

Minnesota State Board of Investment

Financial Audit

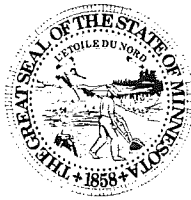
Fiscal Year Ended June 30, 1997

January 1998

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**Financial Audit Division
Office of the Legislative Auditor
State of Minnesota**

98-3



STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Deanna Wiener, 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, 1997, as further explained in Chapter 1. The work conducted in the department is part of our Statewide Audit of the State of Minnesota's fiscal year 1997 financial statements. SBI's Annual Report for the year ended June 30, 1997, includes our unqualified audit opinion, dated December 8, 1997, 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 29, 1998.

James R. Nobles
Legislative Auditor

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 8, 1997

Report Signed On: January 23, 1998

SUMMARY

State of Minnesota

Office of the Legislative Auditor

1st Floor Centennial Building

658 Cedar Street • St. Paul, MN 55155

(612)296-1727 • FAX (612)296-4712

TDD Relay: 1-800-627-3529

email: auditor@state.mn.us

URL: <http://www.auditor.leg.state.mn.us>

Minnesota State Board of Investment Financial Audit Fiscal Year Ended June 30, 1997

Public Release Date: January 29, 1998

No. 98-3

Background Information

The Minnesota State Board of Investment (SBI) administers 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. SBI staff manage the other investments.

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.

Audit Objectives and Scope

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 1997. 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 and allocation, security lending income 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. In addition, we audited administrative expenditures.

Conclusions

SBI's Annual Report and the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1997, include our unqualified audit opinions on the Investment Trust Fund's financial statements dated December 8, 1997. We found that SBI designed internal controls to provide reasonable assurance that investments were adequately safeguarded, authorized, and properly recorded in accounting records and financial statements. SBI designed controls to provide reasonable assurance that administrative expenditures were authorized for a proper purpose and accurately recorded in the accounting records and financial statements. For items tested, we also found SBI to be in compliance with material financial legal provisions.

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Audit Participation

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

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Michael Hassing	Audit Director
Beaujon Guerin	Auditor
Susan Kong	Auditor
Marina Mirman	Auditor
Rick Weinmeyer	Auditor
Keith Bispala	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 22, 1998:

Howard Bicker	Executive Director
L. Michael Schmitt	Administrative Director
Mansco Perry	Manager, Research and Development

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 also established a seventeen member Investment Advisory Council to advise the board and its staff on investment matters. The full council reviews all proposed investment policies, including asset allocation and investment manager selection, 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 and 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 deferred compensation plan, other supplemental retirement plans, various retirement funds for local police and firefighters, and the unclassified employees of the state.

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.

SBI prepares its financial statement in accordance with pronouncements of the Governmental Accounting Standards Board (GASB). In fiscal year 1997, SBI implemented GASB Statement No. 28 titled "Accounting and Financial Reporting for Securities Lending Transactions." This statement requires disclosure of financial activity related to securities lending transactions.

State Board of Investment

Table 1-1 shows the total funds under the management of the State Board of Investment as of June 30, 1997.

Table 1-1
State Board of Investment
Market Value of Investments by Fund
At June 30, 1997
(in millions)

<u>Fund</u>	
Basic Retirement Funds	\$15,914
Post Retirement Fund	14,323
State Cash Accounts	4,816
Supplemental Investment Fund	990
Assigned Risk Plan	591
Permanent School Fund	437
Environmental Trust Fund	<u>179</u>
Total	<u>\$37,250</u>

Source: State Board of Investment Fiscal Year 1997 annual report.

Audit Scope, Objectives, and Conclusions

The primary objective of our audit was to render an opinion on the financial statements of the Post Retirement Fund and the Supplemental Investment Fund which comprise the Investment Trust Funds of the state of Minnesota. 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 1997. 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. We also ascertained whether SBI complied with laws and regulations that may have had a material effect on its financial statements.

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.

In addition, we 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 and assumption changes on the basic retirement funds participation in SBI's Post Retirement Fund.

SBI's Annual Report and the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1997, include our unqualified audit opinions on the Investment Trust Fund's financial statements, dated December 8, 1997.

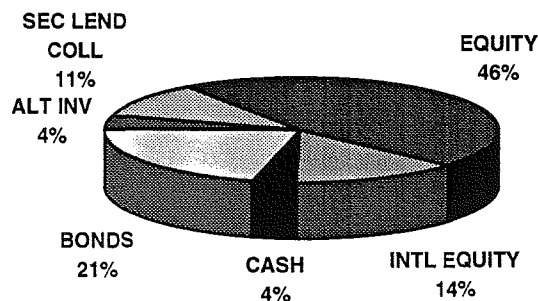
Chapter 2. External Investment Cycle

Chapter Conclusions

Investments and investment income for externally managed investments were fairly presented in the financial statements. The State Board of Investment designed internal 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. The State Board of Investment also complied with material financial legal provisions relating to investments for those items tested, except that SBI exceeded the authorized limit of stock ownership in two companies for a period of time.

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

Figure 2-1
State Board of Investment
Retirement Fund Investments by Type
June 30, 1997
(at Market)



Legend: INTL EQUITY - International Equity
ALT INV - Alternative Investments
SEC LEND COLL - Security Lending Cash Collateral

Source: Analysis of SBI Investments as of June 30, 1997.

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SBI contracts with approximately 80 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' performance against preestablished benchmarks. If a manager fails to meet the expected rate-of-return, SBI may terminate the contract and reinvest funds 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). The custodial bank, in accordance with its contract, 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 records and verifies all SBI 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 Pennsylvania that receives data directly from State Street Bank for all investment transactions. This service prepares detailed asset listings and transaction reports with independent pricing verification for SBI. The physical custody of stocks and securities is maintained by the Depository Trust Company in New York.

