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

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Retirement System

Financial Statement Audit

Fiscal Year Ended June 30, 2011

May 10, 2012 **Report 12-10**

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Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Retirement System Board of Directors

Mr. David Bergstrom, Executive Director
Minnesota State Retirement System

In auditing the Minnesota State Retirement System's basic financial statements for the year ended June 30, 2011, 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), Chau Nguyen, CPA, (Auditor-in-Charge), assisted by auditors Tom Foeller, Reidar Gullicksrud, CPA, Adam Langhorst, and Kelsey Nistler.

Our audit opinion on the financial statements was included in the system's annual financial report. Access to the report is available at the following web site:
http://www.msrs.state.mn.us/pdf/2011CAFR.pdf

We consider the internal control deficiencies described in Findings 1 through 4 to be material weaknesses. A material weakness is a significant deficiency, or combination of significant deficiencies, in internal controls 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. Finding 1 also reports noncompliance with state statutes, but the issue did not have a direct and material effect on the financial statements.

We discussed the results of the audit with the Minnesota State Retirement System at the completion of the audit. 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 May 10, 2012.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: March 19, 2012

Report Signed On: May 7, 2012

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Report Summary

Conclusion

The Minnesota State Retirement System's (MSRS) basic financial statements for the fiscal year ended June 30, 2011, were fairly presented in all material respects. However, MSRS had some material weaknesses in internal control, including two unresolved prior audit findings, and noncompliance over financial reporting, as noted below.

Findings

- Prior Finding Not Resolved:[1] MSRS did not identify, analyze, and document its internal controls related to financial reporting and business operations, which also has resulted in delays in issuing its financial statements in a timely manner. (Finding 1, page 3)
- Prior Finding Not Resolved:[2] MSRS did not have adequate controls to ensure computer users' access was appropriate. It also allowed employees to perform incompatible duties without establishing mitigating controls. (Finding 2, page 4)
- MSRS had material weaknesses in its internal controls over several of its financial operations. (Finding 3, page 5)
- MSRS submitted for audit financial statements, including footnote disclosures, that contained several errors. (Finding 4, page 7)

Audit Objectives and Scope

Audit Objectives:

- To audit MSRS's basic financial statements for the fiscal year ended June 30, 2011.
- To report on MSRS's internal controls and compliance over financial reporting.
- To follow up on the status of prior audit findings.

Audit Scope:

- Cash and Investments
- Contributions and Investment Income
- Transfers
- Refund and Benefit Payments

[1] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 11-04, *Minnesota State Retirement System*, February 18, 2011 (Finding 2).
[2] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 11-04, *Minnesota State Retirement System*, February 18, 2011 (Finding 1).

Findings and Recommendations

Finding 1

Prior Finding Not Resolved:[3] MSRS did not identify, analyze, and document its internal controls related to financial reporting and business operations, which also has resulted in delays in issuing its financial statements in a timely manner.

MSRS did not fully design and implement a comprehensive risk assessment over its financial reporting and business operations. MSRS was aware of certain risks, had control activities in place, and performed some internal control monitoring functions. However, MSRS has not comprehensively identified controls to address the risks or monitoring activities to ensure the controls were effective, as required by the Department of Management and Budget's policy.[4] Since we first reported this issue in April 2009, the system has deferred its target date for the development of its comprehensive internal control structure to June 30, 2012.

Findings 2 through 4 identify deficiencies in the system's internal control procedures and errors in the financial statements submitted for audit. These weaknesses and other factors also contributed to MSRS not complying with statutory requirements that it publish its annual report within six months after the end of the fiscal year or one month following the receipt of the actuarial valuation report, whichever is later.[5] According to statute, MSRS should have published its fiscal year 2011 annual report by January 11, 2012. However, it did not publish its report until April 2, 2012, almost three months later.[6]

If the department had a comprehensive internal control structure, it may have identified these deficiencies, assessed the degree of risk of these deficiencies, designed control procedures to address significant risks, and monitored whether controls were working as designed and effective in reducing the risks to an acceptably low level. Until MSRS designs and implements a comprehensive risk assessment, it has an increased likelihood of additional control deficiencies, financial reporting errors, and delays in publishing its annual report.

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[3] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 11-04, *Minnesota State Retirement System*, February 18, 2011 (Finding 2).
[4] Department of Management and Budget Policy Number 0102-01.
[5] *Minnesota Statutes* 2011, 356.20, subd. 3.
[6] MSRS received the updated actuarial reports for the Legislators Plan and the Elective State Officers Plan on December 12, 2011.

