

State Board of Investment

Statewide Financial Audit For the Fiscal Year Ended June 30, 1996

January 1997

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Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

97-5



STATE OF MINNESOTA

OFFICE OF THE LEGISLATIVE AUDITOR

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Representative Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Board of Investment

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

We have audited the financial statements of the Minnesota State Board of Investment (SBI) as of and for the fiscal year ended June 30, 1996, as further explained in the Background Information section of this report. The work conducted in the department is part of our Statewide Audit of the state of Minnesota's fiscal year 1996 financial statements. SBI's Annual Report for the year ended June 30, 1996, includes our unqualified audit opinion, dated December 2, 1996, on the Supplemental Investment Fund and the Post Retirement Fund financial statements. The following Summary highlights the audit objectives and conclusions.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards also require that we design the audit to provide reasonable assurance that SBI complied with provisions of laws, regulations, contracts, and grants that are significant to the audit. The management of SBI is responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, contracts, and grants.

This report is intended for the information of the Legislative Audit Commission and the management of SBI. This restriction is not intended to limit the distribution of this report, which was released as a public document on January 24, 1997.

A handwritten signature in black ink, appearing to read "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in black ink, appearing to read "John Asmussen".

John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 2, 1996

Report Signed On: January 17, 1997

SUMMARY

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State Board of Investment Statewide Financial Audit For the Fiscal Year Ended June 30, 1996

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No. 97-5

Background Information

The Minnesota State Board of Investment (SBI) administers and directs the investment of state funds, primarily retirement funds. Minn. Stat. Chapter 11A governs the investment activities of the board. Howard J. Bicker is the executive director of the board.

The board uses both internal staff and external investment managers to fulfill its responsibilities. The external firms invest and manage the assets of the Post Retirement Fund and Supplemental Investment Fund, as well as the assets of the basic retirement funds and the assigned risk plan. The basic retirement funds contain the pension assets of the active participants in the following eight statewide retirement plans: Teachers Retirement Fund, Public Employees Retirement Fund, State Employees Retirement Fund, Public Employees Police and Fire Fund, Police and Fire Consolidation Fund, Highway Patrol Retirement Fund, Correctional Employees Fund, and Judges Retirement Fund. SBI staff manage the other investments.

Audit Objectives

The primary objective of our audit was to render an opinion on the Investment Trust Fund financial statements. These financial statements are included both in SBI's Annual Report and in the state of Minnesota's Comprehensive Annual Financial Report for fiscal year 1996. Our objective included determining whether SBI's financial statements presented fairly the financial position, results of operations, and changes in net assets in conformity with generally accepted accounting principles.

As part of our work, we gained an understanding of the internal control structure over investment purchases and sales, investment custody and valuation, investment income collection and allocation, and management fee payments and reimbursement cycles. We also ascertained whether SBI complied with laws and regulations that may have had a material effect on its financial statements.

Conclusions

SBI's Annual Report for the year ended June 30, 1996, includes our unqualified audit opinion, dated December 2, 1996, on the Investment Trust Fund's financial statements. The SBI financial statements are also included in the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1996, which includes our audit opinion dated December 2, 1996. We found that SBI designed and implemented a system of management controls to provide reasonable assurance that investments were adequately safeguarded, authorized, and properly recorded in accounting records and financial statements. For the items tested, SBI complied with material financial legal provisions.

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Audit Participation

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

John Asmussen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Michael Hassing	Audit Director
Karen Dewald	Auditor
Beaujon Guerin	Auditor
Matthew Hoffer	Auditor
Neal Huhnerkoch	Intern

Exit Conference

We discussed this report and minor issues involving the internal control structure with the following SBI staff at an exit conference on January 14, 1997:

Howard Bicker	Executive Director
Beth Lehman	Assistant Executive Director
L. Michael Schmitt	Administrative Director

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Chapter 1. Background Information

The Minnesota State Board of Investment (SBI) administers and directs the investment of state funds, primarily retirement funds. Article XI, Section 8, of the Constitution of the state of Minnesota created the State Board of Investment. The board is comprised of the governor, state auditor, state treasurer, secretary of state, and attorney general. Minn. Stat. Chapter 11A governs the investment activities of the board. Howard J. Bicker is the executive director of the board.