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

- Were the investment balances and associated investment income fairly presented on the financial statements?
- Did SBI design internal 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?
- 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 reviewed an independent auditor's report on the policies and procedures of custody functions at State Street Bank. We verified that SBI reported assets and income associated with security lending transactions in compliance with Governmental Accounting Standards Board (GASB) Statement No. 28.

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We found that SBI fairly presented investments and investment income in the financial statements. SBI designed internal 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.

We noted, however, that SBI exceeded the authorized limit of stock ownership in two companies. Minn. Stat. Section 11A.24 Subd. 5(b) limits SBI's investment to no more than five percent of the total outstanding shares of any company. SBI had stock ownership of approximately 16 and 7 percent of the two companies, respectively. The total value of the SBI's ownership in excess of the five percent restriction for these two companies was approximately \$1.1 million. SBI identified the noncompliance and initiated corrective action in August 1996. SBI instructed the equity manager to liquidate the securities. Due to the restricted nature of the private placement securities, however, the manager could not sell the securities for a period of time. The securities were ultimately liquidated in September 1997. SBI made two policy changes as a result of this situation. First, portfolio managers are no longer allowed to purchase restricted stock or private placement offerings. In addition, SBI will monitor compliance with the stock ownership limitation on a quarterly basis rather than annually. For all other 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. The State Board of Investment (SBI) designed internal controls to provide reasonable assurance that investments managed by its 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.

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
State Board of Investment
Internally Managed Investments
At June 30, 1997
(in millions)

<u>Fund</u>	
Invested Treasurer Cash	\$4,297
Trust Fund Pool	44
Permanent School Fund	437
Environmental Trust Fund	179
Other State Accounts	<u>475</u>
Total	<u>\$5,432</u>

Source: SBI Annual Report 1997.

First Trust National Association, Saint Paul, Minnesota, was the state's custodial and clearing bank for all internally managed state accounts during fiscal year 1997. 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. On July 1, 1997, SBI transferred the custodial duties for the Permanent School Fund, Environmental Trust Fund and the Assigned Risk Plan to State Street Bank, Boston.

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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 fund established for the benefit of Minnesota public schools. Historically, the Permanent School Fund only invested 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. 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 on the financial statements?
- Did SBI design internal 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?
- Did SBI comply with material financial legal provisions related to the investment of assets?

Our audit methodology included verifying investment balances recorded at First Trust Bank and Financial Control Systems. We gained an understanding of the investment process through interviews with SBI staff. We also discussed investment operations and responsibilities with officials from the Department of Finance, State Treasurer's Office, and First Trust Saint Paul. We verified the valuation of a sample of securities to an independent pricing source. We also reviewed an independent accounting firm's most current audit report on the policies and procedures of the Institutional Trust Group of First Trust Saint Paul.

We found that SBI fairly presented investments and investment income in the financial statements. We found that the State Board of Investment designed internal 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.

Chapter 4. Administrative Expenditures

Chapter Conclusions

The State Board of Investment designed internal controls to provide reasonable assurance that administrative expenditures were authorized and properly recorded in the accounting records and financial statements. The State Board of Investment also complied with material financial legal provisions relating to payroll and other administrative expenses for those items tested.

SBI receives a General Fund appropriation to finance its administrative expenditures. SBI's administrative budget for fiscal year 1997 was approximately \$2.1 million. (SBI also incurs management investment fees that are charged back to the participating funds. Those expenditures are not addressed in this chapter.) SBI uses the budgetary and processing controls established by the Department of Finance through the MAPS and SEMA4 accounting systems for administrative expenditures. SBI's primary expenditure is for payroll, which totaled \$1.6 million during fiscal year 1997, or about 74 percent of the total expenditures. Table 4-1 summarizes SBI's fiscal year 1997 General Fund administrative expenditures by type.

Table 4-1
State Board of Investment
General Fund Administrative Expenditures
Fiscal Year 1997

<u>Type</u>	<u>Amount</u>	<u>Percent of Total</u>
Payroll	\$1,582,926	74%
General Operations	388,711	18%
Supplies and Equipment	103,502	5%
Travel	<u>53,223</u>	<u>3%</u>
Total Administrative Expenditures	<u>\$2,128,362</u>	<u>100%</u>

Source: FY97 SBI Administrative Expenditures per MAPS.

As part of our audit of administrative expenditures, we focused on the following questions:

- Did SBI design internal controls to provide reasonable assurance that transactions for administrative expenditures represented reasonable and valid obligations, were properly authorized and accurately recorded in the MAPS and SEMA4 accounting systems?
- Did SBI comply with material financial legal provisions related to administrative expenditures?

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Our audit methodology included gaining an understanding of the administrative expenditure transaction process through interviews with SBI staff. We verified compliance with state statutes and Department of Finance operating procedures. We applied analytical procedures comparing administrative costs for fiscal years 1997 and 1996. We investigated any significant variances. We performed detailed tests of transactions for payroll and other administrative expenditures.

We found that the State Board of Investment designed controls to provide reasonable assurance that transactions for administrative expenditures were authorized and properly recorded in the accounting records and systems. For the items tested, we found that SBI complied with material financial legal provisions for administrative expenditures.

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Status of Prior Audit Issues As of December 1, 1997

Most Recent Audits

The January 24, 1997, Legislative Audit Report 97-5 covered the fiscal year ended June 30, 1996, and had no reportable issues. The audit scope included the Investment Trust Funds and the related external and internal investment cycles. We audit the State Board of Investment on an annual basis. There have been no reportable issues in recent audits.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the Metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.