



FINANCIAL AUDIT DIVISION REPORT

**Minnesota State Retirement
System**

Financial Statement Audit

Year Ended June 30, 2008

April 23, 2009

Report 09-17

FINANCIAL AUDIT DIVISION

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

April 23, 2009

Senator Ann H. Rest, Chair
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

In auditing the Minnesota State Retirement System'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 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 Amy Jorgenson, CPA, (Audit Manager) and Tim Rekow, CPA, (Auditor-in-Charge) assisted by auditors Mark Allan, Lat Anantaphong, Jerry Foty, Kayla Peterson, CPA, Alex Weber, 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 did not note any findings we considered to be significant deficiencies. 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 Minnesota State Retirement System on April 14, 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 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 23, 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: March 27, 2009

Report Signed On: April 20, 2009

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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.

Findings

- MSRS did not identify, analyze, and document its internal controls related to business operations and financial reporting. ([Finding 1, page 3](#))
- MSRS 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. ([Finding 2, page 5](#))

Audit Scope

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

Background

MSRS was established by the state Legislature in 1929 to provide retirement benefits to state employees. MSRS's administration is governed by an 11-member board of directors. MSRS administers ten different retirement plans that provide retirement, survivor, and disability benefit coverage for Minnesota state employees as well as employees of the Metropolitan Council and many nonfaculty employees at the University of Minnesota. In addition, they administer the State of Minnesota Deferred Compensation Plan, the Health Care Savings Plan, and the Supplemental Retirement Plan for Hennepin County. For financial reporting purposes, MSRS is considered a pension trust fund of the State of Minnesota.

MSRS had net assets totaling approximately \$14 billion at June 30, 2008. For the year ended June 30, 2008, MSRS received contributions of about \$572 million and paid benefits and refunds of about \$766 million.

Findings and Recommendations

The Minnesota State Retirement System did not identify, analyze, and document its internal controls related to business operations and financial reporting.

Finding 1

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

Department of Finance's¹ policy states 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. 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. A new audit standard reinforced management's responsibility to have effective internal controls over its financial operations.³

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

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

- MSRS did not have sufficient controls in place to ensure timely financial reporting. Due to desktop publishing limitations, MSRS was unable to

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 Department of Finance Policy 0102-01.

³ Statement on Auditing Standards #109.

provide an accurate Comprehensive Annual Financial Report for audit until two months after its statutory deadline.⁴ 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 documentation to support benefit payments to one annuitant we tested. The payments were for a \$31,550 initial disability payment and \$1,163 ongoing monthly benefits. MSRS was not able to locate paper or imaged copies of documentation to support the determination or authorization of these payments. At our request, MSRS recreated the calculation for the payment, verified the recipient's personal information, and verified that the payment was deposited in the individual's account. We also contacted the recipient to ensure the payment was valid.
- MSRS did not adequately segregate incompatible receipt duties. One employee prepared the deposit and entered the receipts into the accounting system. MSRS did not perform an independent deposit review. Department of Finance's policy states that the same employee should not complete the following duties: open mail and receive cash or checks, prepare deposits for the bank, or enter receipts into the accounting system.⁵ This policy also requires that an independent employee review and approve the daily deposits. MSRS performs monthly reconciliations; however, this is not an effective mitigating control as undeposited receipts would not be part of the reconciliation. MSRS had not identified the risks related to these incompatible duties and had not developed adequate mitigating control activities.

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

Recommendations

- *MSRS should frequently review and clearly document its risks, control activities, and internal control monitoring functions for its key business processes.*
- *MSRS should design controls to address the specific weaknesses noted in this finding. It should:*

⁴ *Minnesota Statutes* 2008, 356.20, subd. 3.

⁵ Department of Finance Policy 0602-031.

- *Design controls to ensure it can complete the Comprehensive Annual Financial Report within a reasonable period after fiscal year end.*
- *Strengthen its record retention control activities to ensure proper documentation for benefit payments.*
- *Adequately segregate receipt duties.*

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.

Finding 2

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

- Request, review, and authorize access for computer users.
- Periodically review and recertify computer users' access.
- Notify security staff when an employee leaves the organization.

MSRS did not have adequate documentation to help managers make informed access decisions for its 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, MSRS 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. MSRS did not have an authorized access request form on file for 20 of 20 employees sampled.

Some employees had inappropriate access to computer systems. Of most significance, the system did not adequately restrict system access for business system users.

- Twenty-four MSRS employees had incompatible access to the department's business system. Based on inquiry and analysis, these 24 employees had the ability to change an 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 member knowledge. MSRS's business system automatically generated a letter to a member whose bank routing information had been changed; however, this was not an effective mitigating control as these employees also had the ability to modify a member's name and address and could redirect the letter.
-

- All three key employees in the contributions refund process who 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, six MSRS employees with access to the state's accounting system had incompatible access; they could encumber funds, create contracts, enter purchase orders, receive goods, and make payments. Some employees had incompatibilities relating to the accounts receivable function.

