



FINANCIAL AUDIT DIVISION REPORT

**Teachers Retirement
Association**

Financial Statement Report

Year Ended June 30, 2008

February 26, 2009

Report 09-05

FINANCIAL AUDIT DIVISION

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

February 26, 2009

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Teachers Retirement Association of Minnesota Board of Trustees

Ms. Laurie Fiori Hacking, Executive Director
Teachers Retirement Association of Minnesota

In auditing the Teachers Retirement Association's basic financial statements for the year ended June 30, 2008, 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. This report contains our findings and recommendations on internal control over financial reporting. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the Teachers Retirement Association'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 Amy Jorgenson, CPA, (Audit Manager) and Tim Rekow, CPA, (Auditor-in-Charge), assisted by auditors Mark Allan, and Zach Yzermans, CPA.

We consider the internal control deficiencies described in Findings 1 and 2 related to the preparation of the basic financial statements to be material weaknesses. A material weakness is a deficiency, or combination of 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. We consider Finding 3 to be a significant control deficiency. 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.

We discussed the results of the audit with the Teachers Retirement Association's management on February 18, 2009. 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 Teachers Retirement Association'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 February 26, 2009.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: December 30, 2008

Report Signed On: February 23, 2009

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Report Summary

Conclusion

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

Findings

- TRA did not identify, analyze, and document business risks and controls related to business operations and financial reporting. ([Finding 1, page 3](#))
- TRA's internal controls over financial reporting did not sufficiently mitigate the risk of potential financial statement errors. ([Finding 2, page 5](#))
- Prior Finding Not Resolved: TRA 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. ([Finding 3, page 5](#))

Audit Scope

We audited TRA's basic financial statements for the fiscal year ended June 30, 2008.

Background

TRA administers a multi-employer, cost sharing retirement fund to provide retirement and disability benefits to Minnesota's public school teachers. It was established in 1931 by the Minnesota Legislature. TRA administers a Basic Plan (without social security coverage) and a Coordinated Plan (coordinated with social security coverage). For financial reporting purposes, TRA is a pension trust fund of the State of Minnesota.

TRA had net assets totaling approximately \$18 billion at June 30, 2008. For the year ended June 30, 2008, they received contributions of approximately \$445 million and paid benefits and refunds of over \$1.3 billion.

Findings and Recommendations

TRA did not identify, analyze, and document internal controls related to business operations and financial reporting.

Finding 1

TRA did not have a comprehensive risk assessment for its financial reporting and business operations. TRA has an increased likelihood of a control deficiency and financial misstatement if it does not clearly communicate to all staff its risk, control activity, and monitoring policies and procedures.

A Minnesota Department of Finance¹ policy details 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.² 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. This 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.

TRA is aware of certain risks, has many control activities in place, and performs selected internal controls monitoring functions. However, TRA has not comprehensively identified and analyzed the risks in its financial reporting process, designed its controls to address significant risks, or developed monitoring procedures to ensure that the controls are in place and are effective to reduce the significant risks identified.

TRA had the following deficiencies in its internal controls for financial reporting:

- TRA did not have sufficient controls to ensure that it received the correct amount from the state and the City of Minneapolis related to the merger of the Minneapolis Teachers Retirement Fund into the state's fund, as required by statute.³ The City of Minneapolis underpaid its direct aids for fiscal year 2008 by about \$48,000. The state's contribution was correct, but TRA did not have controls in place to verify the amount.

¹ Effective June 2008 the Legislature reorganized the Department of Finance to include the duties of the Department of Employee Relations. Although still identified in statute as the Department of Finance, in October 2008, the department changed its name to Minnesota Management and Budget. The department will seek legislative approval for the name change in the 2009 legislative session.

² Minnesota Department of Finance Policy Number 0102-01.

³ *Minnesota Statutes* 2007, 354A.12 and 432.02.

- TRA did not formalize its internal review process to ensure that its computer system accurately determined benefit payments. Occasionally, TRA support staff manually recalculated system payments for different scenarios; however, they did not perform them on a consistent basis. During fiscal year 2008, TRA made benefit payments of over \$1.3 billion. A lack of internal review methodology could lead to infrequent verification of some benefit calculations and increase the risk of incorrect system generated calculations.
- TRA did not perform criminal history background checks on new hires. TRA's policies do not require a criminal background check. Because of its fiduciary duty to safeguard \$18 billion of assets, TRA should ensure that new employees do not have criminal histories. In fiscal year 2008, TRA hired six new employees.

Frequent review and documentation of business risks, internal controls, and monitoring activities will assist the entity in finding and reducing control weaknesses.

