FINANCIAL AUDIT
OF THE

STATE TREASURER'S ANNUAL REPORT

DEPARTMENT OF TREASURY

October 1, 2000 through September 30, 2001

27-252-02M

Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit
State Treasurer's Annual Report
Department of Treasury
Fiscal Year Ended September 30, 2001

Report Number:
27-252-02M

Released:
October 2002

A financial audit determines if the financial schedules are fairly presented; considers internal control over financial reporting; and determines compliance with State compliance requirements material to the financial schedules. This financial audit of the State Treasurer's Annual Report was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Schedules:

Auditor's Report Issued

We issued an unqualified opinion on the State Treasurer's financial schedules. Our opinion and the financial schedules are included in the State Treasurer's Annual Report issued by the Department of Treasury.

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Internal Control Over Financial Reporting

We did not identify any material weaknesses in internal control over financial reporting. However, we did identify a reportable condition (Finding 1).

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Noncompliance Material to the Financial Schedules

We did not identify any instances of noncompliance applicable to the financial schedules that are required to be reported under *Government Auditing Standards*.

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Background:

The State Treasurer, under the authority provided by State statutes, is responsible for the investment activities and the safekeeping of assets of the State Police, State Employees', Public School Employees', and Judges' Retirement Systems; various trust funds; and the State's Common Cash pool. The State Treasurer is also responsible for accounting for the investment activities and the safekeeping of assets of the Legislative Retirement System.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: www.state.mi.us/audgen/

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

October 31, 2002

Dr. Douglas B. Roberts
State Treasurer
Treasury Building
Lansing, Michigan

Dear Dr. Roberts:

This is our report on the financial audit of the State Treasurer's Annual Report, Department of Treasury, for the period October 1, 2000 through September 30, 2001.

This report contains our report summary; description of agency; finding, recommendation, and agency preliminary response; and independent auditor's report on compliance and on internal control over financial reporting. The independent auditor's report on the financial schedules was provided to the Department of Treasury separately for inclusion in the State Treasurer's Annual Report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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STATE TREASURER'S ANNUAL REPORT
DEPARTMENT OF TREASURY

Description of Agency

The State Treasurer, under the authority provided by State statutes, is responsible for the investment activities and the safekeeping of assets of the State Police, State Employees', Public School Employees', and Judges' Retirement Systems; various trust funds; and the State's Common Cash pool. The State Treasurer is also responsible for accounting for the investment activities and the safekeeping of assets of the Legislative Retirement System.

The Bureau of Investments, Department of Treasury, manages the investments for the State Treasurer. As of September 30, 2001, the market value of the retirement systems and the State's Common Cash pool totaled over $50 billion.

FINDING, RECOMMENDATION, AND AGENCY PRELIMINARY RESPONSE

FINDING

1. **Value Estimation for Private Alternative Investments**

The Bureau of Investment's (BOI's) value estimation methodology for private alternative investments (PAIs) of the pension trust funds needs enhancement to comply with applicable accounting standards.

Governmental Accounting Standards Board (GASB) Statement No. 25 requires pension trust fund investments to be reported at fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for the investment in a current sale between willing parties, other than in a forced or liquidation sale.

As of September 30, 2001, BOI had invested $6.5 billion (13.5%) of $48.0 billion total investments in private and public alternative investments. Our review of 6 PAI balances at September 30, 2001 disclosed:

a. BOI's PAI fair value estimates did not consider changes, other than cash flow transactions, in the PAIs' capital balances between the PAIs' financial statement dates and the State's September 30 financial statement date. By comparison, for public alternative investments, BOI obtained September 30 fair values from a pricing service, which appropriately included increases or decreases in the capital balances through September 30.

   The fair values for 2 PAIs originated from their capital balances as of March 31 and for another 2 PAIs as of June 30. As of September 30, the capital balances for these 4 PAIs had decreased by $43.9 million (15%), which is approximately a tenth of a percent (.1%) of total investments. By not taking these capital reductions into account, BOI overstated the fair value of these 4 PAIs by this amount in the schedule of investment portfolios of specific funds in the Annual Report of the State Treasurer.

   The American Institute of Certified Public Accountants (AICPA) *Codification of Statements on Auditing Standards*, AU section 560.03, states that all information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

b. BOI estimated the fair value of 2 PAIs' capital balances using March 31 capital balances for the current fiscal year ended September 30, 2001 and June 30 capital balances for the prior fiscal year ended September 30, 2000. This resulted in an inconsistency in year-to-year comparability of the financial schedules. The AICPA *Codification of Statements on Auditing Standards*, AU section 332.32, recognizes that time lags may occur in reporting the fair value of investments. However, it states that a time lag should be consistent from period to period. In addition, AU section 332.32 states that a time lag could be material to the financial statements because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag.

   The financial managers for the PAIs are required to provide financial statements to BOI at various intervals after the end of the quarter. For the 2 PAIs, the financial statements for the quarter ended June 30, 2001 were due August 15 and September 30 and, thus, should have been available for estimating fair value balances as of September 30, 2001.

Developing a methodology to identify significant transactions occurring during time lags, such as monitoring the activity of the PAIs and monitoring the difference between the estimated September 30 fair value and the actual fair value as provided in the PAIs subsequently issued September 30 financial statements, could help BOI minimize the effect of time lags on its financial schedule. This is especially important in a volatile market when current fair values could change rapidly.

RECOMMENDATION

We recommend that BOI enhance its value estimation methodology for PAIs of the pension trust funds to comply with applicable accounting standards.

Agency Preliminary Response

BOI concurs with the finding and informed us that it has taken action to address the concerns identified in the finding.

In the absence of current financial statements, a methodology is being developed to more accurately estimate the fair value of the PAIs at the end of each reporting period. Because of concurrent preparation and audits by PAI firms and the State, the PAI financial statements needed to accurately record the current data are not available prior to the State's accounting deadlines. Therefore, this financial information is currently reflected in subsequent reporting periods.

Additionally, BOI informed us that it has taken action to ensure that financial statements are received in a timely manner. This action will minimize the lag time in recording the fair value of PAIs. This will reinforce the consistency and comparability of the statements between periods and ensure compliance with applicable accounting standards.

The results of these changes will be reflected in the fiscal year 2001-02 financial schedules.

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting

April 19, 2002

Dr. Douglas B. Roberts
State Treasurer
Treasury Building
Lansing, Michigan

Dear Dr. Roberts:

We have audited the financial schedules of the State Treasurer as of and for the fiscal years ended September 30, 2001 and September 30, 2000 and have issued our report thereon dated April 19, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the State Treasurer's financial schedules are free of material misstatement, we performed tests of the Department of Treasury's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department of Treasury's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial schedules and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial schedules. The reportable condition is described in Finding 1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules 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 over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition identified in the previous paragraph is not a material weakness.

This report is intended solely for the information and use of the State's management and the Legislature and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL