

**ATTESTATION REPORT
OF THE
NEBRASKA INVESTMENT COUNCIL
JULY 1, 2004 THROUGH JUNE 30, 2005**

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the Auditor of Public Accounts.**

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Issued on October 28, 2005

NEBRASKA INVESTMENT COUNCIL

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NEBRASKA INVESTMENT COUNCIL

BACKGROUND

The Nebraska Investment Council was established under 1967 and 1969 laws as a central State investment agency. The Council provides investment management services for the State.

The agency is governed by a seven-member Council. Five voting members are appointed by the Governor and confirmed by the Legislature. They serve five-year terms, with one expiring each year. The State Treasurer and the Executive Director of the Public Employees Retirement Systems serve as non-voting members.

The Council establishes necessary and proper policies for the investment of the funds for which it is responsible. Such policies include appropriate investment strategy decisions, selection of external managers, and allocation of funds among managers. The Council appoints a State Investment Officer, subject to the approval of the Governor and the Legislature. The State Investment Officer, with the assistance of the agency staff, directs the investments of these funds in accordance with State statutes and the policies of the Council.

Funds managed include the State's general and cash funds; retirement plans for the State Patrol, judges, and school employees (with the exception of Omaha); and trust funds such as the Permanent School Fund, the Veterans' Aid Fund, and the Health Care Trust Fund. The Council is also responsible for investing the State employees' and county employees' retirement system funds, the deferred compensation plan assets, and the funds of the Nebraska Educational Savings Plan Trust.

MISSION STATEMENT

It is the mission of the Nebraska Investment Council to prudently manage the funds entrusted to us by the people of the State of Nebraska. We deliver investment management services to provide direct financial benefit exclusively to the owners of these funds. We are committed to thorough, sound, and informed analysis in order to achieve superior returns while maintaining prudent levels of risk.

NEBRASKA INVESTMENT COUNCIL

ORGANIZATIONAL CHART

As of September 18, 2005

INVESTMENT COUNCIL

Gail Werner-Robertson (Chairwoman)

John G. Maddux

Earl H. Scudder

Richard A. DeFusco

John Maginn

(non-voting)

Ron Ross

Anna Sullivan

State Treasurer

Director-Public Employees Retirement Systems

STATE INVESTMENT OFFICER

Carol L. Kontor

INVESTMENT SECURITIES ANALYSTS

Gayle A. Wrasse

Joseph P. Jurich

JoLynn Winkler

BUSINESS MANAGER

Kathy Dawes

SECRETARY

Brandee Freauf

AUDITOR

Ray Friesen

NEBRASKA INVESTMENT COUNCIL

EXIT CONFERENCE

An exit conference was held September 22, 2005 with the Council to discuss the results of our examination. Those in attendance for the Nebraska Investment Council were:

NAME	TITLE
Carol Kontor	State Investment Officer
Kathy Dawes	Business Manager
Ray Friesen	Internal Auditor

NEBRASKA INVESTMENT COUNCIL

COMMENT AND RECOMMENDATION

During our examination of the Nebraska Investment Council, we noted a certain matter involving the internal control over financial reporting and other operational matters which is presented here.

Reconciliation of Bank Records to the Nebraska Information System

Good internal control requires a plan of organization, procedures, and records designed to safeguard assets and to provide reliable financial information. Without a timely and complete reconciliation of bank records to the Nebraska Information System (NIS), there is a greater risk for fraud and errors to occur and to remain undetected.

During the audit of the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, the Auditor of Public Accounts (APA) noted the absence of reconciliation between the Nebraska State Treasurer's actual bank statements and Nebraska accounting records (in both NIS and NAS, the Nebraska Accounting System before NIS). This has been an issue for the Department of Administrative Services (DAS) Accounting Division for many years. The APA's previous versions noted monthly reconciliations have not been completed in a timely manner and reconciliations performed have shown significant unknown variances between the bank records and the accounting records, with the bank being short compared to the accounting records. Although DAS Accounting Division continues to work on correcting the reconciliation of bank records to NIS, the APA continues to note areas where improvement is still needed in the reconciliation process to ensure NIS integrity and operational efficiency. Specifically, the APA noted the status of the reconciliation process as of August 11, 2005 to be as follows:

DAS Accounting Division has worked on the reconciliation process, but continued progress is needed. DAS Accounting Division's reconciliation process has developed into a very detailed process of analyzing bank activity, compared to activity recorded on NIS, to identify reconciling items. DAS Accounting Division has completed their reconciliation process for the months of June and July of 2004. The APA has reviewed these reconciliations. These two months show variances of \$2,944,126 and \$2,932,824, respectively. Again, the reconciliations show the bank being short compared to the accounting records. Per inquiry of management, DAS Accounting Division has started the reconciliation process for various months of the fiscal year ended June 30, 2005; however, the reconciliation process has not been a continuous monthly process and no monthly reconciliation has been completed since July of 2004.