Recommendations

- *TRA should frequently review and clearly document its risks, control activities, and internal control monitoring functions for its key business processes.*
 - *TRA should design controls to address the specific weaknesses noted in this finding. It should:*
 - *Design controls to ensure that it receives from the City of Minneapolis and the state the correct amounts as determined by statute related to the former Minneapolis Teachers Retirement Fund.*
 - *Formalize its process to routinely review system calculations of benefits and contribution amounts.*
 - *Include in its policies a requirement for criminal history background checks for all potential new employees.*
-

TRA's internal controls over financial reporting did not sufficiently mitigate the risk of potential financial statement errors.

Finding 2

TRA's fiscal year 2008 preliminary financial statements required significant adjustments. These adjustments stemmed from a lack of sufficient mitigating controls to address the weaknesses in internal controls over financial reporting.

TRA had the following errors in its preliminary financial statements:

- TRA did not have adequate controls to assure that the notes to the financial statements were free from misstatement. TRA failed to report all of its international securities, resulting in a \$1.5 billion understatement of total international equity investments. TRA failed to include its portion of the Minnesota Post Retirement Investment Fund's investments in the calculation.
- TRA made incorrect journal entries and improperly recorded a receivable. These errors led to four audit adjustments. The four audit adjustments totaled approximately \$20 million and resulted in an adjustment to net assets of over \$2 million. TRA could have identified these errors by performing basic analytical reviews.
- TRA failed to detect numerous mathematical, wording, and disclosure errors in the final draft financial statements before submitting them for audit.

The number and type of audit adjustments necessary to TRA's final draft financial statements demonstrated weaknesses in its financial reporting process.

Recommendation

- *TRA should strengthen its internal control procedures to mitigate the risk of errors in the financial statements.*

Prior Finding Not Resolved:⁴ TRA 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.

Finding 3

TRA did not have adequate controls to ensure it provided employees with appropriate access to critical resources, such as business applications and data. More specifically, the association lacked the following formal processes to:

⁴ Office of the Legislative Auditor's Financial Audit Division Report 07-23, *Teachers Retirement Association Information Technology Security Controls*, issued August 30, 2007.

- request, review, and authorize access for computer users;
- periodically review and recertify computer users' access; and
- notify security staff when an employee leaves the organization.

TRA did not have adequate documentation to help managers make informed access decisions for their staff. Such documentation would describe, in nontechnical terms, the access options available in the business application and any access combinations that would result in someone having incompatible access. Without adequate information, the managers often requested someone's 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. TRA did not have an authorized access request form on file for any of the 20 business system employees we tested.

TRA employees had access to the system that allowed them to make changes to members' addresses and bank routing information. TRA did not have controls in place to review these changes. TRA could produce a report and have supervisors verify that members had authorized the changes. TRA employees had the following weaknesses related to incompatible access to members' personal and banking data:

- Thirty-eight TRA employees had incompatible access to the department's business system. Based on inquiry and analysis, these 38 employees had the ability to change a retirement member's name, address, and bank routing information without proper controls in place to monitor these changes. These incompatibilities allowed employees to modify benefit and refund payments without member knowledge. TRA's business system automatically generated a letter to a member whose bank routing information changes occurred; however, this was not an effective mitigating control as these employees had the ability to modify members' names and addresses.
- All four key employees in the contributions refund process that had physical access to refund checks also had the ability to change a retirement member's name, address, and bank routing information in the system. Granting these employees this incompatible access increased the risk of fraudulent activity in the refund process.

In addition, five of TRA's six employees with access to the state's accounting system had incompatible access. The incompatibilities allowed some employees the opportunity to encumber funds, create contracts, enter purchase orders, receive goods, and make payments, and some employees had incompatibilities relating to the accounts receivable general accounting function.

Department of Finance's policy⁵ requires agencies that assign users to incompatible security profiles to develop and adhere to a written plan that contains a description of the independent reviews it will perform to monitor the related transactions. TRA had some mitigating controls, but they were ineffective because TRA had not documented the controls, and employees did not perform the reviews regularly. In addition, an employee who had incompatible access performed the controls. This created vulnerabilities within TRA that allowed for potential errors or fraud.

Recommendations

- *TRA should develop formal procedures to request, review, and authorize access for computer users and periodically review and recertify computer users' access.*
- *TRA should develop security documentation to provide guidance to managers making decisions about business system access for its employees.*
- *TRA should establish internal controls to ensure that changes to member banking information are authorized and correct.*

⁵ Minnesota Department of Finance Policy Number 1101-07.



February 23, 2009

Mr. James R. Nobles
Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
Saint Paul, MN 55155-1603

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to your report on the internal control over TRA's financial reporting process.

Finding #1: TRA did not identify, analyze, and document their internal controls related to business operations and financial reporting.

Recommendation: TRA should frequently review and clearly document its risks, control activities, and internal control monitoring functions for its key business processes.

TRA Response: TRA agrees that written documentation and risk assessment of existing procedures and controls need improvement. In December 2008, the TRA Board of Trustees authorized the establishment of an internal audit function. The position is expected to be filled this spring. The Board has established an audit subcommittee and audit charter to manage the planning, conducting, and reporting of the internal audit function. TRA management, with the assistance of the internal auditor, will prepare a comprehensive risk assessment of the internal control environment of all TRA operations, including financial reporting.

