



State of Wisconsin \ LEGISLATIVE AUDIT BUREAU

July 9, 2003

JANICE MUELLER
STATE AUDITOR

22 E. MIFFLIN ST., STE. 500
MADISON, WISCONSIN 53703
(608) 266-2818
FAX (608) 267-0410
Leg.Audit.Info@legis.state.wi.us

Ms. Patricia Lipton, Executive Director
State of Wisconsin Investment Board
121 East Wilson Street
Madison, Wisconsin 53703

Mr. Eric Stanchfield, Secretary
Department of Employee Trust Funds
801 West Badger Road
Madison, Wisconsin 53702

Dear Ms. Lipton and Mr. Stanchfield:

The Department of Employee Trust Funds (ETF) and the Investment Board are partners in administering the Wisconsin Retirement System (WRS). As part of this relationship, ETF relies on investment information the Investment Board provides to properly report WRS investments and returns. During our audit of ETF's 2001 financial statements, we found that an error in information the Investment Board provided ETF resulted in a significant error in the crediting and reporting of the investment account balances for the Milwaukee Retirement Systems, which invest in the WRS investment trust funds. The balances in the Milwaukee Retirement Systems were overstated by a total of \$3.87 million for the period February 2001 through January 2003. The investment balance for the Milwaukee Schools Retirement System was adjusted for its overage, while ETF is attempting to recover funds from the City of Milwaukee Retirement System, which had discontinued its investment in the WRS funds as of June 2002.

The error occurred as the result of human error by Investment Board staff in transcribing information from its custodial bank. However, ETF may have been able to detect the error earlier if it had been more diligent in reviewing information in its financial reports. Further, the error demonstrates a need for additional care and collaboration by both agencies in ensuring that information is correctly calculated and communicated. Both the Investment Board and ETF have responded quickly to correct the error and to take steps to prevent similar errors from occurring in the future.

A more detailed description of the error and the responses from the Investment Board and ETF on their plans to implement recommendations are attached.

Sincerely,

Janice Mueller
State Auditor

JM/DA/bm

Enclosure

cc: Senator Carol A. Roessler
Senator Robert Cowles
Senator Alberta Darling
Senator Gary George
Senator Jeffrey Plale

Representative Suzanne Jeskewitz
Representative Samantha Kerkman
Representative Dean Kaufert
Representative David Cullen
Representative Mark Pocan

MILWAUKEE RETIREMENT SYSTEMS ERROR

The Department of Employee Trust Funds (ETF) and the Investment Board are partners in administering the Wisconsin Retirement System (WRS): ETF collects contributions and administers benefits, while the Investment Board is responsible for investing WRS assets.

ETF relies on investment information the Investment Board provides to properly report WRS investments and returns. However, an error in information the Investment Board provided ETF resulted in a significant error in the crediting and reporting of investment returns for other retirement systems investing in WRS funds. This error demonstrates a need for additional care and collaboration in ensuring that information is correctly calculated and communicated between the agencies.

Section 40.03(1)(n), Wis. Stats., allows other retirement systems to invest in the two WRS funds: the Fixed Retirement Trust Fund (Fixed Fund) and the Variable Retirement Trust Fund (Variable Fund). Since the provision was established in 1984, two retirement systems have opted to invest in the WRS funds: the City of Milwaukee Retirement System, which recently discontinued investing in the Fixed Fund, and the Milwaukee Schools Retirement System, which currently invests in both the Fixed Fund and the Variable Fund. Collectively, these two separate retirement systems are reported as the Milwaukee Retirement Systems.

As provided by administrative code, the Milwaukee Retirement Systems' investments in the two WRS funds are adjusted to fair value as of the last day of each month. Monthly, the Investment Board reports to ETF the fair values and rates of return for the Fixed and Variable funds, which ETF uses to allocate earnings and calculate the month-end balances for the Milwaukee Systems.

As part of analytical procedures we performed during our calendar year 2001 audit of ETF, we noted that investment returns reported for the Milwaukee Retirement Systems did not match our expectations. Specifically, the positive investment income reported for the Milwaukee Retirement Systems was inconsistent with our expectations of investment losses, since both the Fixed Fund and the Variable Fund had experienced net investment losses for the year. Upon further review of the Investment Board files, we determined that the rates of return included in the February 2001 reports that the Investment Board had sent to ETF were in error. Based on revised reports included in the Investment Board files, the rates of return were off by two decimal places—the rate of return for the Fixed Fund should have been (4.5488 percent), rather than the (0.0455 percent) originally reported, and the rate of return for the Variable Fund should have been (8.9008 percent), rather than (0.0890 percent).

