

MARK B. DAYTON  
STATE AUDITOR

# STATE OF MINNESOTA

OFFICE OF THE STATE AUDITOR  
SUITE 400  
525 PARK STREET  
SAINT PAUL 55103

910621

296-2551

## MANAGEMENT LETTER

Members of the Retirement Board  
Minneapolis Employees Retirement Fund

We have audited the basic financial statements of the Minneapolis Employees Retirement Fund (MERF) as of and for the year ended June 30, 1990, and have issued our report thereon dated December 21, 1990. The basic financial statements are the responsibility of MERF's management. This letter resulting from that audit includes our report on internal control structure, compliance, management practices, and items that were previously reported but have been resolved.

### INTERNAL CONTROL STRUCTURE

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement.

In planning and performing our audit of the basic financial statements of MERF for the year ended June 30, 1990, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control structure.

The management of MERF is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, management must make estimates and judgments that assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- assets are safeguarded against loss from unauthorized use or disposition,
- transactions are executed in accordance with management's authorization, and
- transactions are recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection or any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect MERF's ability to record, process, summarize, and report financial data consistent with the assertions of management in the basic financial statements.

#### ITEMS ARISING THIS YEAR

##### I. Overall Control Structure--No Accounting Procedures Manual

In past years we have recommended to MERF management that it develop an accounting procedures and policies manual to be followed by the MERF staff. This recommendation was never implemented.

On May 5, 1990, the resignation of a key MERF accountant impeded MERF management's ability to generate timely and accurate accounting data. Specific examples of the problems created are:

- The June 30, 1990 general ledger was not available until August 24, 1990.
- With the exception of In-house Investment Accounts 23 and 39, MERF accounting personnel were not able to provide the auditors with reconciliations of assets or income as reported by the MERF general ledger.
- Cash receipt and disbursement postings to the general ledger for the months April through June, while correct in total, were coded incorrectly to the individual accounts. The errors were material to the financial statements of both the Active and Retired Accounts.
- Material postclosing year-end journal entries were omitted.
- Many year-end supporting schedules were either not produced or were erroneous.

These delays, omissions, and errors caused us to extend the scope of our audit tests and perform additional accounting services.

We recognize that increased number of errors result whenever there is a change in personnel. However, in this case, the number of errors would have been limited if accounting policies and detailed procedures had been available. In most instances, the errors found were due to lack of guidance afforded the MERF staff as to the nature and extent of the required procedures.

We again recommend strongly that MERF develop a detailed accounting procedures manual and thoroughly train the appropriate staff as to the proper use of this manual.

Client's Response:

We agree, a detailed accounting policy and procedures manual for MERF is necessary. The development of such a manual is now underway. Every effort is being made to complete this project before fiscal year end. In addition, every effort will be made to assure that the MERF accounting staff is thoroughly familiar with these new procedures.

In your commentary on this matter, you acknowledged that disruption and errors do result when there is a change in accounting staff personnel as there was at MERF last year. The problems this caused our accounting and your audit staff were compounded by the consequences of other extraordinary events that were transpiring. For example, the separation of MERF's former director diverted the time and attention of MERF's Accounting Manager who was obliged to assume the director's responsibilities.

Simultaneously, a major transfer of securities from internal management to external management occurred during this period. Although it is likely, given the circumstances then existing, that problems would still have occurred, even if [sic] MERF had had a procedure manual, we recognize the need for one and have made it a priority project.

II. Specific Control Categories

A. Receipts/Revenue--Receivables, Taxes and Contributions

There is confusion on the part of the MERF accounting staff about the posting of receivables and subsequent cash receipts. Our audits have consistently found errors resulting from receivables being posted to 1110 Accounts Receivable and the corresponding cash receipts being posted to either the 1109 Contributions Receivable or the 1103 Tax Receivable accounts.

MERF's accounting system for receivables should incorporate methods and records to identify, assemble, analyze, classify, and report MERF's receivable transactions and maintain accountability for the related assets and liabilities. An effective receivable accounting system should:

1. Identify all receivables and subsequent payments.
2. Describe on a timely basis the transactions in sufficient detail to permit proper classification of the receivables for financial reporting.