Based on the risk assessment results, TRA management will revise internal control policies and procedures, communicate them to employees, and implement procedures to regularly monitor their effectiveness.

Persons Responsible: John Wicklund, Asst. Exec. Director – Administration
Karen Williamson, Asst. Exec. Director- Operations

Resolution Date: June 30, 2010

Recommendation: TRA should design controls to address the specific weaknesses noted in this finding. It should:

- Design controls to ensure that it receives from the City of Minneapolis and the state the correct amounts as determined by statute related to the former Minneapolis Teachers Retirement Fund Association.

- Formalize its process to routinely review system calculations of benefits and contribution amounts.
- Include in its policies a requirement for criminal history background checks for all potential new employees.

TRA Response – Bullet 1: TRA staff will meet with City of Minneapolis staff and the Department of Revenue staff, the agency responsible for the calculation and distribution of the portion of state aid payments for pensions passed by the 1993 and 1996 legislatures. We will review their procedures and effectiveness in calculating the statutory distributions.

Persons Responsible: John Wicklund, Asst. Exec. Director- Administration
Robert Johnson, Accounting Director

Resolution Date: June 30, 2009

TRA Response – Bullet 2: The forthcoming internal audit function, with the assistance of TRA's Support Unit, will document and formalize an audit plan to select and verify samples of benefit calculations and contribution amounts.

Persons Responsible: Karen Williamson, Asst. Exec. Director- Operations
Kathy Welsh, Support Unit Manager

Resolution Date: December 31, 2009

TRA Response – Bullet 3: TRA has recently implemented procedures for checking the criminal history background checks for new employees. The procedures will be incorporated into the TRA Employee Manual.

Persons Responsible: John Wicklund, Asst. Exec. Director- Administration
Carol Sellner, Executive Assistant

Resolution Date: June 30, 2009

Finding # 2: TRA's internal controls over financial reporting did not sufficiently mitigate the risk of potential financial statement errors.

Recommendation: TRA should strengthen its internal control procedures to mitigate the risk of errors in its financial statements.

TRA Response: TRA management will assess and review risks associated with financial reporting. We agree that written policies and procedures need to be developed to document the existing process and controls already established. We will also coordinate our procedures and schedules with the State Board of Investment, the custodian of TRA assets and Minnesota Management and Budget (MMB), which also incorporates TRA financial statements in the state's financial reporting structure.

One of the duties of the internal auditor will be to perform tests of controls over key processes, such as the financial reporting and the compilation of the annual Comprehensive Annual Financial Report (CAFR). The work completed by the internal auditor will provide management a basis to review the effectiveness of the internal control structure over financial reporting and review CAFR results before it is transmitted to the OLA.

Persons Responsible: John Wicklund, Asst. Exec. Director- Administration
Robert Johnson, Accounting Director

Resolution Date: September 30, 2009

Finding # 3: Prior Finding Not Resolved- TRA did not have adequate controls to ensure computer users' access was appropriate.

Recommendations:

- TRA should develop formal procedures to request, review, and authorize access for computer users and periodically review and recertify computer users' access.
- TRA should develop security documentation to provide guidance to managers making decisions about business system access for its employees.
- TRA should establish internal controls to ensure that changes to member banking information are authorized and correct.

TRA Response to Recommendations: The TRA Security Management Team is responsible for establishing written policies and procedures defining initial system access and ongoing monitoring of security level access for employees into TRA's business systems. The TRA systems division is also evaluating the development of a new security access package that improves the ability to establish and modify access groups. The operational managers will regularly review the security access approvals for individual employees and verify the access level is appropriate. In addition, security access will be reviewed when duties of a position change.

We agree that documentation needs to be strengthened on procedures to establish and modify security access groups and protocols. The Security Management Team will provide policies and procedures to assist operational managers in their verification of proper security clearances.

TRA management will assess internal control risks over the refund of contributions process and consider alternatives in further segregating of key duties over the process.

TRA members and retirees have the ability to modify their mailing address and bank account information online through the internet. Alternatively, account holders may call or write with the notification of the change. As part of the risk assessment project, management will review existing procedures, ascertain their effectiveness, and consider additional procedures and controls. We also believe the internal audit function will provide an independent verification of selected banking and address changes.

Mr. James R. Nobles

February 23, 2009

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Persons Responsible: Laurie Hacking, Executive Director
Karen Williamson, Asst. Exec. Director- Operations
Mark Roemhild, TRA Systems Manager

Resolution Date: September 30, 2009

Thank you for the opportunity to respond to your report's findings and recommendations.

Sincerely,

A handwritten signature in cursive script that reads "Laurie Fiori Hacking".

Laurie Fiori Hacking
Executive Director