The Legislature has also established a 17 member Investment Advisory Council to advise the board and its staff on investment related matters. All proposed investment policies, including asset allocation and investment manager selection, are reviewed by the full council before they are presented to the board for official action. The council is comprised of ten members from the corporate investment community, the state commissioner of Finance, the executive directors of the three statewide retirement systems, and three employee plan participants.

The board uses both internal staff and external investment managers to fulfill its responsibilities. The external firms invest and manage the Post Retirement Fund and Supplemental Investment Fund, as well as the assets of the basic retirement funds and the assigned risk plan. SBI staff manage the other investments. The Post Retirement Fund is composed of the reserves or retirement benefits to be paid to retired employees. The Supplemental Investment Fund includes assets of the state employee deferred compensation plan, the unclassified employee retirement plan, and various other supplemental retirement programs.

The basic retirement funds contain the pension assets of the active participants in eight statewide retirement plans:

- Teachers Retirement Fund
- State Employees Retirement Fund
- Police and Fire Consolidation Fund
- Correctional Employees Fund
- Public Employees Retirement Fund
- Public Employees Police and Fire Fund
- Highway Patrol Retirement Fund
- Judges Retirement Fund.

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Table 1-1 shows the total funds under the management of the SBI as of June 30, 1996.

Table 1-1
Market Value of Investments by Fund
At June 30, 1996
(in millions)

<u>Fund</u>	<u>Amount</u>
Basic Retirement Funds	\$13,147
Post Retirement Fund	11,916
State Cash Accounts	4,503
Supplemental Investment Fund	799
Assigned Risk Plan	538
Permanent School Fund	417
Environmental Trust Fund	<u>138</u>
Total	<u>\$31,458</u>

Source: State Board of Investment fiscal year 1996 annual report.

The primary objective of our audit was to render an opinion on the Investment Trust Fund financial statements. The Investment Trust Fund is comprised of the Post Retirement Fund and the Supplemental Investment Fund. These financial statements are included both in SBI's Annual Report and in the state of Minnesota's Comprehensive Annual Financial Report for fiscal year 1996. Our objective included determining whether the financial statements presented fairly the financial position, results of operations, and changes in net assets in conformity with generally accepted accounting principles.

As part of our work, we gained an understanding of the following internal control cycles:

- investment purchases and sales,
- investment custody and valuation,
- investment income collection and allocation, and
- management fee payments and reimbursements.

We also ascertained whether SBI complied with laws and regulations that may have had a material effect on its financial statements. In addition, we also considered the annual actuarial valuation performed by the Legislative Commission on Pension and Retirement's actuary. We used the actuarial information to determine the impact of mortality gains and losses on the basic retirement funds participation in SBI's Post Retirement Fund.

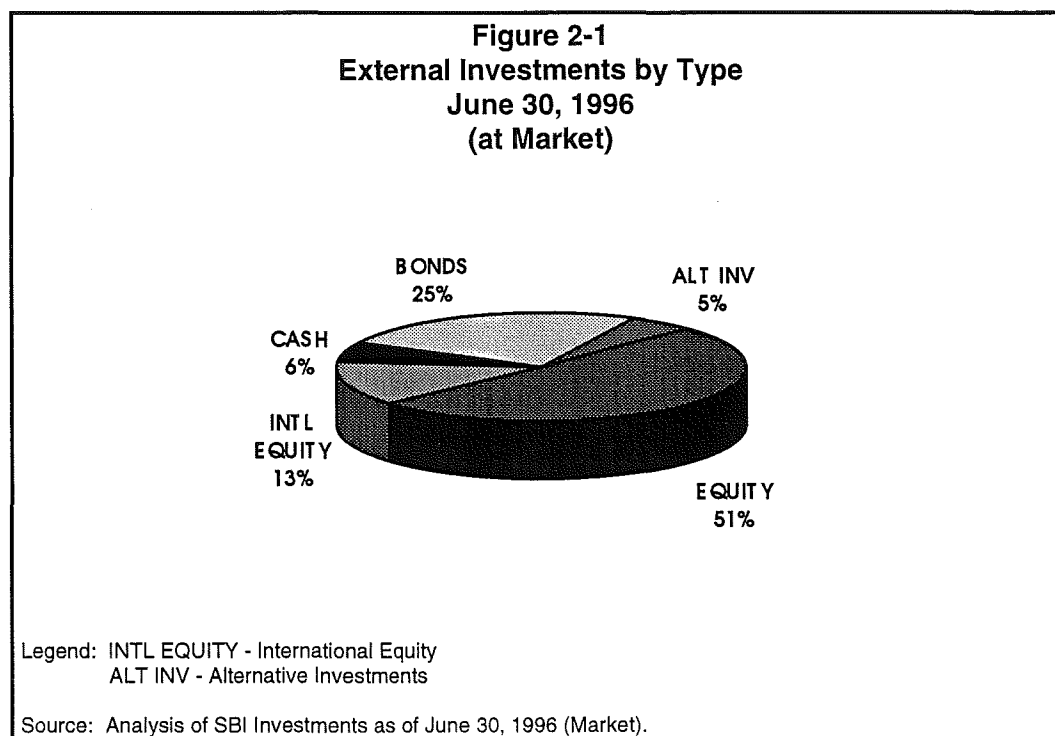
SBI's Annual Report for the year ended June 30, 1996, includes our unqualified audit opinion, dated December 2, 1996, on the Investment Trust Fund's financial statements. The SBI financial statements are also included in the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1996, which also includes our audit opinion dated December 2, 1996.