MERF's current receivable accounting system has insufficient methods and controls to adequately identify receivable transactions in the MERF general ledger.

During our June 30, 1990, audit, we found seven instances in which receivables were posted to accounts 1110, 1109, 1105 Contributions Receivable-MWCC, or 1103, and the cash receipt was not credited to the account in which the receivable was posted. In addition, we found receipts totaling \$68,352.80 from the Building Commission credited to 1110 Accounts Receivable when no receivable had been established in any account. Consequently, it was necessary to prepare schedules detailing 100 percent of all receivables established and their subsequent receipt postings to determine whether individual receivable accounts were valid and fairly stated at year-end.

We recommend that a clear definition of each receivable account be established in an accounting procedures manual to reduce these types of errors. We also recommend that MERF establish more contribution receivable accounts to classify contributions by source rather than combine the contributions into either accounts 1109 or 1110.

Client's Response:

As recommended, our accounting staff shall clearly define each receivable account for the fiscal year beginning July 1, 1991. We are unable to implement this change immediately because that would necessitate redoing journal entries that have already been made and that would cause further confusion for both MERF and audit staff.

We do not, however, believe that establishing additional receivable accounts to classify contributions by source will eliminate the need to prepare schedules detailing 100% of all receivables and the subsequent receipt postings. Instead, MERF's accounting staff, prior to an audit will prepare the necessary detailed listings as of fiscal year-end.

With reference to the \$68,352 receipt from the Building Commission, our Manager of Finance and Accounting acknowledges the error or posting it to a receivable when a receivable had not been set up. This particular type of payment from the Commission will terminate in 1991 and, therefore, the potential for future error will decline. But to make sure, the MERF accounting staff will, prior to the annual audit, review receipts and postings to the various receivable accounts and prepare a detailed listing.

B. Receipts/Revenue--Limited Partnerships

MERF does not have a consistent policy for recording the receipt of cash and stock distributions from its limited partnership investments. The unwritten policy prior to the year being audited was to record all distributions as limited partnership income. However, during fiscal year ending June 30, 1990, MERF recorded some Balcor distributions as a return on investment.

We reviewed the limited partnership agreements and found no indications how to account for partnership distributions. We attempted to confirm MERF's limited partnership interests at June 30, 1990, with the general partners. In most instances we were unable to do so, because the

partnerships' records were based on market value and unit prices rather than cost.

We recommend that MERF obtain from each general partner a determination of whether the limited partnership distributions are income or return of investment capital. In the absence of this information, MERF should develop a policy to consistently credit such distributions either to income or to reduce the value of the invested asset. This policy should be included in the accounting procedures manual.

Client's Response:

MERF's policy heretofore has been that, in the absence of some indication from the general partner as to how a partnership distribution is to be recorded (i.e., as income or return of capital), MERF has treated the distribution as income. However, when MERF does receive some indication as to how a distribution should be treated, as was the case with certain Balcor distributions received in FY '90, MERF treats them accordingly. We shall try to comply with your recommendation that we obtain from each general partner a determination as to how each distribution is to be treated; but we may not always be successful. Therefore, we shall continue to follow consistently our current policy and that policy shall be reflected in our accounting procedures manual.

C. Investments--Advent

During fiscal year ending June 30, 1990, the former management replaced MERF's manual securities subledger with a computerized portfolio analysis software package (Advent). During our review of the Advent system, it was determined that basic accounting controls were not in place during the operation of the system. The missing controls included both procedural and physical safeguards.

The primary procedural problem was the lack of segregation of duties. For successful internal control, it is vital that employees be limited in the number of procedural duties they execute in the performing and recording of a financial transaction. In MERF's case, the procedures executed in the Advent system are as follows:

- Programming the Advent system;
- Investing;
- Inputting investment information on the Advent system;
- Reconciling the Advent reports with custodial and investors' records;
- Posting Advent reports to the MERF general ledger;
- Reconciling Advent reports and the MERF general ledger.