Department of Finance's policy 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.⁶ MSRS had some mitigating controls, but they were ineffective because MSRS 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 MSRS that allowed for potential errors or fraud.

Recommendations

- *MSRS should develop formal procedures to request, review, and authorize access for computer users and periodically review and recertify computer users' access.*
- *MSRS should develop security documentation to provide guidance to managers making decisions about business system access for employees.*
- *MSRS should establish internal controls to ensure that changes to member banking information are authorized and correct.*
- *MSRS should ensure it eliminates unnecessary or incompatible access to state business systems. If incompatible access is unavoidable, MSRS must implement controls designed to mitigate the risk of error or fraud.*

⁶ Department of Finance Policy 1101-07.



MSRS
MND
HCSP

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

April 17, 2009

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 respond to your audit of the Minnesota State Retirement System (MSRS) for the year ending June 30, 2008. As always, we take any audit finding very seriously and will take steps to address your findings and recommendations.

Finding 1. The Minnesota State Retirement System did not identify, analyze, and document its internal controls related to business operations and financial reporting.

I am pleased that you acknowledge that we are aware of certain risks, have many control activities in place and perform internal control monitoring functions. However, I agree that we must complete a comprehensive risk assessment of MSRS' financial reporting and business operations. We also must do a better job of documenting our control procedures. Assistant Director, Judy Hunt, will be responsible for completing a risk assessment and documenting our internal control processes. We have already started discussing how to proceed with a comprehensive risk assessment, and will have the project complete by December 31, 2010.

You also mention three specific deficiencies I would also like to address:

- 1) I would agree that we need to design and implement controls to ensure that we complete our Comprehensive Annual Financial Report (CAFR) within a reasonable period after fiscal year end. To achieve this goal, we will research alternative desktop publishing software. Accounting Director, Dennis Jensen, will be responsible for researching alternative software. We would also like to work with your office to see what steps we can take to expedite the auditing of our assets. Since MSRS administers six defined benefit plans and four defined contribution plans, finding ways to finalize the audit of these assets earlier will give us a better chance of meeting the deadline to properly report financial information for all of these plans. Our target date for resolving this audit issue is January 1, 2010.

- 2) MSRS did not have documentation to support one benefit payment, but we were able to recreate the calculation to the penny. While we feel this is an isolated case, we will begin scanning our disability documents more quickly as part of our work flow. The person responsible for ensuring proper documentation is retained for benefit payments is Assistant Director, Erin Leonard. The target date for resolution of this audit issue is June 30, 2009.
- 3) We have already segregated incompatible receipt duties. Specifically, our senior account clerk will continue to prepare the deposit for the bank. An intermediate accounting officer is entering the deposit transaction into the state's accounting system. A senior accounting officer is performing the independent review and approval of the daily deposits. The person responsible for segregating receipt duties is Accounting Director, Dennis Jensen. We resolved the audit issue earlier this month.

Finding 2. 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.

We concur with these findings. In the past year, we have taken considerable action to strengthen access controls to our online participant account system. We developed a data authorization form and a formal process for requesting and terminating access to this system. We also completed our first annual recertification designed to ensure that employees still need access to this system to perform their assigned job duties. This recertification process extends to select employees from other retirement systems and agencies as well as to MSRS employees. We also recently began to develop documentation for managers and supervisors to aid them in determining the appropriate level of employee access to our online participant account system. Persons responsible for developing formal access-related procedures and guidance for managers and supervisors include Deb Mulcahy and Lloyd Johnson.

As to the component of this finding that pertains to incompatible access for employees who have the ability to update indicative member account information while processing distributions to members, we are currently exploring alternatives to limit their access to certain functions. Procedurally, we have already eliminated some of the incompatible duties. Assistant Directors, Erin Leonard and Judy Hunt, are responsible for resolving this matter prior to December 31, 2009.

A similar corrective action plan applies to the finding that pertains to employees with incompatible access to the state's accounting system. Mitigating controls have and will continue to be implemented. Many of the incompatible duties have already been

James R. Nobles

April 17, 2009

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separated. Accounting Director, Dennis Jensen, is responsible for resolving this audit issue prior to December 31, 2009.

Again, we appreciate 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,

A handwritten signature in cursive script that reads "Dave Bergstrom". The signature is written in black ink and is positioned below the word "Sincerely,".

Dave Bergstrom
Executive Director

cc: Judy Hunt
Dennis Jensen
Deb Mulcahy

Erin Leonard
Al Cooley
Lloyd Johnson