OLA
OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Retirement System

Financial Statement Audit

Year Ended June 30, 2009

April 12, 2010 **Report 10-14**

FINANCIAL AUDIT DIVISION
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Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Minnesota State Retirement System Board of Trustees

Mr. David Bergstrom, Executive Director
Minnesota State Retirement System of Minnesota

In auditing the Minnesota State Retirement System's basic financial statements for the year ended June 30, 2009, we considered internal controls over financial reporting. We also tested compliance with significant legal provisions impacting the basic financial statements. We did not identify any instances of noncompliance with legal provisions material to the financial statements. This report contains our findings and recommendations on internal controls over financial reporting. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the Minnesota State Retirement System's internal controls or compliance. In addition, our work may not have identified all significant control deficiencies or instances of noncompliance with legal requirements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. This report meets the audit standard requirements of the American Institute of Certified Public Accountants and the Government Accountability Office to communicate internal control matters identified in a financial statement audit. The audit was conducted by Jim Riebe, CPA, (Audit Manager), Carl Otto, CPA, (Audit Coordinator), Xin Wang, CPA, (Auditor-in-Charge), assisted by auditors Lat Anantaphong, CPA, Adam Spooner, and Alex Weber.

We consider the internal control deficiencies described in Findings 1 through 3 related to the preparation of the basic financial statements to be material weaknesses. A material weakness is a significant deficiency, or combination of significant deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. Finding 4 does not have a direct or material effect on the financial statements; however, it addresses noncompliance with state statutes.

We discussed the results of the audit with the Minnesota State Retirement System on April 6, 2010. Management's response to our findings and recommendations is presented in the accompanying section of this report titled, *Agency Response.* We did not audit the response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Minnesota State Retirement System's management and the Legislative Audit Commission and is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit the distribution of this report, which was released as a public document on April 12, 2010.

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

End of Fieldwork: December 18, 2009 and January 5, 2010

Report Signed On: April 9, 2010

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Report Summary

Conclusion

The Minnesota State Retirement System's (MSRS) financial statements were fairly presented in all material respects. However, MSRS had some weaknesses in internal control over financial reporting, as noted below.

Key Findings

- Prior Finding Not Resolved: MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting. (Finding 1, page 3)

- Prior Finding Partially Resolved: MSRS did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis, and it did not implement adequate mitigating controls over incompatible access. (Finding 2, page 4)

- MSRS did not accurately report foreign currency risk in its draft financial statement footnote disclosures. (Finding 3, page 6)

Audit Scope

We audited MSRS's basic financial statements for the fiscal year ended June 30, 2009.

Findings and Recommendations

Finding 1

Prior Finding Not Resolved:[1] MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting.

MSRS did not fully design and implement a comprehensive risk assessment for its financial reporting and business operations. MSRS was aware of certain risks and performed selected internal control monitoring functions. In fiscal year 2009, MSRS initiated a preliminary risk analysis of its business operations. However, MSRS had not considered or addressed the following risks:

- MSRS did not have sufficient controls in place to ensure timely financial reporting by the statutory deadline.[2] Delays in financial reporting diminish the usefulness of information to members, employers, and legislators who need reliable financial information to make important decisions.

- MSRS did not have control procedures in place to ensure employers reported payroll amounts based on statutory requirements. This internal control weakness increased the risk of pension contributions and retirement benefits being inaccurate. Employers are responsible to report members' eligible salaries in accordance with *Minnesota Statutes*.[3] According to statute, eligible salaries exclude employer paid fringe benefits, employer contributions to deferred compensation plans, and insurance coverage. Although MSRS provided training to employers on how to calculate and report salary information and pension contributions, it did not verify that employers reported the correct base salaries and pension contributions.

- MSRS did not have adequate controls to safeguard and track refund payments made outside the regular state payment process. MSRS allowed employees who processed refunds to members through the state's accounting system to authorize special handling of these payments. The special handling involved creating a paper state warrant (similar to a check) and physically obtaining the warrant from the Department of Management and Budget for mailing or delivery to the member. Processing refunds and physically handling warrants are incompatible duties because together they could allow an employee to process an

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[1] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 09-17, *Minnesota State Retirement System*, April 23, 2009 (Finding 1).

[2] *Minnesota Statutes* 2009, 356.20, subd. 3, requires MSRS to report on its financial operations within six months of the end of the fiscal year or one month after receiving the actuary report, whichever is later.

[3] *Minnesota Statutes* 2009, 352.01, subd. 13.

inappropriate refund and obtain physical access of the warrant. MSRS couriers picked up these warrants and left them in an employee's office whether or not the employee was present. MSRS did not have a process to track the exact number and status of these special warrants. Without adequately tracking and safeguarding these special warrants, the risk of loss and theft is high.

State policy requires that each agency head has the responsibility to identify, analyze, and manage business risks that impact an entity's ability to maintain its financial strength and the overall quality of its products and government services.[4] This policy also requires communication of the internal control policies and procedures to all staff so they understand what is expected of them and the scope of their freedom to act. The policy also requires follow-up procedures that, at a minimum, should include mechanisms for monitoring results and reporting significant control deficiencies to individuals responsible for the process or activity involved, including executive management and those individuals in a position to take corrective action. Until MSRS fully designs and implements a comprehensive risk assessment, it increases the risk of errors or fraud in its business operations.

Recommendations

- *MSRS should continue its process of developing and implementing a comprehensive control structure that identifies financial reporting and business risks, implements effective controls, and establishes a monitoring function to ensure controls are operating as designed.*

- *MSRS should design controls to ensure that:*
  - -- *MSRS publishes its financial statements within the statutory deadline.*
  - -- *Participating employers properly calculate and report eligible wages and contributions.*
  - -- *MSRS adequately tracks and safeguards special warrants.*

Finding 2

Prior Finding Partially Resolved:[5] MSRS did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis, and it did not implement adequate mitigating controls over incompatible access.

MSRS did not provide adequate documentation to help managers make informed decisions about the level of computer access to grant their staff. MSRS also did not implement a formal process to periodically review and recertify current

[4] Department of Management and Budget Policy 0102 – 01 Internal Control.
[5] Minnesota Office of the Legislative Auditor, Financial Audit Division, Report 09-17, *Minnesota State Retirement System*, April 23, 2009 (Finding 2).

computer users' access. However, MSRS made some progress in addressing prior audit security findings by developing a formal process to request and authorize computer access and to notify security staff when employees terminated employment. In addition, MSRS eliminated employees' incompatible access to the state's accounting system.

Without adequate information describing, in non-technical terms, the access options available in the business application and any access combinations that would result in someone having incompatible access, MSRS managers often requested someone's computer access be set the same as another employee's access without explicitly defining the specific access needed. This is a high-risk practice because it can lead to employees obtaining inappropriate access without mitigating controls being implemented.

MSRS had the following system access issues:

- Sixty-five MSRS employees had incompatible access to the MSRS business system. Based on inquiry and analysis, these employees had the ability to change a future annuitant's name, address, and bank routing information without proper controls in place to monitor these changes. These incompatible duties allowed employees to redirect benefit and refund payments without a member's knowledge. Although MSRS's business system automatically generated a letter to a member whose bank routing information had been changed, employees with this incompatible access could redirect the letter.

- Two of the sixty-five employees with incompatible access also had physical access to refund checks, increasing the risk of fraud.

State policy specifies that agencies should not grant access that includes incompatibilities, and agencies should implement and maintain mitigating controls in cases where incompatible functions exist.[6] Allowing employees incompatible access without implementing effective mitigating controls creates vulnerabilities with MSRS for potential errors or fraud.

Recommendations

- *MSRS should develop security documentation to provide guidance to managers making decisions about business system access for employees. This documentation should specifically identify incompatible access profiles within its business systems.*

[6] Department of Management and Budget Policy 0102 – 01 Internal Control.

- *MSRS should periodically review and recertify computer users' access.*

- *MSRS should ensure it eliminates unnecessary or incompatible access to its business system. If incompatible access is unavoidable, MSRS should implement controls to mitigate the risk of error or fraud.*

Finding 3

MSRS did not accurately report foreign currency risk in its draft financial statement footnote disclosures.

MSRS did not accurately disclose $17.2 million of cash and $5.9 million of fixed income investments as investments held in foreign currencies in its draft foreign currency risk footnote. Instead, MSRS erroneously reported that the funds were invested in other types of foreign currencies not specified in the disclosure. MSRS relied on the State Board of Investment to provide the information included in the foreign currency investment disclosure since the board invests the pension's funds. Ultimately, however, MSRS is responsible for the accuracy of its financial statements and footnote disclosures.

Governmental accounting principles require that if a government's deposits or investments are exposed to foreign currency risk, the government should disclose the U.S. dollar balances of such deposits or investments, organized by currency denomination and, if applicable, investment type.[7] The State Board of Investment provided the foreign currency schedule to MSRS that incorrectly summarized cash and fixed income balances into an "Other" denomination classification without allocating the amounts to their respective currencies. However, MSRS did not question the accuracy of the information received. Uncorrected, the inaccuracies in the foreign currency disclosure may have been misleading to users of MSRS's financial statements.

Recommendation

- MSRS *should work with the State Board of Investment to ensure the accuracy of the foreign currency risk disclosures reported in its footnotes to the financial statements.*

Finding 4

The Minnesota State Retirement System did not always deposit contribution receipts in a timely manner.

MSRS did not always deposit contribution receipts daily, as required by state statute.[8] MSRS did not promptly deposit three checks in our sample deposits test.

[7] Government Accounting Standards Board Statement 40: Deposit and Investment Risk Disclosures, paragraph 17.
[8] *Minnesota Statutes* 2009, 16A.275.

The deposit delays ranged from three to seventeen days. MSRS deposited the largest amount, totaling $78,180, eight days late. The statute requires state agencies to deposit receipts totaling $250 or more in the state treasury daily. The delay in depositing these receipts increased the risk of loss or theft.

Recommendation

- *MSRS should deposit contribution receipts of $250 or more in a timely manner.*

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

April 7, 2010

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to the findings and recommendations resulting from your audit of our financial statements for the fiscal year ended June 30, 2009. As always, we take any audit finding very seriously and have already initiated corrective actions to address your findings and recommendations.

Finding 1: Prior Finding Not Resolved: MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting.

Recommendation: MSRS should continue its process of developing and implementing a comprehensive control structure that identifies financial reporting and business risk, implements effective controls, and establishes a monitoring function to ensure that controls are operating as designed.

Response:
In 2009, when your office initially brought this finding and recommendation to our attention, we also received the results of a security audit of our information technology environment conducted by your office. We focused considerable time and resources to address the security findings and to rebuild a secure network architecture. It's been our priority, since the security audit occurred, to continue to strengthen our controls further and to protect the confidentiality, integrity, and availability of our computer systems and member data.

While we have spent some time analyzing and documenting internal controls, we will now focus on strengthening our internal controls over our financial reporting processes and performing formal risk assessments periodically. We intend to fill an Accounting Division vacancy with an individual qualified to assist in this effort.

Persons responsible: Dennis E. Jensen, Accounting Director
Judy Hunt, Assistant Executive Director

Target Implementation Date: December 31, 2011

Recommendation: MSRS should design controls to ensure that:

- ***MSRS publishes its financial statements within the statutory deadline.***
- ***Participating employers properly calculate and report eligible wages and contributions.***
- ***MSRS adequately tracks and safeguards special warrants.***

Response:

- We will (1) prepare a project time line detailing tasks and key milestones, (2) obtain additional desktop publishing resources dedicated to this project, and (3) step up our monitoring efforts to ensure our project efforts keep on track toward this goal. We are appreciative that your office is willing to release its conclusions on investment balances, an integral component of our financial statements, to us by October 31, 2010. Hopefully, this will accelerate our receipt of final actuarial valuation results and completion of the comprehensive annual financial report by December 31, 2010.

  Persons responsible: Dennis E. Jensen, Accounting Director
  Judy Hunt, Assistant Executive Director

  Target Implementation Date: December 31, 2010

- Of the MSRS funds that require statutory contributions, over 97 percent of our members are employed by payroll units that use the PeopleSoft application. We will work with these employer units to ensure that their payroll earnings codes are appropriately set up to report salaries and retirement contributions to us. For participating employers who do not use Peoplesoft, we are considering various measures (e.g., checklist, site visits) to ensure that their payroll systems are reporting salaries and contributions properly to us.

  Person responsible: Dennis E. Jensen, Accounting Director
  Erin Leonard, Assistant Executive Director

  Target Implementation Date: December 31, 2010

- We have made changes in the persons with authority to approve warrant special handling requests. Employees who process refunds to members no longer have this authority. We also require our couriers to log each special warrant that they receive from Minnesota Management and Budget (MMB) and its disposition status. The couriers are also required to deliver the warrant directly to the requestor. If that person is unavailable to accept the warrant, the couriers are required to deliver the warrant to the Accounting Director who will place the warrant in a locked cabinet.

