and manager approval.

These incompatible duties allowed employees the ability to redirect benefit and refund payments without a member's knowledge. Although MSRS's business system automatically generates a letter to a member whose bank routing information had been changed, employees with this incompatible access could redirect the letter.

State policy specifies that agencies should not give employees incompatible access and, in cases were that is not possible, agencies should implement and maintain mitigating controls.[2] Allowing employees incompatible access without implementing effective mitigating controls creates vulnerabilities with MSRS for potential errors or fraud.

Recommendations

- *MSRS should finalize security documentation to provide guidance to managers making decisions about business system access for employees. This documentation should specifically identify incompatible access profiles within its business systems.*
- *MSRS should periodically review and recertify computer users' access.*
- *MSRS should ensure it eliminates unnecessary or incompatible access to its business system. If incompatible access is unavoidable, MSRS should implement controls to mitigate the risk of error or fraud.*

Finding 2

Prior Finding Not Resolved:[3] MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting.

MSRS did not fully design and implement a comprehensive risk assessment over its financial reporting and business operations. We first reported this issue in 2009. MSRS was aware of certain risks, had control activities in place, and performed selected internal control monitoring functions. However, MSRS did not have a comprehensive internal control structure. MSRS began to develop its comprehensive internal control structure by drafting an outline of risks, but had not fully assessed and documented its financial reporting risks. In addition, the

[2] Department of Management and Budget Policy 0102 – 01 Internal Control.

[3] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 10-12, *Minnesota State Retirement System*, April 12, 2010 (Finding 1) and Report 09-17 *Minnesota State Retirement System*, April 23, 2009 (Finding 1).

system delayed its target date for the development of its comprehensive internal control structure until after June 30, 2011, when it plans to hire an individual whose responsibilities will include that task. MSRS has an increased likelihood of a control deficiency if it does not clearly communicate to staff its risks, control activities, and monitoring policies and procedures.

The state's policy on internal controls requires that each agency head identify, analyze, and manage business risks that impact the entity's ability to maintain its financial strength and the overall quality of government services.[4] 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. The policy further requires follow-up procedures that, at minimum, should include ways to monitor controls and report significant weaknesses to individuals responsible for the process or activity involved, including executive management and those individuals in a position to take corrective action.

Findings 1, 3, and 4 identify deficiencies that MSRS's internal control procedures did not prevent or detect. Until MSRS fully designs and implements a comprehensive risk assessment, it increases the risk of errors or fraud in its financial reporting process and its business operations.

Recommendation

- *MSRS should develop and implement a comprehensive control structure that identifies financial reporting and business risks and establish a monitoring function to ensure controls are operating as designed.*

Finding 3

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

MSRS did not properly disclose in the notes to the financial statements information related to certain types of derivatives, including TBA mortgage-backed securities,[5] futures securities,[6] and synthetic guaranteed investment contracts.[7] A number of factors contributed to the errors, including the

[4] Department of Management and Budget Policy 0102 – 01 Internal Control.
[5] 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.
[6] 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.
[7] 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.

implementation of a new accounting principle on derivative disclosures[8] and the extremely technical and complex nature of derivatives. Despite some coordinated effort among MSRS, the State Board of Investment, and the state's master custodian, MSRS's footnote initially included the following errors:

- MSRS erroneously reported its TBA mortgage-backed securities as currency futures, including changes in fair value of $12.6 million, a fair value at June 30, 2010 of $1.6 million, and a notional amount of $197.8 million. The State Board of Investment provided the derivative schedule to MSRS that correctly classified the investments as TBA mortgage-backed securities; however, MSRS used the currency futures classification in its draft disclosure.

- MSRS incorrectly disclosed the fair value of futures at negative $2.1 million. The futures should have been valued at zero dollars for reporting purposes because futures trades settle daily. MSRS 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 MSRS 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, MSRS is ultimately responsible for the accuracy of its financial statements and footnote disclosures.

- MSRS inaccurately reported the fair value of its synthetic guaranteed investment contract at $1.6 billion and the corresponding insurance wrap at $382 million. MSRS should have valued the contract and wrap at $748 million and $38 million respectively. The State Board of Investment initially provided a derivative disclosure to MSRS that incorrectly valued the synthetic guaranteed investment contract and insurance wrap, but later provided a corrected disclosure. However, MSRS failed to correct the values in its draft derivative disclosure.

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, MSRS did not confirm the accuracy of the information it presented. Uncorrected, the inaccuracies in the derivative disclosure may have been misleading to users of MSRS's financial statements.

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

Recommendation

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

MSRS lacked sufficient controls to ensure that some eligible annuitants received their initial postretirement benefit increases.

Finding 4

MSRS did not have adequate controls to ensure that it properly applied manually-calculated postretirement increase adjustments to eligible annuitants' accounts.[9] Ten eligible annuitants did not receive the increase in 2010 because of this weakness. MSRS manually-calculated postretirement benefit increases in cases where new annuitants received retroactive payments covering multiple months during the fiscal year. As of June 30, 2010, the total underpayment was $339 for the ten annuitants. Not considering compounding effects on future postretirement benefit increases, in total MSRS would have underpaid the ten annuitants a minimum of $56 per month for future benefit payments. Although this error was small, without a control to ensure that employees properly apply manually-calculated post retirement adjustments, there is a risk of larger errors occurring without detection.

Minnesota Statutes require that when authorized, each individual who received a monthly annuity or benefit for at least 12 full months prior to January 1 receive a postretirement benefit increase.[10] Each annuitant or benefit recipient who received a payment for at least one full month receives a prorated benefit increase. In fiscal year 2010, the postretirement benefit increase amounted to 2.5 percent.

