
State Board of Investment

Financial Audit

Fiscal Year Ended June 30, 1998

January 1999

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

99-6



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, 1998, 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 1998 financial statements. SBI's Annual Report for the year ended June 30, 1998, includes our qualified audit opinion, dated December 1, 1998, on the Supplemental Investment Fund and the Post Retirement Fund's financial statements. The financial statements were fairly presented. Our report was qualified, however, because of uncertainties about the potentially adverse affects the year 2000 computer issue may have on SBI's operations. Information technology experts believe that many computer applications in private business and government may fail as a result of data integrity problems and erroneous calculations beyond December 31, 1999. SBI is currently addressing year 2000 issues relating to their custodial bank (State Street Bank) and accounting system vendor (Financial Control Systems). The custodial bank has provided assurances that their software has been tested, and the required remediation has been completed. The management of Financial Control Systems also has provided assurances that their software has been tested, and the required remediation has been completed. Auditing SBI's year 2000 compliance efforts was not an objective of this audit. As a result, we do not provide assurance that SBI is or will be year 2000 ready, that its year 2000 remediation efforts will be successful in whole or in part, or that parties with which SBI does business will be year 2000 ready. The following Summary highlights the audit objectives and conclusions. We discuss these issues more fully in the individual chapters of this report.

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 over financial reporting to plan the audit and to determine the nature, timing, and extent of our audit tests. The standards also require that we design the audit to provide reasonable assurance of detecting noncompliance with provisions of laws, regulations, contracts, and grants that have a direct and material effect on the financial statements. The management of SBI is responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, contracts, and grants.

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As part of obtaining reasonable assurance about whether SBI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*

In planning and performing our audit, we considered SBI's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all financial reporting matters that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce, to a relatively low level, the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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, 1999.

James R. Nobles
Legislative Auditor

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 1, 1998

Report Signed On: January 25, 1999

SUMMARY

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Minnesota State Board of Investment

Financial Audit Fiscal Year Ended June 30, 1998

Public Release Date: January 29, 1999

No. 99-6

Background Information

The Minnesota State Board of Investment (SBI) administers the investment of state funds, including retirement funds. State funds consist of invested treasurers cash, which is the idle cash of various state funds and other state agency cash, including Housing Finance and the Minnesota State Colleges and Universities Revenue Bond Fund. SBI also invests funds for the three major retirement associations -- Minnesota State Retirement System, Teachers Retirement Association, and the Public Employees Retirement Association. 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.

Audit Objectives and Scope

The primary objective of our audit was to render an opinion on the Supplemental Investment and Post Retirement Funds financial statements. These financial statements are included in SBI's Annual Report for fiscal year 1998. 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. We also ascertained whether SBI complied with laws and regulations that may have had a material effect on its financial statements.

Conclusions

SBI's investment activities were fairly presented in the general purpose financial statements of the State of Minnesota's Comprehensive Annual Financial Report and SBI's Annual Report. SBI's Annual Report for the year ended June 30, 1998, included our qualified audit opinion, dated December 1, 1998, on the Supplemental Investment and Post Retirement Funds financial statements. We qualified our report because sufficient evidence did not exist to support the SBI's disclosures with respect to the year 2000. Auditing SBI's year 2000 compliance efforts was not an objective of this audit. As a result, we do not provide assurance that SBI is or will be year 2000 ready, that its year 2000 remediation efforts will be successful in whole or in part, or that parties with which SBI does business will be year 2000 ready. 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. 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
Jack Hirschfeld, CPA	Audit Director
Keith Bispala	Auditor
Mike Byzewski	Auditor
Patrick Phillips, CPA	Auditor
Eric Roggeman	Intern

Exit Conference

We discussed this report and minor issues involving the internal control structure with the following State Board of Investment staff at an exit conference on January 22, 1999:

Howard Bicker	Executive Director
Mansco Perry	Assistant Executive Director
L. Michael Schmitt	Administrative Director

Chapter 1. Background Information

The Minnesota State Board of Investment (SBI) manages the investment of state funds and retirement funds. The board is comprised of the governor, state auditor, state treasurer, secretary of state, and attorney general. Howard J. Bicker is the executive director of the board.