The application of the incorrect rates of return to the balances for the Milwaukee Retirement Systems not only resulted in errors for the month of February 2001, but it also had an accumulating effect in subsequent months because future returns were applied to an incorrect balance. Between February 2001 and January 2003, when we identified the error, the balance in the Milwaukee Retirement Systems was overstated by \$3.87 million. In the case of the City of

Milwaukee Retirement System, which had discontinued its participation in the Fixed Fund as of June 2002, the overage had already been remitted to the system. ETF is currently attempting to recover \$1.15 million from the City of Milwaukee Retirement System. The investment balance for the Milwaukee Schools Retirement System, which continues to participate in the Fixed and Variable funds, has been adjusted for an overage of \$2.72 million.

The overages in the Milwaukee Retirement Systems also affected the balances in the WRS and other state programs invested in the Fixed Fund. Because the Milwaukee Retirement Systems' balances were overstated, the WRS and other state programs' balances invested in the Fixed Fund were understated, with most of the understatement reflected in the WRS. Fortunately, the errors in the WRS funds did not alter the effective rates used to determine interest distributed to WRS participants in 2001 because of rounding requirements for the effective rates. In addition, in March 2003, ETF adjusted the balances reported for the WRS and Milwaukee Retirement Systems to correct the overage credited to the Milwaukee Retirement Systems for calendar year 2001 financial statement purposes. ETF determined the errors in the other state programs, which totaled \$78,065, were immaterial, and it decided not to correct their corresponding investment returns or balances for the calendar year 2001 financial statements. ETF corrected these errors as part of its calendar year 2002 earnings allocation process.

The Investment Board's Quantitative Analytics Group obtains the monthly rates of return from the custodial bank and compares these rates to its own independently calculated rates to ensure their reasonableness. However, when transcribing the rate from the custodial bank's report into the report sent to ETF, a human error was made, placing the decimal points in the wrong place.

In response to the error, the Investment Board is taking steps to provide for an additional review by the Quantitative Analytics Group and the Director of the Investment Operations and Fund Accounting Group to ensure the accuracy of the rates of return provided to ETF for allocating earnings to the Milwaukee Retirement Systems. Similar steps should also be taken to ensure the accuracy of other information the Investment Board provides to ETF for financial reporting purposes, including information that is used for ETF's calendar year financial statements, submissions for the State's fiscal year financial statements, and the determination of the effective rates used in allocating and applying earnings to WRS participants, reserves, and other state programs investing in the Fixed Fund. Therefore, *we recommend the State of Wisconsin Investment Board review its procedures in order to ensure the accuracy and reasonableness of all information provided to the Department of Employee Trust Funds.*

During the course of our audits of the two agencies, we have identified past instances in which the Investment Board has not communicated subsequent identification of errors or revisions in information provided to ETF, such as errors identified as part of the audit process. For example, during the fiscal year 2000-01 audit of the Investment Board, the Audit Bureau requested revisions to the WRS financial statements. However, the Investment Board never notified ETF of the changes, even though ETF relies on such information for submissions for the State's financial report. Therefore, *we recommend the State of Wisconsin Investment Board and the Department of Employee Trust Funds establish procedures for ensuring that errors or revisions in information the Investment Board provides the Department of Employee Trust Funds are adequately disclosed and acknowledged between the agencies.*

While the responsibility for the origination of the error largely rests with the Investment Board, ETF also may have been able to detect the error if it had been more diligent in reviewing the reasonableness of information in its financial reports based on trends and relationships of information between years and accounts. In response to the errors, ETF is taking steps to compare the monthly investment returns reported by the Investment Board to industry benchmarks. However, to ensure overall reasonableness of its financial information, we recommend the Department of Employee Trust Funds establish procedures to assess the reasonableness of financial information based on trends and relationships in information between years and with corresponding accounts and expectations. In addition, we recommend the Department of Employee Trust Funds document the reviews performed to serve as support for the audit process. Further, we support ETF's efforts to prepare more timely financial reports for calendar year 2002, as more timely reporting would have contributed to earlier detection of the error as part of the audit process.



State of Wisconsin Investment Board

MAILING ADDRESS
PO BOX 7842
MADISON, WI 53707-7842

121 EAST WILSON ST
MADISON, WI 53702
(608) 266-2381
FAX: (608) 266-2436

June 13, 2003

Ms. Diann Allsen
Legislative Audit Bureau
22 E. Mifflin Suite 500
Madison, WI 53703

Dear Ms. Allsen:

I appreciate the opportunity to respond to your memo regarding the error in reporting the Milwaukee Retirement Systems' investment account balances. We agree with the recommendations in your report and we have taken additional steps to ensure the accuracy of information we report to the Department of Employee Trust Funds (ETF).

Each month we report status information for the Fixed and Variable Trust Funds to ETF so that they can calculate investment account balances for the Milwaukee Retirement Systems. When we placed the rates of return for February 2001 into an email to ETF the decimal points were put in the wrong spot.