Our review found the following people performing multiple procedures in the Advent system:

- The programmer was also inputting investment data, reconciling Advent to the custodial records, and reconciling the general ledger to Advent reports;

- Investors were also inputting data into the Advent system;
- The general ledger accountant was reconciling both the Advent system to the custodial records and Advent to the general ledger.

The heightened control risk resulting from a lack of segregation of duties can be mitigated by adequate managerial review and authorization. However, MERF has no provisions for managerial review or authorization of the financial records produced by the Advent system.

Adequate segregation of duties strengthens the internal control structure and allows MERF employees to find potential errors or irregularities in the course of performing their assigned tasks. It is our opinion that Advent duties are not sufficiently segregated, nor are Advent transactions adequately monitored and authorized by management. As a result, the Advent reports could be materially erroneous and not corrected in a timely manner.

Physical safeguards include preventing unauthorized access to MERF's assets or records. The physical safeguards surrounding the Advent system are nonexistent. Every employee with access to a MERF online computer has the capability to manipulate the Advent data. Changes to the financial data could be accomplished without management's knowledge and would not be discovered in a timely manner.

We found material discrepancies among the monthly Advent reports, the MERF general ledger, and the Bankers Trust custodial reports. Upon notification of our findings, the MERF staff renewed its attempt to reconcile the monthly Advent reports to the custodial records. The staff's second attempt was materially correct. However, the MERF In-house Split Investment Account and the Bankers Trust Investment Account reconciliations were not completed until October 28, 1990, and could not account for all corrections necessary to reconcile completely with the custodial records.

More significantly, we discovered an error exceeding \$250,000,000 which was created by transferring assets from fund 23 to fund 56 (two MERF In-house retired investment accounts) via purchases and sales in the Advent system without first transferring the assets in the general ledger. Consequently, the MERF general ledger had the same investments recorded as assets in both funds.

We recommend that MERF management establish new procedures for the inputting, reconciling, authorizing, and reporting of the Advent report. Furthermore, we urge the Board to insist that management's new procedures achieve the following objectives:

1. Investors should not input investment data.
2. One person in the Advent system should be made responsible for the input of the investment data, and other personnel should be limited to "reading" and "printing" capabilities of the Advent system.

3. One person, different from the persons mentioned above, should reconcile Advent to the custodial records on a monthly basis.
4. Management should review the reconciliation and authorize the necessary changes to the Advent system resulting from the reconciliation.
5. The general ledger accountant should use the "reviewed and reconciled" Advent report to enter information on the general ledger. The general ledger accountant should be a person different from any of the personnel listed in 1 through 4.
6. Once the general ledger is posted, the general ledger should be reconciled to Advent. This reconciliation could be performed by the same person who reconciles Advent and the custodial records mentioned in 3.
7. Management should review the reconciliation and authorize any necessary corrections to the general ledger.
8. Adequate cross-training should be provided to prevent delays caused by leave or termination of employment.

Client's Response:

With respect to MERF's internal computerized portfolio analysis software called Advent, we fully agree that both procedural and physical safeguard problems existed. Indeed, because of those problems and because MERF has gotten out of the business of managing money internally, the use of Advent for input into the MERF general ledger has been discontinued.

MERF is now using only the Bankers Trust reports and the Solomon General Accounting System.

D. Property Management

Starting with the June 30, 1988, MERF Comprehensive Annual Financial Report, MERF's management has reported that the goals of the property management account were to renovate, rent, and sell repossessed properties resulting from the default of mortgagees on home loans administered by MERF (MERFCO).

During the fiscal year ending June 30, 1990, the property management account had grown to a point where its balances and activities were material to both the active and retired funds of MERF. Consequently, we included property management as a control category and performed extended tests to determine how this financial information was generated. Through our tests of this control category, we found two reportable conditions.

The first condition is the property management system's inability to provide a list of managed properties which supports the valuation of the assets reported by the general ledger.

Per MERF management, the reported balance of the property management account should be the total outstanding balances of the mortgage principals of the repossessed properties. The property management system cannot provide support for these values since the system adjusts each property's value whenever a financial transaction involves the property. For instance, a renter's monthly payment reduces the value of the property. Similarly, payments of property taxes, renovations, and repossession costs are capitalized. While this practice allows management to determine if the property is "profitable" on a cash basis, it does not support the value reported on the MERF general ledger given MERF management's stated criteria.

