

Public Employees Retirement System

Financial Audit

Fiscal Year Ended June 30, 1997

February 1998

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

98-4



STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
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Public Employees Retirement Association

Mary Most Vanek, Executive Director
Public Employees Retirement Association

We have audited the financial statements of the Public Employees Retirement Association (PERA) as of and for the fiscal year ended June 30, 1997, as further explained in the Background section of this report. The work conducted in the department is part of our Statewide Audit of the state of Minnesota's fiscal year 1997 financial statements. PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997, includes our unqualified audit opinion thereon, dated December 8, 1997. The following summary highlights the audit objectives and conclusions.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of internal controls relevant to the audit. The standards also require that we design the audit to provide reasonable assurance that PERA complied with provisions of laws, regulations, contracts, and grants that are significant to the audit. The management of PERA 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 PERA. This restriction is not intended to limit the distribution of this report, which was released as a public document on February 5, 1998.

A handwritten signature in cursive script, reading "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in cursive script, reading "Claudia Gudvangen".

Claudia Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 8, 1997

Report Signed On: January 30, 1998

SUMMARY

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Public Employees Retirement Association

Financial Audit

For the Fiscal Year Ended June 30, 1997

Public Release Date: February 5, 1998

No. 98-4

Agency Background

The Public Employees Retirement Association (PERA) administers pension funds that serve approximately 200,000 county, school, and local public employees, their survivors and dependents. Approximately 2,000 separate Minnesota government units participate in the retirement funds administered by PERA. These units include counties, cities, townships, and school districts.

The association administers three defined benefit funds. These funds provide retirement annuities and survivor and disability benefits to members. The PERA Board of Trustees is responsible for administering these funds in accordance with state statutes and has a fiduciary obligation to PERA's members, the employers, and the state. PERA also administers a defined contribution plan. PERA assets at June 30, 1997, totaled approximately \$12.5 billion for all of its retirement plans.

Audit Objectives and Scope

The primary objective of our audit was to render an opinion on PERA's financial statements. These financial statements are included in both PERA's and in the state of Minnesota's Comprehensive Annual Financial Report for fiscal year 1997. Our objective included determining whether PERA's financial statements presented fairly its financial position, results of operations, and changes in cash flows in conformity with generally accepted accounting principles.

As part of our work, we gained an understanding of the internal control structure and ascertained whether PERA complied with laws and regulations that may have a material effect on its financial statements. During our audit, we gained an understanding of the contributions, annuities, refunds, Police and Fire Consolidation Fund mergers, and the financial statement preparation cycles. We also tested the association's administrative expenditures.

Conclusions

PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997, includes our unqualified audit opinion thereon, dated December 8, 1997. The PERA financial statements are also included in the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1997, which includes our audit opinion dated December 8, 1997. PERA designed internal controls for its material financial activities and complied with material legal provisions for the items tested.

Public Employees Retirement Association

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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
Carl Otto, CPA, CISA	Auditor-in-Charge
Jason Stauffenecker	Auditor

Exit Conference

We discussed the results of the audit at an exit conference with the following PERA staff on January 29, 1998:

Mary Most Vanek	Executive Director
David DeJonge	Manager of Finance
Gary Hovland	Senior Accounting Supervisor

Public Employees Retirement Association

Chapter 1. Background

The Public Employees Retirement Association (PERA) administers pension funds that serve approximately 200,000 county, school, and local public employees, their survivors and dependents. Approximately 2,000 separate Minnesota government units participate in the retirement funds administered by PERA. These units include counties, cities, townships, and school districts.

The association administers the following defined benefit funds. These funds provide retirement annuities and survivor and disability benefits to members.

Basic Plan: Participants in this plan are public employees hired prior to January 1, 1968, who did not elect to be covered by social security benefits. This plan is closed to new members.

Coordinated Plan: Members in this plan include public employees other than police officers and firefighters. Coordinated members are covered by social security benefits.

Police and Fire Fund: Originally established for police officers and firefighters not covered by a local relief association, the fund now covers all police officers and firefighters hired since 1980.

