

**STATE BOARD OF INVESTMENT  
FINANCIAL AND COMPLIANCE AUDIT  
FOR THE YEAR ENDED OCTOBER 31, 1985**

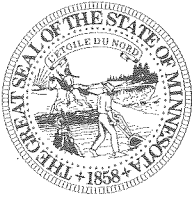
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**FEBRUARY 1986**

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Program Evaluation Division  
Office of the Legislative Auditor  
State of Minnesota





STATE OF MINNESOTA

OFFICE OF THE LEGISLATIVE AUDITOR

VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708

JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Randolph W. Peterson, Chairman  
Legislative Audit Commission

Members of the Legislative Audit Commission

and

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

Audit Scope

We have completed a financial and compliance audit of the State Board of Investment for the year ended June 30, 1985. Our audit was made in accordance with generally accepted auditing standards, and the standards for financial and compliance audits contained in the U.S. General Accounting Office Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, and accordingly, included such audit procedures as we considered necessary in the circumstances. Field work was completed on November 22, 1985.

The objectives of the audit were to:

- express an opinion on the financial statements of the State Board of Investment (SBI) for the year ended June 30, 1985;
- study and evaluate major SBI internal control systems, including a review of investment transactions and administrative disbursements; and
- verify that financial transactions were made in accordance with applicable laws, regulations, and policies, including Minnesota Statute Chapter 11A and other finance-related laws and regulations.

The management of SBI is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly.

Senator Randolph W. Peterson  
Members of the Legislative Audit Commission  
and  
Mr. Howard J. Bicker  
Page 2

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

The management of SBI is also responsible for the agency's compliance with laws and regulations. In connection with our audit, we selected and tested transactions and records from the programs administered by SBI. The purpose of our testing of transactions was to obtain reasonable assurance that SBI had, in all material respects, administered their programs in compliance with applicable laws and regulations.

### Conclusions

We have issued an unqualified opinion on the SBI financial statements for the year ended June 30, 1985. Our audit opinion, dated November 22, 1985, is included within the 1985 SBI Annual Report.

In our opinion, except for the issues raised in Section I, the SBI system of internal accounting control in effect on June 30, 1985, taken as a whole, was sufficient to provide management with reasonable, but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly.

In our opinion, for the year ended June 30, 1985, SBI administered its' programs in compliance, in all material respects, with applicable finance-related laws and regulations.

Section I of this Audit Report contains the recommendations we developed during this audit. It is presented to assist you in improving accounting procedures and controls. Progress on implementing these recommendations will be reviewed during our audit next year. Section II of this report includes a summary of the progress on all recommendations developed during our fiscal year 1984 audit.

We would like to thank the State Board of Investment staff for the cooperation extended to us during this audit.



James R. Nobles  
Legislative Auditor



John Asmussen, CPA  
Deputy Legislative Auditor

February 21, 1986

# STATE BOARD OF INVESTMENT

## TABLE OF CONTENTS

	<u>Page</u>
I. CURRENT FINDINGS AND RECOMMENDATIONS	1
II. STATUS OF PRIOR AUDIT RECOMMENDATIONS	3
AGENCY RESPONSE	5

## AUDIT PARTICIPATION

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

John Asmussen, CPA	Deputy Legislative Auditor
Claudia Gudvangen, CPA	Audit Manager
Jay Stoffel	Auditor-in-Charge
Brad Olson	Staff Auditor
Kathy Quandt	Staff Auditor
Kari Bergum	Staff Auditor
Kevin Kirchenwitz	Intern

The findings and recommendations in this report were discussed with the following staff of the State Board of Investment on February 4, 1986:

Howard Bicker	Executive Director
Jeff Bailey	Assistant Executive Director
Mike Schmitt	Administrative Director



## STATE BOARD OF INVESTMENT

### SECTION I. CURRENT FINDINGS AND RECOMMENDATIONS

Certain securities loaned out by SBI were backed by insufficient collateral from the borrower.

As a method of earning additional income, SBI loans out U.S. government and government agency securities to banks and brokers. During fiscal 1985, there were approximately 1400 loans initiated which earned \$1,736,000 in additional income. Internal guidelines developed by SBI specify that collateral in the amount of 102-105 percent of the market value of the loaned security is required from the borrower.

We tested the collateral for a sample of 37 loaned securities outstanding on June 30, 1985. Seventeen of the loans tested were backed by collateral with a market value of less than 102 percent of the market value of the security loaned. Of these 17, six were backed by collateral valued at less than 100 percent of the value of the security loaned, including one loan collateralized at only 86 percent. The insufficient collateral on some loans is due to fluctuations in the market value of both the securities loaned and the collateral. Failure to monitor market value may expose the loaned securities to excess risk.

#### *RECOMMENDATION:*

- 1. SBI should more closely monitor the market value of securities loaned and the collateral on loans. Additional collateral should be required from the borrower if the market value of the collateral falls below 102 percent of the market value of the security loaned.*

SBI does not have a current policy on reimbursement of travel and other expenses of board members and their staffs.

The State Board of Investment is a policy-making board composed of five Constitutional Officers. The board is supported by a staff under the direction of an Executive Director. SBI receives a General Fund appropriation to fund its activities. A portion of the costs incurred by the board are subsequently reimbursed by the various retirement funds for which SBI provides investment services. Each of the Constitutional Officers who serve on the board also receive General Fund appropriations to fund the activities of their respective offices.

Generally, members of policy-making boards are entitled to reimbursement for expenses incurred in performing their duties in these positions. This may include attendance at meetings, as well as participation in other job-related activities such as training seminars and conferences. The expenses are paid from the various funding sources which support the different boards. In most cases, the board members are not state employees. The State Board of Investment is somewhat unique in that its membership,

## STATE BOARD OF INVESTMENT

as established in the Constitution, is composed entirely of state officials. A question then arises as to whether the expenses of board members should be paid from their individual appropriations or from the appropriation made to SBI to administer its' activities.

At its meeting in June 1982, the board adopted a motion to allocate \$5,000 of the SBI appropriation for fiscal year 1983 to out-of-state travel for the board members and their deputies. We found no evidence that such an allocation was formally adopted by the board for subsequent years. However, certain board members, as well as members of their staffs, have traveled out-of-state and had their expenses paid by SBI.

During the period July 1984 through November 1985, approximately \$6,400 was expended by SBI on out-of-state travel by board members and their staffs. In some instances, the purpose of the travel was to attend annual conferences of professional organizations. In other cases, it was to attend special meetings of investment related organizations. Two board members and their deputies, and a representative of a third board member were the only ones to take advantage of the arrangement to have SBI finance their travel to various locations. The travel included conferences or meetings in Alabama, Puerto Rico, Illinois, Massachusetts, Hawaii, New York and Georgia. We are not questioning whether the trips served a public purpose. However, we do question whether the current system provides equity among board members or a proper accountability over the travel of these elected officials. Since the expenditures are not charged to their individual budgets, the board members are not individually held accountable for the type or location of their travel.

It may be argued that this travel by board members and their staffs related specifically to their duties and responsibilities in establishing investment policy for the state, rather than to their individual duties as Constitutional Officers. If this is the philosophy of the board, we believe that they should formally adopt a policy on allowable travel by board members and their staffs and the procedures to be followed in obtaining approval for such travel. This information is needed in order for SBI to monitor its budget each year. In addition, without formal authorization, the Executive Director is placed in the difficult position of approving or disapproving such travel.

### RECOMMENDATION:

2. *The State Board of Investment should establish a formal policy on reimbursement of out-of-state travel by board members and their staffs. In addition, they should annually establish a budgeted amount for such travel and the procedures for approving expenditures for this purpose.*

STATE BOARD OF INVESTMENT

SECTION II. STATUS OF PRIOR AUDIT RECOMMENDATIONS  
AND

PROGRESS TOWARD IMPLEMENTATION

Documentation provided to user agencies for SBI's computerized investment accounting system is inadequate.

1. SBI should develop and provide each user agency with a user's manual for the computerized accounting system. In addition, information should be provided for the retirement systems on the data included in the master custodian reports identifying any differences from the accounting system reports.

*Recommendation Implemented.*

SBI does not adequately process and monitor the billings for reimbursement of their administrative expenditures.

2. SBI should calculate and process billings for their administrative costs by the end of the first month following each quarter.
3. SBI should establish a system to record the amounts billed and paid each quarter for all retirement funds. SBI should monitor payments for both the funds they administer and the basic retirement funds to ensure that the General Fund receives the reimbursements in a timely manner.

*Recommendations Implemented.*

SBI has not complied with guidelines concerning disposition of airline benefits received by state employees.

4. SBI should inform staff of the state requirement concerning disposition of airline benefits received when traveling at state expense.
5. Airline benefits received by SBI staff while traveling at state expense should be returned to SBI and used for departmental travel. Any airline tickets used for personal travel should be refunded to the state.

*Recommendations Implemented.*

STATE BOARD OF INVESTMENT

There is inadequate documentation and control over certain fixed assets at SBI.

6. SBI should formally document all agreements with outside vendors to properly identify ownership rights relating to all fixed assets in the possession of SBI. All fixed assets should either be recorded on the statewide fixed asset inventory system or maintained on other records and marked to distinguish them from state-owned property.

*Recommendation Implemented.*

SBI has inadequate segregation of duties in the administrative disbursement area.

7. The functions of approving and processing payments should be segregated so that one individual does not perform both procedures.

*Recommendation Implemented.*

MEMBERS OF THE BOARD:  
GOVERNOR RUDY PERPICH  
STATE AUDITOR ARNE H. CARLSON  
STATE TREASURER ROBERT W. MATTSON  
SECRETARY OF STATE JOAN ANDERSON GROWE  
ATTORNEY GENERAL HUBERT H. HUMPHREY III



EXECUTIVE DIRECTOR  
HOWARD J. BICKER

STATE OF MINNESOTA  
STATE BOARD OF INVESTMENT

Room 105, MEA Building  
55 Sherburne Avenue  
Saint Paul 55155  
296-3328

February 21, 1986

Mr. James R. Nobles  
Legislative Auditor  
Veterans Service Building  
St. Paul, Mn. 55155

Dear Mr. Nobles

In response to your draft management letter and the recommendations contained therein we would like to make the following comments.

Recommendation number 1 deals with the monitoring of collateral on security loans.

- 1). Staff is currently working on developing a new computer system which will more efficiently track the market value of securities on loan and the collateral backing those loans.
- 2). Until this new system is completed, staff will manually check the market value of loaned securities and collateral.

Recommendation number 2 relates to the reimbursement of travel expenses for board members and their staffs.

- 1). The Administrative and Asset Allocation Committees of the Investment Advisory Council will recommend that the Board adopt the following policy:

For fiscal year 1986 and 1987, each Board member and/or staff may utilize up to \$2,000 of the SBI,s budget for travel. All travel shall be for SBI-related activities. Reimbursements shall comply with general State guidelines adopted by the Commissioner of Employee Relations.

The responsibility for implementing these recommendations rests with the Administrative Director.

Sincerely,

A handwritten signature in cursive script that reads "Howard Bicker".

Howard Bicker  
Executive Director