Only through researching and listing all MERFCO foreclosures (from inception through June 30, 1990) could the MERF staff supply support for the reported value of the property management account at fiscal year-end. This list was not submitted for our review until November 28, 1990.

The second condition is the lack of oversight controls for the property management system and the property manager. The majority of the property management activity occurs outside the MERF general ledger. Cash receipts and disbursements are posted to the property management checkbook or savings account and the property management subsystem. The balances of the checking and savings accounts are not maintained on the MERF general ledger except at year end.

MERF employees do reconcile the checkbook to the bank statement monthly, and the Assistant Executive Director periodically compares canceled checks to documentation maintained by the property manager. However, no internal review of property management's subsystem is made to determine whether the balance in the reconciled checkbook is a balance supported by the activity in the property management subsystem. Finally, there has never been an attempt made by management to test for irregularities.

These tests would include, but would not be limited to, the following:

- Confirming occupancy and vacancy of the units;
- Confirming rental rates of the units;
- Confirming the costs and locations of contractual services performed;
- Observing the rental sites for occupancy, vacancy, condition, and renovations.

Our tests of the property management subsystem found no evidence of errors or irregularities which could be considered material to either the retired or the active funds. Furthermore, during the course of our audit, nothing came to our attention to indicate that errors or irregularities were occurring in the property management area. However,



as indicated above, there are virtually no controls over the property management system and its manager, and that errors or irregularities could occur without discovery by either MERF management or staff in the normal course of their duties.

Therefore, we recommend the following:

1. MERF management should maintain, separate from the property manager, a list of all properties in the property management account. The list should include the value of the property as transferred from MERFCO as well as the dates and amounts of any subsequent write downs based on activity reports from the property management subsystem. This list should be the supporting document for the property management general ledger accounts.
2. MERF management should consider creating general ledger account codes for the property management checking and savings accounts. Cash receipts and disbursements for property management could be handled in a similar fashion as those of MERFCO. This practice would afford MERF management the same controls as all other non-custodial cash receipts and disbursements.
3. MERF management should be instructed to perform reconciliations of property management cash with the activities recorded on the property management subsystem on a monthly basis.
4. The MERF Board should assign the appropriate staff to perform an internal audit of the property management area to search for potential errors or irregularities. This should be done on quarterly basis.

Client's Response:

With respect to your first recommendation, a list of all properties in the property management account has been produced and that list will be updated on a regular basis by MERF management with input from MERFCO. Income statements will be prepared on each property. In the case of properties with a net profit, the net profit will be used to decrease the principal balance in MERF's General Ledger. A net loss will be taken as an expense and not increase the principal balance.

In response to your second recommendation, MERF Property Management will make every effort to create general ledger account codes for Property Management checking and savings accounts before the close of the current fiscal year.

As to your third recommendation, we are informed that monthly receipts and disbursements are available from MERF Property Management's subsystem for reconciliation to the reconciled bank balances and also to the general ledger. Inquiries have been made to determine if there is a consolidated monthly cash disbursement report available on the system that can be used instead of the disbursement report for each individual property.

Finally, in response to your fourth recommendation, management is planning to augment the accounting staff during the current fiscal year. Assuming that happens and workload and training permit, staff shall undertake to perform internal audit of the Property Management area to check for potential errors or irregularities. We have an acute appreciation for the value of ongoing internal audit.

\* \* \* \* \*

A material weakness is a reportable condition in which the design or operation of the specific internal control structure element does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the basic 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 structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as described in the prior paragraph. However, we believe all the reportable conditions described above are material weaknesses.

#### COMPLIANCE

Compliance with laws, regulations, contracts applicable to the Minneapolis Employees Retirement Fund, is the responsibility of the Minneapolis Employees Retirement Fund's management. As part of obtaining reasonable assurance about whether the basic financial statements are free of material misstatement, we performed tests of MERF's compliance with certain provisions of laws, regulations, and contracts. However, our objective was not to provide an opinion on overall compliance with such provisions. The following are our observations and comments regarding our findings.