Recommendation

- *MSRS should develop and implement a comprehensive control structure in order to prepare accurate and timely financial statements. The internal control structure should identify and document MSRS's financial reporting and business risks, related control procedures, and ways to monitor controls to ensure they are effective and operate as designed.*

Finding 2

Prior Finding Not Resolved:[7] MSRS did not have adequate controls to ensure computer users' access was appropriate. It also allowed employees to perform incompatible duties without establishing mitigating controls.

MSRS did not have adequate documentation, including the identification of incompatible security access profiles, to help managers make informed decisions about the level of security access to grant their staff. In addition, the retirement system lacked a formal process to periodically review and recertify computer users' access. In fiscal year 2011, although MSRS did analyze incompatible profiles of individual employees, it did not modify any users' access for incompatibilities and did not establish any mitigating controls to manage the risk of error or fraud that could occur.[8] These incompatibilities increased the risks of unauthorized or fraudulent activities in changing an annuitant's name, address, and bank information, death records and beneficiary information, and processing refunds and annuity payments. The retirement system did not have any mitigating controls to prevent or detect inappropriate or unauthorized changes. Since we first reported these issues in 2009, MSRS had a high risk of erroneous or fraudulent financial activities occurring without detection.

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.*

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[7] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 11-04, *Minnesota State Retirement System*, February 18, 2011 (Finding 1).
[8] In the prior year's audit report, 59 employees had incompatible access to the department's business system.

Finding 3

MSRS had material weaknesses in its internal controls over several of its financial operations.

MSRS had the following material weaknesses in internal controls and errors either because it had not designed effective controls or had not monitored staff performance of those controls to ensure they were operating as expected:

- **Changes to the General Ledger Subsystem**: MSRS did not design and implement proper security controls to ensure the integrity of financial information produced by its general ledger subsystem. MSRS identified a programming flaw that caused the post-closing trial balance totals to not match the general ledger details. MSRS authorized the business manager to directly change a system program in order to produce an accurate beginning trial balance in the following year. However, MSRS did not adequately test, validate, and document the propriety of the changes.

  A strong information technology control framework requires that 1) the organization implements separation of duties through assigned information system access authorizations; 2) the organization allows access to information system components for the purpose of initiating changes, including upgrades and modifications to only qualified and authorized individuals; 3) the organization tests, validates, and documents changes to the information system before implementing the changes on the operation system; and 4) the information system produces audit records that contain sufficient information to, at a minimum, establish what type of event occurred, when the event occurred, where the event occurred, the source of the event, the outcome of the event, and the identity of any user/subject associated with the event.[9] We did not identify any inappropriate entries to the general ledger based on the transactions we tested.

- **Payroll Exception Report**: MSRS did not require independent reviews or any monitoring controls over its process to ensure participating employers paid the correct contribution amounts based on submitted payroll details. One employee had sole responsibility to investigate the differences in the payroll exception report and make changes in the system without added controls to ensure that the employee had accurately resolved all discrepancies and that the employee had not made unauthorized changes that could affect contributions collected and also impact members' future annuity payments. In addition, the exception report did not identify all discrepancies in the payroll details because the

[9] National Institute of Standards and Technology *Special Publication 800-53, Recommended Security Controls for Federal Information Systems and Organizations* – Security Controls AC-5 Separation of Duties, CM-5 Access Restrictions for Change, CM-3 Configuration Change Control, and AU-3 Content of Audit Records.

report only applied to the current pay period and incoming contributions. Without an all inclusive report, MSRS would not identify unresolved discrepancies in previous pay periods.

- **Cash Receipt Process**: MSRS did not have adequate separation of duties in its cash receipt process. One employee in the retirement services unit received all defined contributions plan checks, recorded them in a check log, and then mailed them to the third-party record-keeper. This practice increased the risk of errors or fraud because the same employee had both custodial and recording responsibilities for the assets. During fiscal year 2011, the system received $20 million in checks, mostly for the deferred compensation plan rollovers.

- **Calculation of Refunds**: MSRS did not have adequate internal controls to ensure the accuracy of manual refund calculations, and the process lacked an adequate separation of duties. The same employee performed the calculations and entered the transactions into the accounting subsystem without any independent review or approval. Absent independent review and approval of the complex calculations, material errors, or potentially fraudulent transactions could occur. We found 1 minor error in the 15 manual refund calculations we tested.