Police and Fire

Consolidated Fund: Legislation passed in 1987 allows local police and salaried firefighters' relief associations to consolidate retirement programs with PERA. The law requires the local relief associations to transfer all assets to PERA as of the effective date of each merger. Four mergers took place during the fiscal year ending June 30, 1997. As of June 30, 1997, 41 local relief associations had consolidated with PERA.

PERA also administers a defined contribution plan. This plan is a tax-deferred retirement savings program for elected public officials and public ambulance service personnel.

Agency Management

The PERA Board of Trustees is responsible for administering these funds in accordance with state statutes and has a fiduciary obligation to PERA's members, the employers, and the state. The board consists of ten members and the State Auditor. The Governor appoints five of the members who serve four-year terms. These members represent cities, counties, school boards, retired annuitants, and the general public. The PERA active membership elects the remaining

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five trustees. One of these trustees must be a member of the Police and Fire Fund, and one member must be a former member of PERA or a member who receives a disability benefit.

The board appoints the Executive Director of PERA. Mary Most Vanek was appointed Executive Director in January 1997. With the approval of the board, the director develops the annual administrative budget, determines staffing requirements, contracts for actuarial and other services, and directs the day-to-day operations of the association. The director also is a member of the State Investment Advisory Council. The council advises the State Board of Investment on the management and investment of pension funds and other assets.

Financial Information

During the year ended June 30, 1997, PERA adopted the provisions of GASB Statement No. 25, "Financial Reporting for Defined Benefit Pension Plans & Note Disclosures for Defined Contribution Plans." The provisions of this statement require reporting investments at fair value rather than cost.

PERA also adopted GASB Statement No. 28. This statement requires the disclosure of financial activity related to security lending transactions. PERA does not own specific securities, but instead owns shares in pooled funds administered by the State Board of Investment (SBI). PERA disclosed its portion of security lending activity in the investment pools administered by SBI.

For the three defined benefit pension funds administered by PERA, Table 1-1 shows plan net assets at June 30, 1997, and Table 1-2 shows the changes in plan net assets during fiscal year 1997.

Public Employees Retirement Association

Table 1-1
Public Employees Retirement Association
Defined Benefit Funds
Statement of Plan Net Assets (in thousands)
as of June 30, 1997

	Public Employees Retirement Fund	Police and Fire Fund	Police and Fire Consolidation Fund
Assets:			
Cash	\$ 2,297	\$ 595	\$ 87
Accounts Receivable	8,111	501	8,795
Investments	3,422,839	1,625,311	463,821
Equity in Minnesota Post Retirement Investment Fund	4,466,879	600,130	596,790
Securities Lending Collateral	958,469	258,783	124,214
Fixed Assets (Net)	<u>517</u>	<u>0</u>	<u>0</u>
Total Assets	<u>\$8,859,112</u>	<u>\$2,485,320</u>	<u>\$1,193,707</u>
Total Liabilities	<u>\$ 960,918</u>	<u>\$ 276,209</u>	<u>\$ 162,175</u>
Net Assets Held in Trust	<u>\$7,898,194</u>	<u>\$2,209,111</u>	<u>\$1,031,532</u>

Note: Assets are reported at fair value.

Source: Condensed information from PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997.

Public Employees Retirement Association

Table 1-2
Public Employees Retirement Association
Defined Benefit Funds
Statement of Changes in Plan Net Assets (in thousands)
for the Year Ended June 30, 1997