#### PREVIOUSLY REPORTED ITEM--NOT RESOLVED

##### Fiduciary Disclosure

In our December 1, 1989, letter we notified the Board of our discovery that the Executive Director was also serving as a director of Applied Vision Systems Incorporated (AVSI) and had a personal investment in the company. Our tests found no evidence of the Director's disclosure of this activity to the Board in the MERF Board minutes, nor was an Economic Interest Statement filed with the MERF Board.

Subsequently, we discovered that the former Executive Director of MERF had a personal investment in Ultimap Corporation. As was the case with our discovery of the Director's investment in AVSI during the June 30, 1989, audit, we were unable to verify that he had disclosed his personal holdings in Ultimap to the MERF Board.

The former Executive Director's investment in Ultimap had been brought to the attention of the Hennepin County Attorney's Office. Their primary review focused on whether the former Executive Director had purchased stock in violation of Minn. Stat. § 471.87, relating to a public officers' interest.

Except as authorized in 471.88, a public officer who is authorized to take part in any manner in making any sale, lease, or contract in official capacity shall not voluntarily have a personal financial interest in that sale, lease, or contract or personally benefit financially therefrom. Every public officer who violates this provision is guilty of a gross misdemeanor.

The Hennepin County Attorney's Office completed an Investigative Report on its review, HCAO File No. (90-0169). We are not aware of any action by the County Attorney against the former Executive Director, nor does the Investigative Report, issued to us upon our request, indicate that action was recommended.

Regardless of the applicability of Minn. Stat. § 471.88 to these occurrences, the failure of the former Executive Director to file with MERF an Economic Interest Statement disclosing his investment in Ultimap would be a violation of Minn. Stat. § 356A.06 subd. 4, "Economic Interest Statement," which states:

Each member of the governing board of a covered pension plan and the chief administrative officer of the plan shall file with the plan a statement of economic interest.

The former Director's personal investment in Ultimap and his subsequent management of MERF's Ultimap investment may also be a violation of Minn. Stat. § 356A.06 subd. 3, "Absence of Personal Profit." This provision states:

No fiduciary may personally profit directly or indirectly as a result of the investment or management of plan assets.

It is our position that this statute prohibits any fiduciary from managing plan assets in a manner that would minimize personal losses.

In the Ultimap instance, MERF exercised its rights to convert \$390,000 of convertible debentures in Ultimap to stock. According to the former Executive Director, this conversion was made to improve the balance sheet of Ultimap and help draw potential investors into the company. It is questionable whether it was in the best financial interest of MERF to move from a creditor position to that of an owner of Ultimap. Ultimap had cash flow problems and the possibility of bankruptcy was evidenced by the need to consider such a conversion. Since creditors are paid before shareholders in bankruptcy proceedings, it may have been more prudent for MERF to retain a creditor's position. However, MERF's change of position benefited the former Executive Director since his position as an owner was improved by the large reduction of debt from Ultimap's balance sheet.

This is the third time we have notified the MERF Board of the former Executive Director's personal interests as either a director or shareholder in venture capital investments of MERF. Authorizing the Executive Director to sit on corporate or limited partnership boards and allowing his personal investment in

these entities could lead to potential conflicts of fiduciary duty. We have also warned the MERF Board that, if the Executive Director's participation in these venture capital investments were viewed as activities of an agent of MERF, MERF could be liable to minority shareholders or third parties for his actions.

Until recently, the MERF Board has openly disagreed with our opinion. MERF has stated to us that it viewed its approach as part of a national trend in which pension funds are responsibly seeking an active role in the corporations in which they invest. MERF has also argued that there has been no conflict of interest because MERF's interest as a corporate shareholder is identical to that of all other shareholders including its Executive Director.

We believe that our concerns have been justified.

Finally, we must alert the MERF Board that the former Executive Director falsely represented to us in MERF's November 17, 1989, Audit Representation Letter that all relevant disclosures had been made to us. Based on state statute, past audits, and our Management Study, the former Executive Director was aware that we expected complete fiduciary investment disclosure. Yet, the former Executive Director failed to inform us of his Ultimap investment when we asked if there were any other investments besides AVSI and those previously disclosed in our MERF Management Study in which both he and MERF had financial interests.