Chapter 2. External Investment Cycle

Chapter Conclusions

Investments and investment income for externally managed investments were fairly presented in the financial statements. SBI designed and implemented management controls to provide reasonable assurance that investments managed by private investment firms were adequately safeguarded, and that investments were authorized and properly recorded in the accounting records and financial statements. SBI also complied with material financial legal provisions relating to investments for those items tested.

SBI contracts with outside investment management firms to invest the majority of retirement assets under its control. To gain greater operating efficiency, the external managers are grouped into several investment pools which are segregated by asset class. This investment management structure allows SBI to gain greater operating efficiency within asset classes and keeps management costs as low as possible for all participants. Figure 2-1 shows the main classes of assets by type. Alternative investments include real estate, resources (oil and gas), and venture capital accounts.



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SBI has contracts with approximately 85 external investment managers, of which nearly one-half are retained as alternative investment pool managers. The board has the authority to invest up to 15 percent of the assets in the alternative investment market, but has not yet fully funded this pool.

SBI evaluates the investment managers based on performance against preestablished benchmarks. If a manager fails to meet the expected rate-of-return, the manager's contract may be terminated and funds reinvested with another manager. SBI meets with all of the external managers at least once a year.

The investing and recording of investment transactions is a complicated, multidimensional process. All external manager trades and investment transactions must clear through the state's custodial bank, State Street Bank and Trust of Boston, Massachusetts. The custodial bank has the authority to process investment transactions on behalf of SBI. The asset managers do not have physical access to cash or investment securities. The custodial bank maintains access to the cash accounts of the external investment managers. Any uninvested cash from the managers' accounts is invested by the custodial bank.

The custodial bank has a group of employees dedicated exclusively to the Minnesota SBI account. This group records and verifies all investment transactions. The custodial bank provides monthly reports to SBI for all investment transactions and balances. As an additional control, SBI contracts with Financial Control Systems, an accounting service in Philadelphia, Pennsylvania, that receives data directly from State Street Bank for all investment transactions. This service produces detailed asset listings and transaction reports with independent pricing verification which are forwarded to SBI. The physical custody of stocks and securities is maintained by the Depository Trust Company in New York.

We focused our audit of external investments on the following questions:

- Were the investment balances and associated investment income fairly presented in the financial statements?
- Did SBI design and implement management controls to provide reasonable assurance that investments were adequately safeguarded, and that transactions were authorized and properly reported in the accounting records and financial statements? Our objective in reviewing management controls over investments was not to provide an opinion on the effectiveness of the controls.
- Did SBI comply with material financial legal provisions related to the investment of assets?

Our audit methodology included confirming investment balances with all external managers. We then verified the confirmed balances with State Street Bank and Financial Control Systems' investment records. We also reconciled the accounts for timing and transaction differences to verify the accuracy of accounting reports, which are used for financial statement preparation. We verified the valuation of a sample of securities to an independent pricing source. We also

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reviewed an independent auditor's report on the internal control policies and procedures of custody functions at State Street Bank.