	Public Employees Retirement Fund	Police and Fire Fund	Police and Fire Consolidation Fund
<u>Additions:</u>			
Member Contribution	\$ 128,234	\$ 26,354	\$ 3,950
Employer Contribution	136,686	39,508	13,509
Net Investment Income	700,967	191,544	88,669
Net Appreciation in Fair Value of Investments	685,804	200,330	90,863
Net Income from Securities Lending Activity	2,824	766	363
Other Additions	<u>1,133</u>	<u>59</u>	<u>33,647</u>
Total Additions	<u>\$1,655,648</u>	<u>\$ 458,561</u>	<u>\$ 231,001</u>
<u>Deductions:</u>			
Benefits Paid	\$ 342,155	\$ 43,045	\$ 47,322
Refunds of Contributions	16,267	933	8
Other	<u>6,786</u>	<u>587</u>	<u>297</u>
Total Operating Expenses	<u>\$ 365,208</u>	<u>\$ 44,565</u>	<u>\$ 47,627</u>
Net Increase	<u>\$1,290,440</u>	<u>\$ 413,996</u>	<u>\$ 183,374</u>
Net Assets Held in Trust, July 1, 1996	<u>\$6,607,754</u>	<u>1,795,115</u>	<u>\$ 848,158</u>
Net Assets Held in Trust, June 30, 1997	<u>\$7,898,194</u>	<u>\$2,209,111</u>	<u>\$1,031,532</u>

Source: Condensed information from PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997.

Total assets of the defined contribution plan increased approximately \$2.3 million during fiscal year 1997 to a total of \$9.3 million as of June 30, 1997. The plan is reported as an Agency Fund.

Table 1-3 below highlights the funding ratios of the three defined benefit funds at June 30, 1997, as reported by the consulting actuary for the Legislative Commission on Pensions and Retirement. The purpose of an actuarial valuation is to test how the retirement system is achieving its fundamental financing objectives and to determine the actuarial status of PERA's defined benefit funds.

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Table 1-3
Public Employees Retirement Association
Defined Benefit Funds
Funding Ratios
June 30, 1997

<u>Retirement Fund Name</u>	<u>Funding Date</u>	<u>Funding Ratio</u>
Public Employees	2020	82.72%
Police and Fire	2020	126.87%
Police and Fire Consolidated	2010	99.54%

Source: Condensed information from PERA's Comprehensive Annual Financial Report, Actuarial Section, for the year ended June 30, 1997. This funding ratio, based on the entry age normal actuarial cost method, is the ratio of assets to actuarial accrued liabilities. According to statute, assets for this computation are valued at cost plus one-third of the difference between cost and market values.

Audit Scope, Objectives, and Conclusions

The primary objective of our audit was to render an opinion on PERA's financial statements. Our objective included determining whether PERA's financial statements presented fairly its financial position, results of operations, and changes in cash flows in conformity with generally accepted accounting principles. As part of our work we gained an understanding of the internal control structure and ascertained whether PERA complied with laws and regulations that have a material effect on its financial statements.

Our audit focused on cash and investments, contributions, annuities, defined contribution plan refunds, and investment income cycles. We also reviewed Police and Fire Consolidation Fund mergers and administrative expenses of the association. The State Board of Investment (SBI) performs a significant portion of the controls over PERA investments. We review the controls over state investments as part of our annual audit of SBI.

To address our audit objectives, we interviewed key department employees, reviewed applicable policies and procedures, and reviewed PERA's process for preparing its financial statements. We tested representative samples of financial transactions and performed analytical procedures as we considered appropriate. We also relied on the annual actuarial valuation performed by the Legislative Commission on Pension and Retirement's actuary.

PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997, includes our unqualified audit opinion thereon, dated December 8, 1997. PERA's financial statements are also included in the State of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1997, which includes our audit opinion dated December 8, 1997.

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Chapter 2. Contributions

Chapter Conclusions

PERA's financial statements fairly presented employee and employer contributions. PERA designed internal controls to provide reasonable assurance that contributions were adequately safeguarded and that transactions were authorized and properly reported in the accounting records and financial statements. PERA complied with material financial legal provisions for contributions tested.

PERA collects and processes employee and employer contributions from participating counties, cities, townships, school districts, and other public agencies. Table 2-1 shows contribution rates for fiscal year 1997. Employers make additional contributions to cover unfunded liabilities. As stated in Minn. Stat. Section 353A.09, Subd. 5(b), cities where relief associations have consolidated with PERA also must make an additional municipal contribution to amortize the unfunded liability of the relief association at the time of consolidation.