In our judgment, the "prudent person" standard indicates the MERF Board had a fiduciary responsibility to insist that the former Executive Director provide written disclosure of all his personal investments to the MERF Board. The Board did not demand written disclosure after the Management Study results were published, nor did it force disclosure when written disclosure was required by Minn. Stat. § 356A subd. 4. The Fiduciary Act of 1989 was passed, effective June 2, 1989, approximately 11 months prior to the former Executive Director's resignation from MERF.

MERF is conducting an investigation to determine whether there are any other instances of undisclosed personal investments by the former Executive Director in which MERF also has or had funds. MERF management has verbally disclosed that 22 other instances have been detected since the end of the audited year. MERF has also indicated its intention to intensify its investigation to determine if any evidence exists to support potential allegations of fiduciary misconduct.

We believe the management and Board of MERF have the most access, authorization, and obligation to pursue this investigation. Therefore, we recommend that MERF continue its investigation. We also recommend that MERF be prepared to provide us written documentation to support all verbal disclosures prior to the initiation of the June 30, 1991 audit.

#### Client's Response:

This Board acted last May to sever the relationship with MERF's former director. Since then over twenty instances have been identified where the former director had invested personal funds in companies or entities in which he also invested MERF money. Not only did he fail to disclose these personnel [sic] investments to us, but he also failed to file a Statement of Economic Interest, even though

he knew such a statement was required and even though each Board member filled [sic] a statement in January of 1990. Eventually we would have learned of the former director's failure to file an Economic Interest Statement and we would have insisted that he file. But that was preempted by our action in May of 1990 when we ended his association with MERF.

On November 20, 1990 we voted to repeal MERF's 1984 blanket authorization that allowed the director to serve on corporate boards and other panels and to receive the normal stipend for such service. The full extent of this type of activity was never disclosed to us (in fact the director led us to believe that he was ceasing such activity) and even now, is not fully known; had it been, we would have had the same concern over the potential for conflict of interest and personal gain that motivated us to rescind the authorization last November.

On February 19, 1991 this Board voted to begin legal action against MERF's former director for violations of fiduciary responsibility that have caused significant losses to the MERF funds. In part, this legal action, which began on March 9th, arises from the kind of personal investment and other practices the former director was pursuing privately that were either misrepresented or not disclosed to this Board.

As you understand, we as a Board were in no better position (and may have been in a worse position) than your audit staff to know whether, and to assure that, the former director had fully and completely disclosed his personal investment and other potential conflict of interest and personal gain activities. We assumed full disclosure had been made; we now know it was not. We did not expect to find the large number of potential conflict of interest situations that we now - fortuitously - know about. We reasonably expected him to file an Economic Interest Statement routinely, just as we did in January, 1990 to comply with the Fiduciary Responsibility Act. What we, of course, cannot know, had any such statement been filed, is whether it would have contained a full and complete disclosure. We would have had to rely on your audit staff to verify the completeness of the disclosure.

We certainly had no better means available to us than did your audit staff for verifying that full disclosure had - or had not - been made. Indeed, it is quite accidental that we were able to identify the more than twenty instances where the former director's personal money and MERF money were invested in the same enterprises. Even now, with litigation underway, it is unclear whether we shall ever know the full extent of this potential conflict of interest and personal gain activity. Nevertheless, we can assure you that this matter is being, and will be, aggressively pursued. Unless our attorneys assert attorney/client privilege, we shall be happy to share with your audit staff all documentation we have of these conflict of interest situations.

#### MANAGEMENT PRACTICES

As part of our financial statement audit, we also reviewed certain management practices. Our review was not a detailed study of every system, procedure, and transaction. Accordingly, the items presented here may not be all-inclusive of areas where improvement may be needed.

With respect to your recommendation for the preparation of a Section 11A.24, Subd. 6 asset class list, we shall do that quarterly. Such quarterly reporting should be more than sufficient to alert us as a Board to any problem or any possibility that the 35% limit might be exceeded, especially in view of the fact that MERF no longer participates in the BTC cash plus account and is seeking legislative authorization to allow participation in commingled funds.

With respect to your comments on the purchase of below investment grade securities in FY '90, as you know we were unaware that his practice was going on. Most of this was done in the last quarter of 1989 and the first quarter of 1990. When we learned of it in May, we acted promptly to turn over the management of the bond component of the in-house managed, fixed income portfolio to Investment Advisers, Inc. to rate all bonds and begin the process of disposing of these below investment grade securities. In addition, at our September 18, 1990 meeting we adopted as policy, a provision requiring MERF's performance measurement consultant to report quarterly to the Board on each portfolio manager's performance and rate all bonds.

Finally, the fact that over \$80 million was invested in FY'90 in below investment grade securities without the Board's knowledge or approval was another factor that motivated us to initiate legal action against MERF's former director.

#### ITEMS ARISING THIS YEAR

##### Property Management Vacancy and Sales Rates

During our review of the property management control category it came to our attention that 53 of the 142 (37 percent) units administered by the property manager were vacant at June 30, 1990. Furthermore, only five of the units repossessed since the inception of MERFCO have been resold. Both the property manager and the manager of MERFCO have represented to us that rental and condominium markets are sufficiently soft to cause MERF to lose tenants or sales by insisting on the monthly lease rates or sale prices necessary to cover MERF's costs.

We recommend that the MERF Board instruct MERF management to provide the Board with a cost/benefit analysis of the effects of lowering the rental rates and sales prices of the property management holdings. This analysis should address cash flow needs, opportunity costs, and potential damage and maintenance costs of MERF property.

##### Client's Response:

MERF does not have a policy of insisting on monthly rental rates or sale prices that could cause us to lose tenants or prospective purchasers of MERF owned property. That would be self-defeating. The Board has been assured that MERF Property Management is setting monthly rentals and sale prices at market rates and will be augmenting existing efforts to rent available units until such time as market conditions improve and the properties can be sold. We are also assured that the option of holding and renting MERF-owned residential real estate is constantly being evaluated relative to the option of selling the property in the existing depressed market for condominiums. Even though this

The City of Minneapolis Employee Handbook states on page 18 that an employee is entitled to receive unused sick leave only to the extent that he or she has "banked" over 60 days. If an employee has between 60 and 89 days of sick leave, that employee receives 50 percent of the hours over 60 days. In implementing the above Board resolution with regard to sick leave, the Acting Executive Director did not use the contractual provisions regarding unused sick leave. Rather, he took the entire amount of sick leave per the MERF payroll, that being 677.8 hours, and paid the former Executive Director \$32,154.83. Under the contract with MERF, the former Executive Director would have been paid \$4,691.81, calculated as follows:

60 days = 480 hours  
677.8 hours - 480 hours = 197.8 hours  
50 percent of 197.8 hours = 98.9 hours  
98.9 X \$47.44 per hour = \$4,691.81

The difference between the \$32,154.83 paid to the former Executive Director and the \$4,691.81 owed (as calculated above) is \$27,463.92.

The second item of concern in the Board resolution is the provision that MERF pay the former Executive Director one month's salary as severance pay. This amount was determined to be \$8,222.80. Under the contract between the former Executive Director and MERF, the former Executive Director was not entitled to severance pay. Again, his fringe benefits were exactly the same as regular MERF employees and hence the same as City of Minneapolis employees. Regarding severance pay, City of Minneapolis employees are only entitled to severance pay if they are 60 years of age or older and have been employed by the City 20 years or more. Since, the former Executive Director was neither 60 years of age nor had been employed by MERF for 20 years, he had no right to severance pay. The payment of \$8,222.80 combined with the overpayment of sick-leave pay constitutes a total overpayment of \$35,685.82

We are aware that MERF requested and received on December 9, 1990, an opinion on this issue from MERF's legal counsel. Counsel disagreed with our assessment, stating:

. . . the Acting Executive Director/Chief Investment Officer acted in accordance with the Resolution adopted by the MERF Board and did not make any payment to Mr. Chenoweth which was not authorized by the MERF Board. Nor does the payment appear to be otherwise forbidden by applicable law or regulation.

