OLA **OFFICE OF THE LEGISLATIVE AUDITOR**
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Public Employees Retirement Association

Financial Statement Audit

Fiscal Year 2010

March 2, 2011 **Report 11-05**

FINANCIAL AUDIT DIVISION
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Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Members of the Public Employees Retirement Association Board of Trustees

Ms. Mary Most Vanek, Executive Director
Public Employees Retirement Association of Minnesota

In auditing the Public Employees Retirement Association's basic financial statements for the year ended June 30, 2010, we considered internal controls over financial reporting. We also tested compliance with significant legal provisions impacting the basic financial statements. This report contains our findings and recommendations on internal control and compliance over financial reporting. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the Public Employees 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 Jim Riebe, CPA, (Audit Manager) and Carl Otto, CPA, (Audit Coordinator), Zach Yzermans, CPA, (Auditor-In-Charge), and assisted by auditors Tracia Polden, Kevin Schoenrock, and Alex Weber.

We consider the deficiency described in Finding 1 to be a 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 discussed the results of the audit with the Public Employees Retirement Association on February 23, 2011. Management's response to our finding and recommendation 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.

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This report is intended solely for the information and use of the Public Employees 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 March 2, 2011.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: December 28, 2010

Report Signed On: February 28, 2011

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Table of Contents

Report Summary

Conclusion

The Public Employees Retirement Association's (PERA) financial statements were fairly presented in all material respects. However, PERA had a weakness in internal control over financial reporting, as noted below.

Finding

- PERA did not properly report derivative information in its draft financial statement footnote disclosures. (Finding 1, page 3)

Audit Scope

We audited PERA's basic financial statements for the fiscal year ended June 30, 2010.

Finding and Recommendation

Finding 1

PERA did not properly report derivative information in its draft financial statement footnote disclosures.

PERA did not properly disclose in the notes to the financial statements information related to certain types of derivatives, including "to be announced" (TBA) mortgage-backed securities[1] and futures securities.[2] A number of factors contributed to the errors, including the implementation of a new accounting principle on derivative disclosures,[3] and the extremely technical and complex nature of derivatives. Despite some coordinated effort among PERA, the State Board of Investment, and the state's master custodian, PERA's footnote initially included the following errors:

- PERA erroneously reported its TBA mortgage-backed securities as currency futures, including changes in fair value of $23.2 million, a fair value at June 30, 2010, of $3 million, and a notional amount of $375.4 million. The State Board of Investment provided the derivative schedule to PERA that correctly classified the investments as TBA mortgage-backed securities; however, PERA used the currency futures classification in its draft disclosure.

- PERA incorrectly disclosed the fair value of futures at negative $5.1 million. The futures should have been valued at zero dollars for reporting purposes because futures trades settle daily. PERA relied on the State Board of Investment to provide the information included in the derivative disclosure since the board invests the pension's funds. The State Board of Investment also consulted with the state's master custodian to furnish the derivative disclosures. The derivative schedule that PERA received from the State Board of Investment incorrectly presented the fair value of futures because the master custodian had not updated the initial information based on subsequent discussions with Governmental Accounting Standards Board staff. However, PERA is ultimately

[1] TBA derivatives relate to mortgage-backed securities trades. The term is used because the actual mortgage-backed security that will be delivered to fulfill a TBA trade is not designated at the time the trade is made.

[2] A futures security is a financial contract obligating the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price.

[3] Government Accounting Standards Board Statement 53: *Accounting and Financial Reporting for Derivative Instruments, paragraph. 69.*

responsible for the accuracy of its financial statements and footnote disclosures.

Government accounting principles require derivative disclosures be aggregated by type and presented at fair value as of the end of the reporting period. In both of the instances noted above, PERA did not confirm the accuracy of the information it presented. Uncorrected, the inaccuracies in the derivative disclosure may have been misleading to users of PERA's financial statements.

Recommendation

- *PERA should work with the State Board of Investment and the state's master custodian to ensure the accuracy of the derivative disclosures reported in PERA's footnotes to the financial statements.*

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February 24, 2011

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

Dear Mr. Nobles:

Thank you for the opportunity to review and respond to the audit your office conducted for fiscal year 2010 and to the corresponding report on PERA's internal controls over financial reporting. We are pleased that you found that PERA's financial statements were fairly presented in all material respects. Our responses to your finding and recommendation are provided below.

1. ***Finding: PERA did not properly report derivative information in its draft financial statement footnote disclosures.***

   Recommendation: PERA should work with the State Board of Investment and the state's master custodian to ensure the accuracy of the derivative disclosures reported in PERA's footnotes to the financial statements.

   Response: While your report notes that our draft version of the financial statement disclosures had an incorrect futures value and did not properly categorize one type of derivative, those disclosures were corrected as soon as the State Board of Investment notified us of the error. All three of the statewide retirement systems relied on information provided by the State Board of Investment (SBI) for our footnote disclosures and used that incorrect information in our draft versions of the financial statements. PERA's final CAFR contained the correct disclosures.

   GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* was first implemented in fiscal year 2010. The State Board of Investment has statutory responsibility for the investment of our pension assets and that agency supplies us with appropriate derivative disclosures. All three of the statewide retirement systems worked closely with SBI and Minnesota Management and Budget in mid-December to finalize GASB 53 disclosures. We received initial disclosures from SBI, and then follow-up "correction" spreadsheets as SBI had discussions with State Street, the state's master custodian. We picked up the incorrect heading for TBAs and the incorrect fair value of futures from those spreadsheets. SBI sent a final corrected spreadsheet on December 23rd, after we had provided the auditor's office with our draft disclosures. We made the necessary corrections to the derivative disclosures as soon as we received the final spreadsheet and before issuing our CAFR.

We consider this issue resolved. We are committed to working closely with SBI and the state's master custodian as we prepare future CAFRs to ensure the accuracy of all investment disclosures. We expect that derivative disclosures will be provided earlier in the process in the future, now that GASB 53 has been implemented for a year and both SBI and State Street have received clarifying detail information from GASB about how GASB 53 should be implemented.

Sincerely,

Mary Most Vanek
Executive Director