Table 2-1
Public Employees Retirement Association
Retirement Plan Contribution Rates
Fiscal Year 1997

<u>Retirement Plan</u>	<u>Employee</u>	<u>Employer</u>	<u>Additional Employer</u>
Public Employees Retirement Fund:			
Basic Plan	8.23%	8.23%	2.50%
Coordinated Plan	4.23%	4.23%	0.25%
Public Employees			
Police and Fire Fund	7.60%	11.40%	0.00%
Police and Fire Consolidation Fund	7.60%	11.40%	(1)

(1) Additional lump sum municipal contribution as required by Minn. Stat. Section 353A.09.

Source: Minnesota Statutes 353.27, 353.65, and 353A.09.

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Audit Objectives and Methodology

The primary objectives of our audit were to answer the following questions:

- Were employee and employer contributions presented fairly in PERA's financial statements?
- Did PERA design internal controls to provide reasonable assurance that contributions were adequately safeguarded, and that transactions were authorized and properly reported in the accounting records and financial statements?
- Did PERA comply with material financial legal provisions in administering contributions?

To answer these questions, we gained an understanding of the controls over contributions by interviewing PERA staff, reviewing policies and procedures, and determining if the controls were implemented. We recalculated employee and employer contributions and additional employer contributions as specified in statute for a sample of transactions. We also performed analytical procedures on contribution amounts.

Conclusions

Contributions were fairly presented in PERA's financial statements. PERA also designed internal controls to provide reasonable assurance that employee and employer contributions were adequately safeguarded. Contribution transactions were properly posted to the appropriate units and member accounts and recorded in the proper funds. For the contributions tested, we concluded that PERA complied with material financial legal provisions.

Chapter 3. Annuities and Defined Contribution Refunds

Chapter Conclusions

PERA's financial statements fairly presented annuity benefit and defined contribution plan payments. PERA designed internal controls to provide reasonable assurance that assets for annuity benefits and defined contribution plan refunds were adequately safeguarded, and that payments were authorized and properly reported in the accounting records and financial statements. We concluded that, for the items tested, PERA complied with applicable legal requirements in calculating annuity benefits and defined contribution plan refunds.

PERA provides retirement and disability benefits to members and survivor benefits upon the death of eligible members. Retirement benefits are based on a member's highest average salary for any five successive years of allowable service, age, and years of credit at termination. Table 1-2 (on page 4) shows annuities paid during fiscal year 1997.

A retiring member receives the higher of a step-rate benefit accrual formula or a level accrual formula. Normal retirement age for Public Employees Retirement Fund (PERF) members is age 65 if the member was employed prior to July 1, 1989. For a person who becomes a public employee after June 30, 1989, normal retirement age is the higher of age 65 or retirement age as defined in United State Code, Title 42, Section 416(l), as amended. If the member has reached normal retirement age, the level accrual formula is 2.5 percent for each year of service for basic members and 1.5 percent for each year of service for coordinated members.

Public Employees Police and Fire Fund (PEPFF) members who have attained the age of 55 and received credit for not less than three years of service, qualify for the normal retirement annuity upon separation from public service. PEPFF members receive 2.65 percent for each year of service.

Members of the Police and Fire Consolidated Fund (PFCF) have the option to choose benefits identical to those of the PEPFF or the local relief association of which they were members at the time of consolidation. Certain benefit qualifications apply depending on the effective date of the consolidation.

Members of the various defined benefit funds may select from several different types of retirement annuities. The normal annuity is a lifetime annuity that ceases upon the death of the retiree. Another type of annuity is the joint and survivor annuity, which provides a designated joint annuitant payments upon the members death. For all defined benefit plans, a reduced retirement annuity is available to eligible members seeking early retirement.