Counsel's basic arguments for its conclusions were identified in their opinion letter as bases 1, 5, 6, and 2.

Basis 1 clearly states counsel's assertion there was no written contract between the former Executive Director and the MERF Board.

Basis 5 states that Minn. Chapter 422A gives the MERF Board the authority to compensate the Executive Director/Chief Investment Officer and that civil service rules do not apply to that position.

Basis 6 states that counsel could find no provisions of State law which forbade or otherwise restricted the actions by the MERF Board and the Acting Executive Director/Chief Investment Officer.

Basis 2 states that the Resolution specifically identifies the one month's severance pay as separate from the additional payments for accumulated unused vacation and sick leave time and that the calculation of this time was to be done by the Acting Executive Director.

We disagree with counsel's opinion. While there was no written contract between the former Executive Director and the MERF Board, we believe that the written contract which expired on October 31, 1989, was carried forward as a contract at will by both parties. This is evidenced by the following:

1. The former Executive Director continued to perform the same services and the Board continued to reimburse the former Executive Director at the same rate.
2. Both the Board and the Executive Director believed (as indicated by a written resignation and MERF Board Resolution to accept said resignation) that a contract did exist between the parties at May 11, 1990.
3. There is no possible basis the Acting Executive Director could have used to determine sick leave without reference to a contract.

We believe these facts illustrate both parties' belief that a contract was in existence at May 11, 1990, and that this contract was a contract at will which extended the rights and obligations described in the expired written contract. Therefore, we repeat our finding that MERF had no obligation to pay \$27,463.02 of unused sick leave, nor the \$8,222.80 as one month's severance pay.

Furthermore, if MERF determines that its counsel's advice has greater merit, then the MERF Board should identify what consideration was offered MERF by the former Executive Director to entitle him to any payment other than the current pay due him at May 11, 1990.

In either case, we believe the MERF Board has paid \$35,685.82 that it was not contractually obligated to pay, and for which it appears it received no additional consideration from the former Executive Director.

Therefore, we recommend the MERF Board recover from the former Executive Director a total of \$36,549.61, representing total overpayments of travel reimbursement, accumulated unused sick-leave, and severance paid to him during 1990 for which he was not entitled.

#### Client's Response:

With respect to your recommendation that MERF undertake to recover \$36,550 of overpaid travel reimbursements, accumulated sick leave and severance paid to the former director during FY '90, our comments are as follows: First, the \$864 travel expense item was offset against monies owed to the director in health and child care reimbursements.



With respect to the remaining amount, MERF management has been instructed to issue a request for payment letter, citing your comments as the basis for the request. If not complied with, we shall refer the matter to MERF's attorneys and let them weigh the desirability of including this matter in our current litigation.

PREVIOUSLY REPORTED ITEM RESOLVED

The following item included in our previous management and compliance letter dated December 1, 1989, has been resolved.

<u>Item</u>	<u>Resolution</u>
<u>Travel Claims and Policies -</u>	
We recommended the MERF Board require direct travel claims to be submitted within 30 days of the traveler's return and allow reimbursement of only those expenses supported by original receipt.	The MERF Board amended its policy to require direct travel claims to be submitted within 45 days of the traveler's return. NOTE: The Board still does not require original receipts.

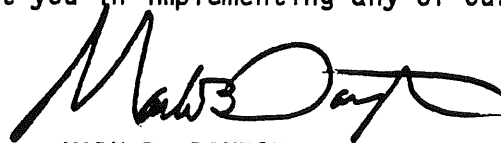
Client's Response:

As a final point on the issue of travel expense reimbursement, we shall be considering this month an amendment to our internal policies to require claims to be submitted within 30 days following the end of the travel status, and also require the submission of original expense receipts for airfare, lodging, registration, tuition or conference fees, and car rental.

\* \* \* \* \*

This report is intended for the information of the MERF Board and the management of MERF. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

We are available throughout the year to assist you in implementing any of our suggestions.



MARK B. DAYTON  
State Auditor

December 21, 1990