Minn. Stat. Chapter 11A governs the investment activities of the board. Generally, authorized investments include common stocks, bonds, short-term securities, real estate, private equity, and resource funds. The statutes prescribe the maximum percentage of fund assets that may be invested in various asset classes and may contain investment restrictions for certain funds.

The Legislature also established a 17-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, the executive directors of the three statewide retirement systems, and two active employee representatives and one retiree representative appointed by the governor.

The board uses both internal staff and external investment managers to fulfill its responsibilities. The external firms invest and manage the funds for the three retirement systems, including the Minnesota State Retirement System, Teachers Retirement Association, and the Public Employees Retirement Association. They also invest the Post Retirement Fund and the Supplemental Investment Fund. 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. SBI staff manage the other investments including invested treasurers cash, Public Facilities and Housing Finance money, the Minnesota State Colleges and Universities Revenue Bond Fund, and other state cash.

Table 1-1 shows the total funds under the management of the State Board of Investment as of June 30, 1998.

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Table 1-1
Market Value of Investments by Fund
At June 30, 1998
(in millions)

<u>Fund</u>	
Basic Retirement Funds	\$18,860
Post Retirement Fund	17,040
State Cash Accounts	6,614
Supplemental Investment Fund	1,247
Assigned Risk Plan	694
Permanent School Fund	507
Environmental Trust Fund	<u>236</u>
Total	<u>\$45,198</u>

Source: State Board of Investment Fiscal Year 1998 Annual Report.

SBI prepares its financial statements in accordance with pronouncements of the Governmental Accounting Standards Board (GASB). GASB Statement No. 31 became effective for financial statements for periods beginning after June 15, 1997. This statement established the accounting and financial reporting standards for all investments held by governmental external investment pools. This statement requires that government entities, including governmental external investment pools, report investments at fair value in the balance sheet. All investment income, including changes in the fair value of investments, are to be reported as revenue in the operating statement.

Audit Scope, Objectives, and Conclusions

The primary objective of our audit was to render an opinion on the financial statements of the Post Retirement and the Supplemental Investment 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 1998. 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.

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SBI's Annual Report and the State of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1998, includes our qualified opinion, dated December 1, 1998, on the Post Retirement Fund and Supplemental Investment Fund's financial statements. The financial statements were fairly presented. We qualified our opinion, however, because of uncertainties about the potentially adverse effect the year 2000 computer issue may have on SBI's operations. Information technology experts believe that many computer applications in private businesses and government may fail as a result of data integrity problems and calculations beyond December 31, 1999. Sufficient audit evidence did not exist to support SBI's disclosures with respect to the year 2000 computer issue. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

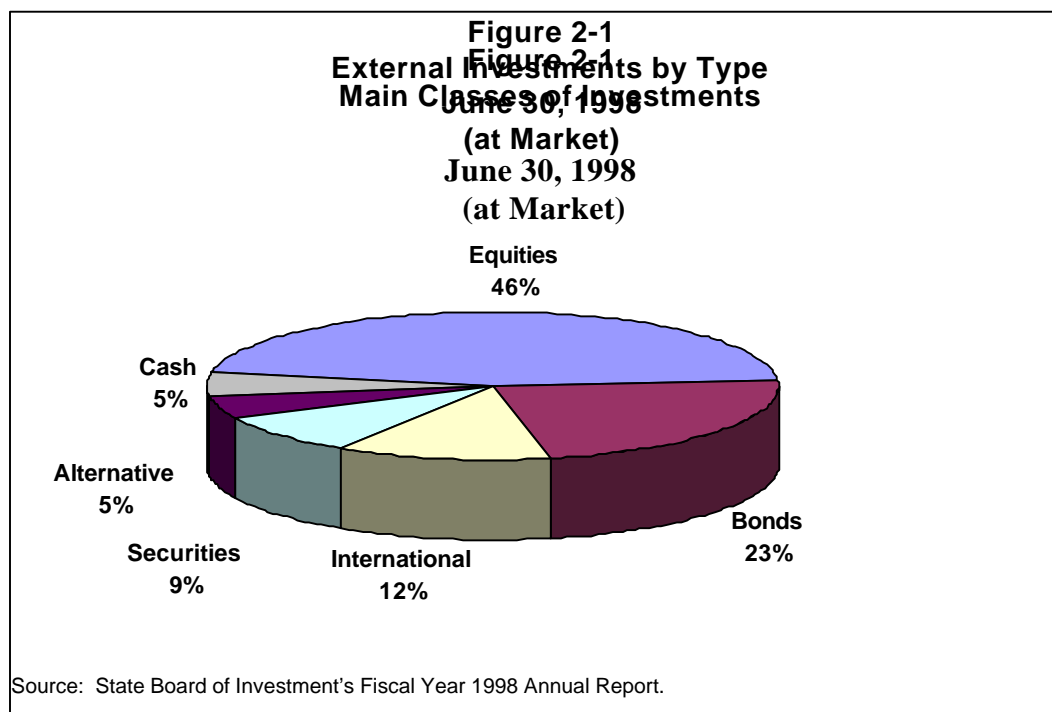
Chapter 2. External Investment Cycle

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.

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.



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SBI contracts with approximately 90 external investment managers, of which approximately 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 alternate investment market.

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. As a part of its ongoing monitoring function, SBI staff meet 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 investment transactions must clear through the state's custodial bank, State Street Bank and Trust of Boston, Massachusetts (the master custodial bank). The master custodial bank, in accordance with its contract, has the authority to authorize investment transactions on behalf of SBI. The asset managers do not have physical access to cash or investment securities. The master custodial bank maintains access to the cash accounts of the external investment managers. The custodial bank invests any uninvested cash from the managers accounts. In addition, the master custodial bank participates in securities lending programs in which securities are loaned to banks and security dealers for a daily fee. The loans are fully collateralized.

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 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. Financial Control Systems prepared reports that SBI used in the preparation of its financial statements. The Depository Trust Company in New York maintains records on ownership of stocks and securities.

We focused our audit of 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, State Street Bank, and Financial Control Systems. 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 reviewed the workpapers supporting an independent auditor's report on the policies and procedures of custody function at State Street Bank. We also reviewed the

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workpapers supporting an internal audit of the controls over the processing of investment transactions. We verified that SBI reported assets and income associated with security lending transactions in compliance with Governmental Accounting Standards Board (GASB) Statement 28.

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

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 found that SBI complied with material financial legal provisions for the items tested.

Chapter 3. Internal Investment Cycle

Chapter Conclusions

Investments and investment income for internally managed investments were fairly presented in the financial statements. 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 the Trust Fund Pool and Invested Treasurers Cash, represent the cash balances of internally managed retirement fund assets and assets of 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, 1998
(in millions)

Fund:

Invested Treasurers Cash	\$5,919
Permanent School Fund	507
Environmental Trust Fund	236
Trust Fund Pool	53
Other State Cash Accounts	<u>642</u>
Total	<u>\$7,357</u>

Source: SBI 1998 Annual Report.

U.S. Bank, Saint Paul, Minnesota and State Street Bank and Trust of Boston, Massachusetts were the state's custodial and clearing banks during fiscal year 1998. These banks do not have independent authority to enter into investment transactions for funds that are managed by SBI staff. SBI must initiate and authorize all transactions processed by the custodial banks on behalf of the state. On July 1, 1997, SBI transferred the custodial duties for the Permanent School Fund and the Environmental Trust Fund to State Street Bank, Boston. The Permanent School Fund is a trust fund established for the benefit of Minnesota schools. The Environmental Trust Fund is a trust established for the protection and enhancement of Minnesota's environment.

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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, banker's 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 daily determination of available cash. SBI then contacts U.S. Bank, Saint Paul, to process the investment transaction. Once the short-term investments have cleared U.S. Bank, SBI enters the transactions directly into the accounting system at Financial Control Systems. SBI also initiates investment transactions for the Permanent School Fund and Environmental Trust Fund with State Street Bank. SBI reconciles transactions and account balances with U.S. Bank, State Street Bank, 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 confirming investment balances recorded at U.S. 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, the State Treasurer's Office, and U.S. Bank. 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 U.S. Bank.

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 transactions were authorized and properly reported in the accounting records. For the items tested, we found that SBI complied with material financial provisions for investments.

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Status of Prior Audit Issues As of December 1, 1998

Most Recent Audit

January 23, 1998, Legislative Audit Report 98-3 covered the fiscal year ended June 30, 1997, and had no reportable issues. The audit scope included the Supplemental and Post Retirement Funds and the related external and internal investment cycles. We audit the State Board of Investment on an annual basis. There were no reportable issues.

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 offices, or the judicial branch.