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At the time of retirement, actuarially determined reserves required to pay the cost of the member's annuity are transferred from the member's retirement fund to the Minnesota Post Retirement Investment Fund (MPRIF). Table 1-1 (on page 3) shows each retirement fund's equity in the MPRIF. Annuitants receive an annual increase in their benefits based on an inflation adjustment and the investment performance of the MPRIF. The benefit increase on January 1, 1997, was 8.04 percent. Either a full or partial increase is granted depending on the member's retirement date.

In addition to the defined benefit plans, PERA administers a defined contribution plan (DCP). This plan is a tax-deferred retirement savings program for elected public officials and public ambulance service personnel. Participants determine how employee and employer contributions are to be invested through the purchase of shares in the Minnesota Supplemental Investment Fund administered by the State Board of Investment. Total contributions plus investment performance determine the ultimate benefit to the member, which is paid as a lump sum upon withdrawal. As stated in Minn. Stat. Section 353D.03, elected public officials contribute five percent of their salary and their employers contribute an identical amount. Since DCP is a qualified tax-deferred program, any time funds are withdrawn they are subject to taxation. If funds are withdrawn before reaching age 59½, and not rolled into another qualified plan, withdrawals are subject to an additional ten percent tax surcharge. For the year ended June 30, 1997, approximately \$492,000 was refunded to DCP members.

Audit Objectives and Methodology

The primary objectives of our audit of annuity benefits and defined contribution refunds were to answer the following questions:

- Were annuity benefits and defined contribution refunds fairly presented in PERA's financial statements?
- Did PERA design internal controls to provided reasonable assurance that annuity benefits and defined contribution refund transactions were authorized and properly reported in the accounting records and financial statements?
- Were annuities and defined contribution refunds paid in accordance with applicable legal requirements?

To answer these questions, we interviewed key department personnel to gain an understanding of the controls over annuity and defined contribution calculations and reviewed applicable policies, procedures, and legal provisions. We also tested a representative sample of annuity payments and defined contribution refunds.

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Conclusions

Annuity benefits and defined contribution refunds were fairly presented in PERA's financial statements. PERA designed internal controls to provide reasonable assurance that annuity benefit and defined contribution refund transactions were authorized and properly recorded in appropriate employer and member accounts and funds, and in the financial statements. For the items tested, PERA complied with applicable legal requirements in calculating annuity benefits and defined contribution refunds.

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Chapter 4. Police and Fire Consolidation Fund Mergers

Chapter Conclusions

PERA fairly presented Police and Fire Consolidation Fund merger financial activity in the financial statements. PERA also designed internal controls to provide reasonable assurance that merger transactions were authorized and properly recorded in the accounting records and financial statements. For the merger transactions tested, PERA complied with material financial legal provisions.

In accordance with Minn. Stat. Section 353A, local police or fire relief associations can merge with the Police and Fire Consolidated Fund administered by PERA. At the time of consolidation, the local relief association transfers all assets to the consolidation fund. These assets are recorded at market value as of the date of consolidation.

Upon consolidation, PERA takes responsibility for administering the association's benefit plan, but bears no responsibility for financing it. The city continues to retain sole responsibility for financing the benefits paid to former members of the local relief association.

Minn. Stat. Section 353A.09, Subd. 5, requires municipalities to make an additional municipal contribution to the consolidation account. The additional payments are required in order to amortize the unfunded actuarial accrued liabilities of the former relief associations (determined at the date of consolidation) by the year 2010. Additional employer contributions are also required in order to amortize subsequent actuarial gains or losses over 15 years. Approximately \$7.5 million of additional municipal contributions were made to the consolidation account in fiscal year 1997.

Prior to 1987, 50 local relief associations administered independent pension plans for their employees. From December 1987 to June 30, 1997, 41 police and fire associations had consolidated with PERA. Four consolidation mergers took place during fiscal year 1997, with assets totaling approximately \$33 million being added to the Police and Fire Consolidation Fund.

Audit Objectives and Methodology

The primary objectives of our audit were to answer the following questions:

- Did PERA fairly present local relief association merger activities in the financial statements?