Person Responsible: Dennis E. Jensen, Accounting Director
Judy Hunt, Assistant Executive Director

Date Audit Issued was Resolved: April 7, 2010

Finding 2: Prior Finding Partially Resolved: The Minnesota State Retirement System did not have adequate controls to ensure computer users' access was appropriate on an ongoing basis, and it did not adequately restrict access to some computer systems to eliminate incompatible duties.

Recommendation: MSRS should develop security documentation to provide guidance to managers in making decisions about business systems access for employees. This documentation should specifically identify incompatible access profiles within its business systems.

Response:
In December, 2009, our database administrator drafted a manual aimed at providing guidance to managers and supervisors in selecting appropriate user privileges and access levels for each of their employees. We plan to develop job-specific user profiles before we finalize the manual.

Persons Responsible: Al Cooley, Information Systems Manager
Lloyd Johnson, Database Administrator

Target Implementation Date: December 31, 2010

Recommendation: MSRS should periodically review and recertify computer users' access.

Response:
Once the manual referred to previously is complete, we plan to conduct an access review for all MSRS employees to ensure that employees' access profiles are appropriate for their assigned job duties. After we complete this initial assessment, we will develop and implement a process for periodic re-certification.

Persons Responsible: Al Cooley, Information Systems Manager
Lloyd Johnson, Database Administrator

Target Implementation Date: June 30, 2011

Recommendation: MSRS should ensure it eliminates unnecessary or incompatible access to its business system. If incompatible access in unavoidable, MSRS should implement controls to mitigate the risk of error or fraud.

Response:
We will continue to explore options to eliminate incompatible access among our employees who have the ability to update member account information or to mitigate the risks of error or fraud associated with their access profiles. Resolution of this audit issue may require computer programming changes, implementation of a quality control function, or other mitigating controls.

Persons Responsible: Al Cooley, Information Systems Manager
Judy Hunt, Assistant Executive Director
Lloyd Johnson, Database Administrator
Erin Leonard, Assistant Executive Director

Target Implementation Date: June 30, 2011

Finding 3: MSRS did not accurately report foreign currency risk in its draft financial statement footnote disclosures.

Recommendation:
MSRS should work with the State Board of Investment (SBI) to ensure the accuracy of the foreign currency risk disclosures in its footnotes to the financial statements.

Response:
In producing the draft footnotes, MSRS confirmed that the SBI-provided information was reasonable when compared with the audited disclosures of prior fiscal years and complied with mutually agreed-upon materiality tests. When the OLA brought this matter to our attention in December 2009, and given that we are committed to full transparency of our financial activities, we immediately modified our foreign currency risk footnote disclosure appropriately for inclusion in our comprehensive annual financial report. We will continue to rely on SBI for this disclosure data. It is our understanding that SBI will proceed with reporting foreign currency investments to the retirement systems in accordance with the new requirements.

Person Responsible: Dennis E. Jensen, Accounting Director

Date Audit Issue was Resolved: December 31, 2009

Finding 4: MSRS did now always deposit contribution receipts in a timely manner.

Recommendation: MSRS should deposit contribution receipts of $250 or more in a timely manner.

Response:
We recognize our responsibility to deposit contributions daily. However, by the nature of our business, we often receive checks from members desiring to purchase prior service credit or to repay a refund with personal funds and assets rolled over from other retirement plans. Prior to depositing these funds, our staff must verify whether the funds received are sufficient to complete the buy back and meet IRS requirements. If we deposit a member's rollover funds prior to completing this verification task, and later we determine that the funds are unacceptable for rollover purposes, we put the member at risk of incurring additional state and federal income taxes and IRS-imposed penalties for taking an early withdrawal of funds from another retirement plan.

For this reason, in late November 2009, we requested a waiver of the daily deposit requirement from MMB. Before MMB could act on our request, MMB requested that we track the type and status of undeposited receipts for a one-month period. Now that we completed this task, we need to convey the results to MMB for a determination on our waiver request. Should our request be denied, we will seek legislative authority to hold buyback funds until we complete the verification process.

Person Responsible: Judy Hunt, Assistant Executive Director

Target Implementation Date: June 30, 2010

Thank you, again, for the opportunity to respond to your report comments. We value the work of your agency to identify areas within MSRS that need improvement. We are committed to taking appropriate actions to further strengthen our internal control structure.

Sincerely,

David Bergstrom

Dave Bergstrom
Executive Director

cc: Judy Hunt
Dennis E. Jensen
Lloyd Johnson
Erin Leonard
Al Cooley