SWIB has added a new level of review of the information we provide to ETF. The Director of Quantitative Analytics and the Director of Investment Operations are included in this review. As a reasonableness check on the data, our Operations Group is reconciling market value data from our accounting system and performance reporting systems before information is provided to ETF. To assist ETF in making a reasonableness check of its own calculations for the Milwaukee Retirement Systems, we will be providing them rolling 12-month return figures for the trust funds. Finally, when this information is put into an email, the Investment Operations Director is reviewing the email itself before it is sent to ETF. These measures should provide added assurance that SWIB is giving accurate information to ETF for their calculations for the Milwaukee Retirement Systems accounts.

At a broader level, we have reviewed our reporting procedures to confirm that all financial information is reviewed by at least one person other than the preparer before it is provided to ETF. We have also extended this check to include financial information we report to other agencies and external parties.

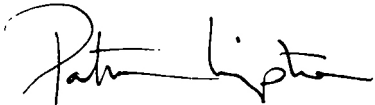
As recommended in your memo we have worked with ETF to improve the process for reporting errors or subsequent corrections in the information we provide. Upon discovering the need to revise a previously issued report, SWIB personnel will update the report and forward it to the appropriate reviewer(s) for approval. Once approved, the revised report will be emailed or faxed

Ms. Diann Allsen
Legislative Audit Bureau
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to ETF with a request to confirm receipt via email or fax. If no confirmation is received, SWIB personnel will follow up with a telephone call to Employee Trust Funds to determine if the revised report was received. If not, the revised report will be sent again with a request to confirm receipt. The process will be repeated until a confirmation of receipt is received from Employee Trust Funds.

Thank you for the opportunity to provide these comments. We expect that the steps we are taking will improve communications and oversight. Please let me know if you have questions or concerns.

Sincerely,

A handwritten signature in black ink, appearing to read "Patricia Lipton". The signature is written in a cursive style with a large initial "P" and "L".

Patricia Lipton
Executive Director



STATE OF WISCONSIN

Department of Employee Trust Funds

Eric O. Stanchfield

Secretary

801 West Badger Road

P.O. Box 7931

Madison, WI 53707-7931

June 27, 2003

Ms. Diann Allsen, Audit Director
Legislative Audit Bureau
22 E. Mifflin Street, Suite 500
Madison, WI 53703

Dear Ms. Allsen:

Thank you for the opportunity to respond to your comments and recommendations related to the error in reporting the investment balance for the Milwaukee Retirement Systems. While your memo was addressed jointly to the State of Wisconsin Investment Board (SWIB) and the Department of Employee Trust Funds (DETF), I will be addressing only those issues related to the DETF. SWIB will be responding independently to you on their issues.

Your audit identified an error in the calculation of the investment account balances for the Milwaukee Retirement Systems. Our subsequent investigation revealed that this error occurred due to a breakdown in communication between DETF and SWIB. We are now working to establish closer working relationships and better communication that, when coupled with improved internal controls, will minimize the risk of future errors remaining undetected.

You have recommended that, *"The State of Wisconsin Investment Board and the Department of Employee Trust Funds establish procedures for ensuring that errors or revisions in information the Investment Board provides the Department of Employee Trust Funds are adequately disclosed and acknowledged between the agencies."*

We agree with your recommendation and are implementing procedures to acknowledge receipt of all initial or revised investment valuation and return reports. While it isn't possible for us to know when there is corrected data that we haven't received, the lack of a positive acknowledgement will serve as a notice to SWIB that we haven't received data that they may have intended for us to have.

You have further recommended that, *"The Department of Employee Trust Funds establish procedures to assess the reasonableness of financial information based on trends and relationships in information between years and with corresponding accounts and expectations. In addition, we recommend the Department of Employee Trust Funds document the review performed to serve as support for the audit process."*

We agree with your recommendation. As your auditors are aware, our quality assurance procedures already include extensive trend and reasonableness testing to identify account balances needing further review. Unfortunately, due to volatility in investment returns, investment income does not lend itself to trend analysis. Therefore, we are adding a new procedure to compare investment income credited to accounts to a meaningful investment benchmark to identify instances in which the reported investment return is suspect. We believe this procedure would have identified the error in the Milwaukee investment account. The results of these reasonableness tests will, of course, be available to your auditors for review.

Ms. Diann Allsen
July 8, 2003
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While the error in the Milwaukee investment account balance was unfortunate, it has provided the needed impetus for DETF and SWIB to reevaluate and strengthen communication protocols between our agencies. We expect the improved communication and better understanding of each other's role in managing the trust funds to pay many dividends in the future.

I appreciate the opportunity to address your recommendations. If you have any questions on our response, you can direct them to Robert Willett, Chief Trust Financial Officer, at (608) 266-0904.

Sincerely,

A handwritten signature in cursive script, reading "Eric O. Stanchfield".

Eric O. Stanchfield
SECRETARY