O L A **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

Financial Audit Division Report

Minnesota State Retirement System

Fiscal Year Ended June 30, 2005

AUGUST 10, 2006 **06-24**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota state government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of representatives and senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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If you have comments about our work, or you want to suggest an audit, investigation, or evaluation, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

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Audit Participation

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
Carl Otto, CPA, CISA	Auditor-In-Charge
John Hakes	Auditor
Caroline Stallkamp	Auditor

Exit Conference

The following representatives from the Minnesota State Retirement System participated in the exit conference held on August 2, 2006:

Dave Bergstrom	Executive Director
Dennis Jensen	Accounting Director
Arvin Herman	Assistant Director of Finance

Report Summary

Audit Conclusions:

- We issued an unqualified opinion on the financial statements of the Minnesota State Retirement System as of and for the year ended June 30, 2005.

- We identified the following finding in our Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*.

Finding:

- The Minnesota State Retirement System's final draft financial statements required significant adjustments. (Finding 1, Page 4)

Background Information:

The Minnesota State Retirement System administers six defined benefit retirement plans and three defined contribution plans:

- State Employees
- State Patrol
- Correctional Employees
- Judges
- Legislators
- Elected State Officials
- Unclassified Employees
- Health Care Savings
- Deferred Compensation

The plans cover most state government and University of Minnesota employees and selected public-service organizations. The deferred compensation plan is available to state employees and other public employees throughout the state.

At June 30, 2005, the Minnesota State Retirement System's total net assets (including the deferred compensation plan) were $11.8 billion. For the year ended June 30, 2005, MSRS received contributions of about $459 million and paid benefits and refunds of about $598 million.

Report on Internal Control Over Financial Reporting and on Compliance and on Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Retirement System Board of Directors

Mr. David Bergstrom, Executive Director
Minnesota State Retirement System

We have audited the financial statements of the Minnesota State Retirement System as of and for the year ended June 30, 2005, and have issued our report thereon dated June 9, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

<u>Internal Control Over Financial Reporting</u>

In planning and performing our audit, we considered the Minnesota State Retirement System'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 an opinion on the internal control over financial reporting. However, we noted in Finding 1 a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the MSRS's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable 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 caused by error or fraud 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is not a material weakness.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Minnesota State Retirement System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Legislative Audit Commission and the Minnesota State Retirement System and is not intended to be and should not be used by anyone other than those specified parties.

/s/ James R. Nobles	*/s/ Cecile M. Ferkul*
James R. Nobles	Cecile M. Ferkul, CPA, CISA
Legislative Auditor	Deputy Legislative Auditor

End of Fieldwork: June 9, 2006

Report Signed On: August 7, 2006

Current Finding and Recommendations

1. The Minnesota State Retirement System's final draft financial statements required significant adjustments.

The number and type of audit adjustments necessary to the Minnesota State Retirement System's (MSRS) final draft financial statements demonstrated weaknesses in its financial reporting process. MSRS financial activities were properly reported to the Department of Finance for inclusion in the State of Minnesota Comprehensive Annual Financial Report. However, MSRS has more extensive pension financial reporting and disclosure responsibilities required by governmental accounting standards, including independent actuarial measurements of pension benefit obligations and unfunded liabilities. For fiscal year 2005, MSRS received its actuarial information late, prompting the need for significant changes to the MSRS preliminary financial statements and note disclosures. These changes caused substantial delay in preparing and submitting an accurate MSRS financial report for audit. Delays in financial reporting diminish its usefulness to members, employers, and to Legislators who need reliable financial information to make important decisions.

Actuarial information for MSRS pension funds was obtained late. This delayed MSRS's ability to finalize its financial statements for several months beyond that of other pension funds managed by the state. MSRS received its actuary letter identifying each plan's unfunded level of obligations on February 27, 2006, for fiscal year ending June 30, 2005.

Although the MSRS financial statements were initially delayed by untimely actuarial reports, it failed to detect numerous and significant errors in the financial statements before submitting them for audit. We noted the following problems, which were subsequently corrected:

- MSRS did not control electronic versions of its financial statement files. As a result, corrected errors made on earlier versions were not brought forward in subsequent versions.

- Incorrect accounting entries were made for the Legislative Plan's actuarial mortality loss adjustment. As a result, plan net assets and general fund contributions differed by $4.7 million from what was previously reported to the Department of Finance.

- MSRS final draft financial statements contained numerous inaccuracies and mathematical errors. However, as adjustments and changes were identified and made, affected column and row totals were not updated to reflect new totals. MSRS failed to review its financial statements and many of its footnotes for mathematical accuracy.

- Pension and investment financial disclosure requirements are extensive. We noted some disclosures made by MSRS that were inadequate. For example, for fiscal year 2005, it added the Deferred Compensation Plan to its financial report for the first time; however, preliminary disclosures failed to discuss the amount involved (an additional reporting of

$2.5 billion of assets. In addition, little attention was drawn to new cash and investment disclosures for fiscal year 2005 that were added pursuant to a newly effective government accounting pronouncement.

Recommendations

- *The Minnesota State Retirement System should review its financial reporting process to identify changes necessary to improve the timeliness and accuracy of its financial reporting process, including:*

  - *control over electronic versions of its financial statements and disclosures;*
  - *internal review and approval of financial adjustments for actuary-determined mortality accruals;*
  - *independent proofing and footing of preliminary financial statements and disclosures for mathematical accuracy; and*
  - *increased diligence in communicating changes and new accounting pronouncements in its financial disclosures.*

Status of Prior Audit Issues

Most Recent Audits

June 30, 2005, Legislative Audit Report 05-39 covered the fiscal year ended June 30, 2004. The audit scope included employer and employee contributions, annuity benefits, and refunds. We audit the Minnesota State Retirement System on an annual basis. There were no reportable issues in that report.

April 20, 2005, Legislative Audit Report 05-24 was a special review of the Minnesota State Retirement System's administration of the Minnesota Deferred Compensation Fund from January 1, 2002, through December 31, 2004. We conducted this special review in response to concerns raised by an MSRS employee. Our review was not a full audit of the deferred compensation plan. We focused this special review primarily on controls over financial activity of the plan's administrative account. We did not find evidence of financial wrongdoing by MSRS employees. In addition, we did not find evidence that MSRS employees were actively involved in the administration of other tax-sheltered annuity plans. However, we identified several weaknesses in MSRS's administration of the state's deferred compensation plan, including weaknesses in controls over the administrative account, contract administration, and system access. We reviewed the status of these findings during our current audit scope and determined that all issues were satisfactory resolved.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on 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 metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

MSRS | Minnesota State Retirement System
MNDCP | Minnesota State Deferred Compensation Plan
HCSP | Health Care Savings Plan

August 4, 2006

Mr. James R. Nobles, Legislative Auditor
ROOM 140 CENTENNIAL BUILDING
658 CEDAR STREET
ST PAUL MN 55155

Dear Mr. Nobles:

Thank you for completing the audit of the Minnesota State Retirement System. While the audit did not identify any material weaknesses, we have taken steps to correct the reportable finding outlined in the report.

We have already established a schedule with our actuary to make sure that this year's report is done in a timely manner. We will monitor the schedule deadlines on a weekly basis to make sure all parties do not fall behind. In addition, we will make sure that preliminary versions of our Comprehensive Annual Financial Report are removed from our system so that adjustments are made to the most recent version of the report. We will also proofread the completed document before it is submitted to assure the corrections do not inadvertently alter items that have already been finalized.

Arvin Herman, Assistant Director of Finance, Accounting, and Records, will be responsible for resolving the finding.

As always, I appreciate the professional manner in which the audit is performed. If you have any questions, please feel free to call me at 651-284-7888.

Sincerely,

/s/ David Bergstrom

David Bergstrom
Executive Director

MSRS
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Administrators of:
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