Recommendations

- *MSRS should improve controls over the manual postretirement increase adjustment to ensure that all eligible annuitants receive their increases.*

- *MSRS should determine the need to review prior years' postretirement increase adjustments to ensure that it has properly applied the manually-calculated increases to all eligible annuitants' accounts.*

[9] MSRS's payment system accurately applied the benefit increases to system-generated amounts.
[10] *Minnesota Statutes* 2010, 356.415, subd. 1.

February 11, 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 comment on your report that summarizes the results of MSRS' recent financial audit. We are very pleased to know that the financial statements for our defined benefit and defined contribution retirement funds are fairly presented in all material respects. Although your report identifies some internal control weaknesses over financial reporting, we're glad that you detected no serious issues regarding the $13 billion of our net pension assets held in trust.

We concur with all of the audit findings contained within the report. As always, we take any audit finding very seriously and have already initiated corrective actions, as noted below.

Finding 1 - Prior Finding Not Resolved: MSRS did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis. It also did not adequately restrict access to eliminate incompatible duties or implement adequate mitigating controls over incompatible access.

We have made some progress in resolving this audit issue in the past fiscal year, but we've devoted considerable staff effort and financial resources to enhancing the security of our network. Specifically, we've embarked on a multi-phased project to develop and implement a more secure network architecture. When this project is complete this Spring, we will focus additional time and effort on fully resolving this audit issue.

We are continuing our efforts to finalize security documentation that will provide guidance to managers to determine the appropriate access for their staff. Last month, managers reviewed employees' access privileges and authorized modifications, where necessary, to limit them to only those necessary for their assigned job duties. We are still developing a formal process to periodically review and recertify computer users' access to our systems. We will continue to explore options to eliminate incompatible access or to implement mitigating controls. Full resolution of this audit issue may require computer programming changes to limit employee tasks associated with certain access flags, independent reviews, implementation of a quality control function for our defined benefit plans, or other mitigating controls.

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Persons responsible for resolution of this audit issue include:

Information Systems Manager Al Cooley
Database Administrator Lloyd Johnson
Assistant Directors Judy Hunt and Erin Leonard

Target date for resolution: December, 2011

Finding 2. Prior Finding Not Resolved: MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting.

We continue to believe that we have strong, effective financial and operational controls in place; however, we recognize that we need to improve documentation of our comprehensive internal control structure and to perform formal risk assessments periodically. We plan to hire an individual prior to fiscal year end whose position responsibilities will include these duties.

Persons responsible for resolution of this audit issue include:
Accounting Director Dennis E. Jensen
Assistant Executive Director Judy Hunt

Target date for resolution: June 30, 2012

Finding 3. MSRS did not properly report derivative information in its draft financial statement footnote disclosures.

While the report notes that our draft or preliminary financial statement disclosures did not properly report derivative information, the *Notes to the Financial Statements* included in our 2010 Comprehensive Annual Financial Report (CAFR) contain corrected amounts. Please refer to our CAFR online at: http://www.msrs.state.mn.us/pdf/2010CAFR.pdf . We always strive to provide users of our financial statements with reliable data for decision making purposes.

Fiscal year 2010 was our first year for implementing the new governmental accounting principle, GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments.* Since the Minnesota State Board of Investment (SBI) has statutory responsibility for investment of our pension assets and investments is their area of expertise, we relied on SBI to provide us with the appropriate derivative disclosure in a timely manner. We had been working with SBI and MMB (Minnesota Management and Budget) financial reporting staff in mid-December to finalize the GASB 53 disclosures; and we were unaware that disclosure issues still existed when we completed the final draft of our CAFR. In the interest of finalizing our CAFR before calendar year end, as required by *Minnesota Statutes* 356.20, subdivision 3, we provided a final version to the OLA auditor-in-charge for review on December 22. On December 23, SBI provided us with revised GASB 53 note disclosure information. By that time, it was too late to modify the final draft of our CAFR; we made the necessary corrections to the derivative disclosures as part of the OLA review process.

We consider this issue resolved. We are committed to working closely with SBI as we prepare future CAFRs to ensure the accuracy of all investment disclosures.

Finding 4. MSRS lacked sufficient controls to ensure that some eligible annuitants received their initial postretirement benefit increases.

The handful of adjustment errors were a result of legislation passed in 2009 shortening the waiting period for the initial post retirement adjustments. The legislation was modified in 2010 to delay the initial post retirement increase to six months. This change will eliminate most of the manual adjustments that resulted from the 2009 law. Generally, our post retirement adjustment process is automated which reduces the chance of error present with manual adjustments. As you recommended, we did a comprehensive audit of these past adjustments and found two minor adjustments that have been corrected. One of the adjustments was $.03 and the other was $18.41.

While the law change should eliminate the need for most adjustments, we are developing policies and procedures that require an independent review of all benefit changes that require a manual adjustment. We will also conduct an annual review of post retirement adjustments.

Person responsible for resolving this finding: Assistant Executive Director Erin Leonard

Target date for resolution: June 30, 2011

We appreciate the work of your agency to identify areas within MSRS that need improvement. We are committed to taking appropriate actions to further strengthen our internal control structure.

Sincerely,

David Bergstrom

Dave Bergstrom
Executive Director

cc: Judy Hunt
Dennis E. Jensen
Lloyd Johnson
Erin Leonard
Al Cooley