Public Employees Retirement Association

- Did PERA design internal controls to provide reasonable assurance that merger transactions were authorized and properly recorded in the accounting records and financial statements?
- Were actuarial calculations completed prior to the local relief association consolidations, and were the assets transferred to PERA after consolidation?

To satisfy our audit objectives, we reviewed the procedures PERA followed to complete consolidation fund mergers. We determined that actuarial calculations were done prior to the consolidation for each local relief association. We verified assets transferred to the state during the consolidation process and traced the individual and total amount of assets to the financial statements.

Conclusions

We found that PERA fairly presented Police and Fire Consolidation Fund merger activity in the financial statements. PERA also designed internal controls to provide reasonable assurance that merger transactions were authorized and properly recorded in the accounting records and financial statements. In addition, for the merger transactions tested, PERA complied with material financial legal provisions.

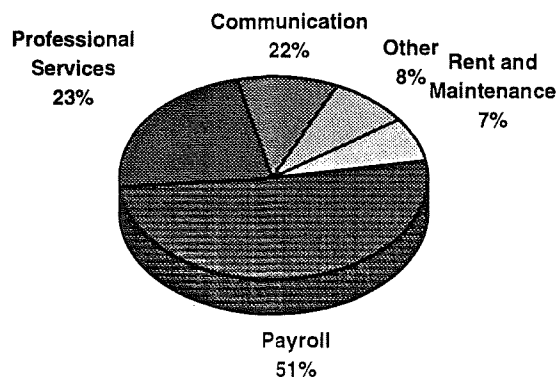
Chapter 5. Payroll and Other Administrative Expenses

Chapter Conclusions

PERA's financial statements fairly presented administrative expenses. PERA designed and implemented management controls to provide reasonable assurance that transactions were authorized and properly reported in the accounting records and financial statements. For transactions tested, PERA was in compliance with material finance-related legal provisions for payroll and other administrative expenses.

PERA's administrative expenses totaled about \$6.3 million for the year ended June 30, 1997. This is about a four percent increase over the previous year. Payroll transactions for the year ended June 30, 1997, were approximately \$3.3 million or 51 percent of total administrative expenses. In addition to payroll costs, PERA incurred approximately \$3 million in other administrative expenses. Other administrative expenses included professional/technical services, communication, rent and maintenance, and other items such as supplies, materials, travel, indirect costs, and depreciation. Figure 5-1 shows administrative expenses for the year ended June 30, 1997.

Figure 5-1
Public Employees Retirement Association
Administrative Expenses
Year Ended June 30, 1997



Sources: Condensed information from PERA's Comprehensive Annual Financial Report for the year ended June 30, 1997.

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Audit Objectives and Methodology

The primary objectives of our audit were to answer the following questions:

- Were administrative expenses presented fairly in PERA's financial statements?
- Did PERA design internal controls to provide reasonable assurance that administrative expenses were authorized and properly reported in the accounting records and financial statements?
- Did PERA comply with material financial legal provisions relating to administrative expenses?

To answer these questions, we gained an understanding of the controls over administrative expenses by interviewing PERA staff and reviewing policies and procedures. We performed tests to verify that transactions were authorized and properly recorded in the accounting records and financial statements. We also performed analytical procedures on expense amounts.

Conclusions

Administrative expenses were fairly presented in PERA's financial statements. PERA designed controls to provide reasonable assurance that expense transactions were authorized and properly reported in the accounting records and financial statements. For the expenses tested, we concluded that PERA complied with material financial legal provisions.

Public Employees Retirement Association

Status of Prior Audit Issues As of December 8, 1997

Most Recent Audits

Legislative Audit Report 97-3, January 1997, covered the fiscal year ended June 30, 1996. The primary objective of our audit was to render an opinion on PERA's financial statements for fiscal year 1996. Our objective included determining whether PERA's financial statements presented fairly its financial position, results of operations, and changes in cash flows in conformity with generally accepted accounting principles. We issued an unqualified opinion on the PERA financial statements. We did not have any written audit findings or recommendations to report to the management of PERA during the audit.

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.