

AUDIT REPORT

Department of the Treasury

For the Year Ended
June 30, 2013



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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March 4, 2014

Members of the General Assembly
Members of the Board of Trustees of the
Baccalaureate Education System Trust
Members of the Board of Trustees of the
Chairs of Excellence Trust
Members of the Board of Claims
Members of the State Funding Board
The Honorable David H. Lillard, Jr., Treasurer

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 2013.

Consideration of internal control over financial reporting and tests of compliance disclosed a deficiency, which is detailed in the Finding and Recommendation section of this report. The department's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

Deborah V. Loveless, CPA
Director

13/076

Audit Report
Department of the Treasury
For the Year Ended June 30, 2013

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State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit

Department of the Treasury

For the Year Ended June 30, 2013

Opinions on the Financial Statements

The opinions on the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Tennessee Stars 529 College Savings Plan, the Chairs of Excellence Trust, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, and the State Pooled Investment Fund are unmodified. Our independent auditor's reports on these financial statements are included in the *State of Tennessee Treasurer's Report* for the year ended June 30, 2013.

Audit Finding

Internal controls were not adequate to ensure that required disclosures of noncompliance with investment policies were included in the notes to the financial statements of the State Pooled Investment Fund and the Chairs of Excellence Trust

During the year ended June 30, 2013, the Treasury Investment Division violated the State Pooled Investment Fund's investment policy and state laws limiting investments of the Chairs of Excellence Trust, and did not report the violations to the Treasury Accounting Division, resulting in an omission of required financial statement disclosures (page 4).



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**Independent Auditor's Report on Internal Control Over
Financial Reporting and on Compliance and Other Matters
Based on an Audit of Financial Statements Performed in
Accordance With *Government Auditing Standards***

Members of the General Assembly
Members of the Board of Trustees of the
Baccalaureate Education System Trust
Members of the Board of Trustees of the
Chairs of Excellence Trust
Members of the Board of Claims
Members of the State Funding Board
The Honorable David H. Lillard, Jr., Treasurer

We have audited the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Tennessee Stars 529 College Savings Plan, the Chairs of Excellence Trust, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, and the State Pooled Investment Fund as of and for the year ended June 30, 2013, and the related notes to the financial statements, and have issued our reports thereon dated December 12, 2013. 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.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the department's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department of the Treasury's internal control. Accordingly, we do not express an opinion on the effectiveness of the department's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a 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. *A significant deficiency* is a deficiency, or a 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, we identified the following deficiency in internal control that we consider to be a material weakness:

- Internal controls were not adequate to ensure that required disclosures of noncompliance with investment policies were included in the notes to the financial statements of the State Pooled Investment Fund and the Chairs of Excellence Trust

This deficiency is described in the Finding and Recommendation section of this report.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department of the Treasury's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement 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 or other matters that are required to be reported under *Government Auditing Standards*.

Department's Response to Finding

The department's response to the finding identified in our audit is included in the Finding and Recommendation section of this report. The department's response was not subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Deborah V. Loveless, CPA
Director
December 12, 2013

Finding and Recommendation

Internal controls were not adequate to ensure that required disclosures of noncompliance with investment policies were included in the notes to the financial statements of the State Pooled Investment Fund and the Chairs of Excellence Trust

Finding

During the year ended June 30, 2013, the Treasury Investment Division violated the State Pooled Investment Fund's investment policy and state laws limiting investments of the Chairs of Excellence (COE) Trust, and did not report the violations to the Treasury Accounting Division, resulting in an omission of required financial statement disclosures. Section 150.135 of the Governmental Accounting Standards Board's *Governmental Accounting and Financial Reporting Codification* requires that significant violations of legal or contractual provisions for deposits and investments and the actions taken to address such violations be disclosed in the notes to the financial statements.

State statutes governing the State Pooled Investment Fund require that investments be made in accordance with policy guidelines approved by the state funding board. The fund's approved policy guidelines (investment policy) limit the purchase of a specific corporation's commercial paper to \$100 million, excluding commercial paper maturing on the next business day. The Second Deputy Treasurer stated that the preparers of the State Pooled Investment Fund's financial statements were unaware of the following instances of noncompliance with the fund's investment policy:

- Purchases of commercial paper issued by the Nieuw Amsterdam Receivables Corporation for \$41 million on September 26, 2012, caused the \$100 million limit to be exceeded by \$41 million, and purchases of \$39 million on September 28, 2012, caused the \$100 million limit to be exceeded by \$80 million. Treasury sold \$80 million of commercial paper on October 3, 2012, to reduce the corporation's commercial paper held to \$100 million.
- The fund held commercial paper issued by Cargill, not maturing on the next business day, of \$70 million before an additional purchase for \$50 million was made on April 15, 2013. The purchase on April 15, 2013, brought the fund's total investment in commercial paper issued by Cargill to \$120 million, which exceeded the limit set forth in the investment policy until May 2, 2013, the day before \$50 million of the commercial paper issued by Cargill matured.
- The fund held commercial paper issued by the Nieuw Amsterdam Receivables Corporation of \$70 million before an additional purchase of the corporation's commercial paper was made for \$34.935 million on May 9, 2013. The purchase on May 9, 2013, brought the fund's total investment in commercial paper issued by Nieuw Amsterdam Receivables Corporation to \$104.935 million, which exceeded the limit set forth in the investment policy until May 15, 2013, the day before \$30 million of the commercial paper matured.

State statutes governing the COE Trust investments and the COE Trust's investment policy authorize the COE Trust to invest in certain Exchange Traded Funds (ETFs). The COE Trust's policy refers to the state statutes governing investments for the Tennessee Consolidated Retirement System, which in turn reference the state statutes governing investments for domestic life insurance companies. The COE Trust's investment policy and state statutes governing investments for the COE Trust require ETFs to be considered an equity interest in a business entity for the purpose of determining compliance with the policy and statutes' investment restrictions. As a result of this reference, the COE Trust is limited to investing 1% of assets in a single business entity. While the COE Trust's investment policy provides for the investment in certain ETFs as an effective and efficient alternative to selecting individual securities for the equity portfolio, the COE Trust's investment in two ETFs exceeded the 1% limitation on the percentage of assets that can be invested in a single business entity, as referenced within the domestic life insurance statutes. At June 30, 2013, 13% of the COE's total assets were invested in one equity ETF (an ETF that replicates all the stocks in the MSCI EAFE index), and 40% of its total assets were invested in another equity ETF (an ETF that replicates all the stocks in the S&P 500 index).

The instances of noncompliance with the State Pooled Investment Fund's investment policy and with the statutes governing the COE Trust's investments were not disclosed to the appropriate financial statement preparers in a timely manner. Existing procedures were not effective in ensuring that all of the required disclosures were included in the notes to the financial statements timely. The notes to the financial statements were revised to disclose these instances of noncompliance.

Recommendation

The Treasurer should ensure that internal controls over financial reporting are properly designed and operating effectively to ensure staff of the Treasury Investment Division, as well as all other divisions, communicate matters that are required to be disclosed in the financial statements to the financial statement preparers.

Management's Comment

We concur. Treasury Department management in the Investments, Legal/Compliance and Accounting divisions have identified and implemented internal reporting processes relative to noncompliance of investment policies, and the department will continue to implement improvements in the communication of information to financial statement preparers that is necessary for the compilation of Treasury financial statements and accompanying required financial disclosures.

The Treasury Department has recently taken a more proactive approach towards the development of a formal compliance program to facilitate the prevention, monitoring, detection and reporting of violations of investment policies and laws, with the hiring of its first investment compliance officer this past year. In addition, the department continuously makes efforts to

utilize available software tools and automated processes to aid and support both the investment compliance and investment management areas.