Recommendations

- *MSRS should improve the information technology controls to ensure that 1) it only grants access to the information system components to qualified and authorized individuals; 2) it tests, validates, and documents changes to the information system before implementing the changes; and 3) it maintains proper documentation to ensure the propriety and accuracy of the changes.*

- *MSRS should separate incompatible duties in all cited areas to ensure no one employee has control over an entire process to help eliminate risks of errors and fraud. If incompatible access cannot be segregated, the system should design, document, and implement effective mitigating control reviews.*

- *MSRS should redesign the payroll exception report to identify all discrepancies between employer contributions and required contributions based on payroll details.*

Finding 4

MSRS submitted for audit financial statements, including footnote disclosures, that contained several errors.

MSRS's internal controls failed to detect several errors in the financial statements before submitting them for audit. We proposed the following audit adjustments that MSRS made:

- MSRS incorrectly disclosed the cost value of certain Deferred Compensation Plan investments because it reported the market value of the investments and initially overstated in the footnote disclosures the cost of the investments in the Supplemental Investment Fund by $214 million and the mutual fund investments by $661 million.

- MSRS incorrectly reported $7.8 million in refunds as ongoing withdrawals on the Unclassified Fund Statement of Changes in Plan Net Assets.

- MSRS did not have internal controls in place to provide assurance about the reliability of the financial information prepared by its administrator of the defined contribution funds as the basis for those financial statements. As a result, the system overstated the account receivable balance by $2 million for the Health Care Savings Plan and understated the account receivable balance by $200,000 for the Deferred Compensation Plan.

- MSRS did not record adjusting entries to its general ledger system before it finalized the basic financial statements. The general ledger balances differed from the basic financial statements by a total of $2 million and a net difference of $598,000 (due to offsetting amounts).

Recommendation

- *MSRS should review its financial reporting process to identify changes necessary to improve the accuracy of its financial reporting process.*

MSRS Minnesota State Retirement System
MNDCP Minnesota Deferred Compensation Plan
HCSP Health Care Savings Plan

Your Foundation for Retirement

May 4, 2012

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 respond to the findings and recommendations contained in your report which indicates the results of the fiscal year 2011 financial audit. We take these findings very seriously, and we have taken significant steps to resolve these issues this fiscal year. We are pleased to report that we recently hired the agency's first internal control specialist. This individual will assist management in monitoring audit follow-up efforts and ensuring sufficient evidence exists to demonstrate corrective actions taken and to support that controls are operating effectively to fully resolve the audit findings.

The following paragraphs summarize our corrective action plans taken and planned for resolving the findings.

<u>Finding 1</u>: Prior Finding Not Resolved: MSRS did not identify, analyze, and document its internal controls related to financial reporting and business operations, which also has resulted in delays in issuing its financial statements in a timely manner.

Recommendation:

- ***MSRS should develop and implement a comprehensive internal control structure in order to prepare accurate and timely financial statements. The internal controls structure should identify and document MSRS' financial reporting and business risks, related control procedures, and ways to monitor controls to ensure they are effective and operate as designed.***

We concur with this finding and the auditor's recommendation. In regard to designing and implementing a comprehensive risk assessment over our financial reporting, information systems functions, and other key business processes, we have made it a priority for this fiscal year and this will continue into fiscal year 2013. Thus far in fiscal year 2012, we developed and published a request for proposal for consultant support to perform our initial risk assessment, to identify related controls, and to develop a plan for maintaining the risk assessment. The latter task involves educating staff on using the risk management framework and methodology to perform future risk assessments and ensures that risks and controls are continuously monitored. Contract negotiations are close to being finalized with the selected firm, and we are targeting the contract to commence later this month, with completion prior to October 31, 2012.

As previously mentioned, we also hired an internal control specialist who will begin work for MSRS on May 9. This individual will be responsible for directing and administering the internal control function

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within MSRS. This individual will be actively involved in our initial risk assessment and will take the lead, once this engagement is complete, in performing periodic risk assessments, identifying control strengths and weaknesses, recommending necessary actions to strengthen weak or missing internal controls, and train staff on the internal control framework and their responsibility for effective internal controls.

With respect to implementing control procedures to ensure production of a timely comprehensive annual report (CAFR), we've assigned and trained additional staff resources on the financial reporting process, and we've created better documentation to support the amounts reported on the fiscal year 2011 financial statements for staff's future reference in producing the fiscal year 2012 CAFR. More importantly, we will begin reviewing and finalizing the annual report's content sooner and keep to our publication time line.

Persons responsible for implementing the recommendations include Judy Hunt, Assistant Executive Director and Joan Weber, Finance Manager, with assistance from the new internal control specialist. The target date for resolution of this audit issue is December 31, 2012

<u>Finding 2</u>: Prior Audit Not Resolved: MSRS did not have adequate controls to ensure computer users' access was appropriate. It also allowed employees to perform incompatible duties without establishing mitigating controls.