We found that SBI fairly presented investments and investment income in the financial statements. SBI designed and implemented management controls to provide reasonable assurance that investments were adequately safeguarded, and that investments were authorized and properly recorded in the accounting records and financial statements. For the items tested, we found that SBI complied with material financial legal provisions.

Chapter 3. Internal Investment Cycle

Chapter Conclusions

Investments and investment income for internally managed investments were fairly presented in the financial statements. SBI designed and implemented management controls to provide reasonable assurance that investments managed by its own staff were adequately safeguarded, and that investments were authorized and properly recorded in the accounting records and financial statements. SBI also complied with material financial legal provisions relating to investments for those items tested. In addition, SBI ensured the complete and accurate transfer of internally invested assets to the state's new depository bank, First Trust Saint Paul.

SBI is directly responsible for investing the assets of the Permanent School Fund, the Environmental Trust Fund, and the state's cash accounts. The cash accounts, referred to as Trust Fund Pool and Invested Treasurers Cash, represent the cash balances of internally managed retirement fund assets and other state agencies. Table 3-1 shows the values of the internal investments managed by SBI.

Table 3-1
Internally Managed Investments
At June 30, 1996
(in millions)

<u>Fund</u>	<u>Amount</u>
Invested Treasurer Cash	\$3,710
Trust Fund Pool	119
Other State Accounts	674
Permanent School Fund	417
Environmental Trust Fund	<u>138</u>
Total	<u>\$5,058</u>

Source: State Board of Investment fiscal year 1996 annual report.

The state of Minnesota changed custodian banks for internally managed funds and other state accounts in January 1996 to First Trust National Association, Saint Paul, Minnesota. First Trust is the state's custodial and clearing bank for all state accounts. The state transferred cash and investments to First Trust from the predecessor bank in January 1996. First Trust does not have independent authority to enter into investment transactions. SBI must initiate, authorize, and approve all transactions processed by First Trust on behalf of the state.

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SBI established an equity pool and a fixed income pool as investment vehicles for the Permanent School Fund and Environmental Trust Fund. The Permanent School Fund is a trust established for the benefit of Minnesota public schools. Due to statutory limitations, the Permanent School Fund is invested only in fixed income securities. The Environmental Trust Fund is a trust established for the protection and enhancement of Minnesota's environment. State law allows it to be invested in both equity and fixed income securities.

SBI invests the internal cash funds in short-term, liquid, high quality debt securities. These investments include U.S. Treasury and Agency issues, repurchase agreements, bankers acceptances, and commercial paper. The Department of Finance is responsible for allocating the short-term income to the appropriate state accounts and agencies.

SBI initiates investment transactions based on the State Treasurer's determination of available cash on a daily basis. SBI then contacts First Trust Saint Paul to process the investment transaction and to move the cash. Once the short-term investments have cleared at First Trust, SBI enters the transactions directly into the accounting system at Financial Control Systems. SBI reconciles transactions and account balances with both First Trust and Financial Control Systems on a regular basis.

As part of our audit of the internal investment cycle, we focused on the following questions:

- Were the investment balances and associated investment income fairly presented in the financial statements?
- Did SBI design and implement management controls to provide reasonable assurance that investments were adequately safeguarded, and that transactions were authorized and properly reported in the accounting records and financial statements? Our objective in reviewing management controls over investments was not to provide an opinion on the effectiveness of the controls.
- Did SBI comply with material financial legal provisions related to the investment of assets?
- Was the transfer of assets to First Trust completed accurately?

Our audit methodology included confirming investment balances with First Trust Bank and verifying investment balances to Financial Control Systems records. We gained an understanding of the investment process through interviews with SBI staff. We also met with officials from the Department of Finance, State Treasurer's Office, and First Trust Saint Paul to review their responsibilities related to the investment, allocation, and reporting of investment transactions and related income. We verified the valuation of a sample of securities to an independent pricing source. We also reviewed an independent accounting firm's audit report on the internal control policies and procedures of the Institutional Trust Group of First Trust Saint Paul.

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We found that SBI fairly presented investments and investment income in the financial statements. We found that the SBI designed and implemented management controls to provide reasonable assurance that investments were adequately safeguarded, and that transactions were authorized and properly reported in the accounting records. For the items tested, we found that SBI complied with material financial legal provisions for investments. We also found that the transfer of assets to the new custodian bank was completed accurately.