Relative to the noncompliance with the statutes governing the limitations on the Chairs of Excellence (COE) Trust's investment in two Exchange Traded Funds (ETFs), the Treasury Department believes that this matter is a technical issue within the referenced state statutes governing the investments of domestic life insurance companies, and is pursuing legislation which would remedy this noncompliance. We continue to feel that the use of the ETFs is an effective and efficient strategy for managing the equity portfolio of the COE Trust without introducing additional risk over the use of a separate account or comingled fund. Please reference the attached letter, dated November 27, 2013, from the Treasury Department's investment consultant, Strategic Investment Solutions, Inc., which further supports our position. (See Appendix.)

Observations and Comments

The operations of the Department of the Treasury are accounted for in the general fund of the State of Tennessee. The department administers the Baccalaureate Education System Trust – Educational Services Plan, a private-purpose trust fund; the Tennessee Stars 529 College Savings Plan, a private-purpose trust fund; the Chairs of Excellence Trust, a permanent fund; the Criminal Injuries Compensation Fund, a special revenue fund; the Flexible Benefits Plan, an employee benefit trust fund; the Risk Management Fund, an internal service fund; the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool); and the Tennessee Consolidated Retirement System, pension trust funds. This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report. Our independent auditor's reports on these financial statements are included in the *State of Tennessee Treasurer's Report* for the year ended June 30, 2013.

In addition to our audit of the financial statements of the funds noted above, we also performed certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2013. For the complete results of our audit of the State of Tennessee, please see the *Tennessee Comprehensive Annual Financial Report* for the year ended June 30, 2013, and the *State of Tennessee Single Audit Report* for the year ended June 30, 2013.

STRATEGIC INVESTMENT SOLUTIONS, INC.

333 BUSH STREET, STE. 2000
SAN FRANCISCO, CALIFORNIA 94104

TEL 415/362-3484 ■ FAX 415/362-2752

Memorandum

Date: November 27, 2013
To: David Lillard, Tennessee State Treasurer
Cc: Bill Abney, Assistant Treasurer; Michael Brakebill, CIO
From: Pete Keliuotis, SIS
Re: Use of ETFs for COE asset class exposure

Dear Treasurer Lillard:

As part of the investment strategy for the Tennessee Chairs of Excellence (“COE”) program, TCRS utilizes exchange-traded funds (“ETFs”). We find ETFs generally to be an efficient and cost-effective means to gain passive asset class exposure and have gained wide popularity among institutional and retail investors. Index fund ETFs are designed to track a standard index benchmark such as the S&P 500 or MSCI EAFE while holding sufficient residual cash and liquidity to accommodate daily cash flows. They are priced daily, with price changes easily referenced online and through Bloomberg. The value of the ETF shares are derived directly from the portfolio of underlying shares being held, which replicates the index being tracked.

Specific to the two ETFs utilized (data as of November 27, 2013, and available via Reuters Online, Vanguard, and BlackRock):

- Vanguard S&P 500 Index Fund (ticker: VOO): Vanguard is one of the largest mutual fund managers in the world as well as one of the largest ETF managers. VOO is designed to track the S&P 500 Index and has a market capitalization of \$13.64 bn. The average daily trading volume is over 1 million shares. The VOO inception date was September 7, 2010. Passive S&P 500 Index assets managed by Vanguard exceed \$100 billion.
- iShares MSCI EAFE Index Fund (ticker: EFA): BlackRock is the largest asset manager in the world and, upon its purchase of the iShares family of ETFs from BGI in 2009, became the world’s largest manager of ETFs. EFA is designed to track the MSCI EAFE Index and has a market capitalization of \$50.8 bn. The average daily trading volume is over 15 million shares. The EFA inception date was August 14, 2001.

Both ETFs in the COE plan, VOO and EFA, are widely used by institutional and retail investors, closely track their relevant indexes with large asset bases, and are sponsored by firms with a longstanding presence in the ETF and institutional investment market.

SIS believes VOO and EFA, and in many cases ETFs generally, are a highly effective and efficient method to manage a portfolio the size of COE. We believe any additional risks relating to the use of these ETFs as opposed to a separate account or commingled fund are minimal.

Best regards,



Pete Keliuotis
Managing Director