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 and incompatible access to its business system. If incompatible access is unavoidable, MSRS should implement controls to mitigate the risk of error or fraud.***

We concur with this finding also, and your recommendations. In fiscal year 2012, we made good progress towards resolving this audit issue. To eliminate incompatible access profiles, we modified system access for 44 employees on January 18, 2012.

Planned corrective actions include:

- further restricting employees' access to our business system based on management's review of each user's profile,
- stepping up our efforts to ensure adequate documentation exists of all changes made to users profiles,
- performing periodic management reviews of their subordinates' profiles,
- performing periodic Finance Division review of all users' profiles, and
- finalizing a manual for managers and supervisors use that clearly explains the capabilities associated with each option, identifies incompatible duties and related risks, and provides instructions for completing access request/change forms.

The person responsible for taking corrective action is Lloyd Johnson, Database Administrator. The target date for resolution of this audit issue is December 31, 2012.

<u>Finding 3</u>: MSRS had material weaknesses in its internal controls over several of its financial operations.

Recommendations:

- ***MSRS should improve the information technology controls to ensure that***
  1) ***it only grants access to the information system components to qualified and authorized individuals;***
  2) ***it tests, validates, and documents changes to the information system before implementing the changes; and***
  3) ***it maintains proper documentation to ensure the propriety and accuracy of the changes.***
- ***MSRS should separate incompatible duties in all cited areas to ensure that no one employee has control over an entire process to help eliminate risks of errors and fraud. If incompatible access cannot be segregated, the system should design, document, and implement effective mitigating control reviews.***
- ***MSRS should redesign the payroll exception report to identify all discrepancies between employer contributions and required contributions based on payroll details.***

MSRS also agrees with this finding and supports the auditor's recommendations. Presently, application developers are working with Finance Division personnel to ensure that the application that generates the post-closing trial balance is designed properly to produce accurate beginning balance amounts derived from the general ledger transaction details. The ability to update general ledger transaction accumulators will be restricted to only those individuals who need it to perform their assigned job duties

Persons responsible for improvements in information technology controls include Al Cooley, Systems Supervisor for Application Development, and Nancy Dean, Systems Analysis Unit Supervisor of the Application Development Team. The target date for resolution of this audit finding is June 30, 2012.

To ensure an adequate separation of duties for Minnesota Deferred Compensation Plan (MNDCP) and Health Care Savings Plan (HCSP) cash receipts, we implemented new check handling procedures on January 30, 2012. Records Division staff that open the mail will make a copy of each check received and place a copy of that check in a binder. Records staff will then give the check to the appropriate MNDCP counselor or HSCP supervisor for handling. The Retirement Services Director later reviews and initials copies of the checks to confirm each was correctly logged into the check log and correctly deposited with the record keeper. Persons responsible for resolving this audit issue are Erin Leonard, Assistant Executive Director for Retirement Services, and Lisa Dietz, Records Division Manager.

To ensure the accuracy of manual refund calculations, the Finance Division Manager, Joan Weber will be reviewing and approving all manual refund calculations. This process change will take effect beginning May 7, 2012.

Application developers will work with Retirement Services Division personnel to modify the payroll exception report to identify all discrepancies in payroll details for previous pay periods. Al Cooley, Systems Supervisor for Application Development and Carol Steward, Senior State Program Administrator are the persons responsible for resolving this audit issue by December 31, 2012.

<u>Finding 4</u>: MSRS submitted for audit financial statements, including footnote disclosures, that contained several errors.

Recommendation:

- ***MSRS should review its financial reporting process to identify changes necessary to improve the accuracy of its financial reporting process.***

We concur with this finding and recommendation also. We are currently working with our record keeper to improve the financial reporting process for our defined contribution funds. System improvements are being made to ensure the accuracy of the defined contribution accounts receivable amounts. Our plans to implement control procedures to ensure production of a timely CAFR will ensure that all necessary adjusting journal entries are incorporated into the financial statements by mid-October, 2012. Lastly, we will be modifying our investment footnote disclosure for our fiscal year 2012 financial statements to reflect data required by governmental generally accepted accounting principles.

Persons responsible for resolving this finding by December 31, 2012 are Judy Hunt, Assistant Executive Director, and Joan Weber, Finance Manager.

We appreciate the opportunity to respond to your report comments. We value 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,

Dave Bergstrom

Dave Bergstrom
Executive Director

cc: Judy Hunt
Joan Weber
Carol Steward
Erin Leonard
Nancy Dean
Internal Control Specialist
Al Cooley
Lloyd Johnson