Although DAS Accounting Division has worked on the reconciliation process, the process is still not done in a timely manner and the variance is inconsistent. The reconciliation continues to reflect unknown variances and shortages. Complete and timely reconciliation procedures between bank records and accounting records are required to provide control over cash and accurate financial information.

NEBRASKA INVESTMENT COUNCIL

COMMENT AND RECOMMENDATION

(Continued)

Reconciliation of Bank Records to the Nebraska Information System (Concluded)

The APA recommends DAS Accounting Division continue their reconciliation process, in a timelier manner, and on at least a monthly basis, to ensure all financial information is correct on NIS. We also recommend, when a consistent cash variance between the bank records and the accounting records is obtained (based on at least six months of reconciliations), DAS submit their plan for adjusting NIS to the Governor and the Legislature so they may take appropriate action to correct NIS and resolve the variances noted.

This issue is the responsibility of DAS Accounting Division; however, as the variances have not been identified by fund or agency, this issue directly affects all Nebraska State agencies' financial information and must be disclosed in this report.

It should be noted this report is critical in nature as it contains only our comment and recommendation on the area noted for improvement.

Draft copies of this report were furnished to the Council to provide them an opportunity to review the report and to respond to the comment and recommendation included in this report. The Council declined to respond.

We appreciate the cooperation and courtesy extended to our staff during the course of the examination

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NEBRASKA INVESTMENT COUNCIL

INDEPENDENT ACCOUNTANT'S REPORT

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Nebraska Investment Council
Lincoln, Nebraska

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We have examined the accompanying schedule of revenues, expenditures, and changes in fund balances of the Nebraska Investment Council (Council) for the fiscal year ended June 30, 2005. The Council's management is responsible for the schedule of revenues, expenditures, and changes in fund balances. Our responsibility is to express an opinion based on our examination.

Tim Channer, CPA
Asst. Deputy Auditor
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Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and the standards applicable to attestation engagements contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and accordingly, included examining, on a test basis, evidence supporting the schedule of revenues, expenditures, and changes in fund balances and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Mary Avery
SAE/Finance Manager
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Dennis Meyer, CGFM
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Coordinator
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In our opinion, the schedule referred to above presents, in all material respects, the revenues, expenditures, and changes in fund balances of the Nebraska Investment Council for the fiscal year ended June 30, 2005, based on the accounting system and procedures prescribed by the State of Nebraska Director of Administrative Services as described in Note 1.

Mark Avery, CPA
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Perry Pirsch, JD, MPA
Legal Counsel
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In accordance with *Government Auditing Standards*, we have also issued our report dated September 22, 2005, on our consideration of the Nebraska Investment Council's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope

of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an attestation engagement performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our examination.

This report is intended solely for the information and use of the Council and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

September 22, 2005

A handwritten signature in black ink that reads "Don Dunlop CPA". The signature is written in a cursive style.

Assistant Deputy Auditor

NEBRASKA INVESTMENT COUNCIL
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
For the Fiscal Year Ended June 30, 2005

	Nebraska Investment Council Cash Fund 27510	Operating Pool Distributive Fund 77500	Total (Memorandum Only)
REVENUES:			
Sales & Charges	\$ 714,008	\$ -	\$ 714,008
Miscellaneous	382,710	-	382,710
TOTAL REVENUES	1,096,718	-	1,096,718
EXPENDITURES:			
Personal Services	493,728	-	493,728
Operating	581,303	-	581,303
Travel	17,665	-	17,665
TOTAL EXPENDITURES	1,092,696	-	1,092,696
Net Change in Fund Balances	4,022	-	4,022
FUND BALANCES, JULY 1, 2004	170,201	-	170,201
FUND BALANCES, JUNE 30, 2005	<u>\$ 174,223</u>	<u>\$ -</u>	<u>\$ 174,223</u>
FUND BALANCES CONSIST OF:			
General Cash	\$ 173,939	\$ (14,472,969)	\$ (14,299,030)
Deposits with Vendors	504	-	504
Due to Vendors	(220)	-	(220)
OIP Interest Receivable	-	14,472,969	14,472,969
TOTAL FUND BALANCES	\$ 174,223	\$ -	\$ 174,223

The accompanying notes are an integral part of the schedule.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

For the Fiscal Year Ended June 30, 2005

1. Criteria

The accounting policies of the Nebraska Investment Council are on the basis of accounting as prescribed by the State of Nebraska Department of Administrative Services (DAS).

Per Neb. Rev. Stat. Section 81-1107(2) R.S.Supp., 2004, the State of Nebraska Director of Administrative Services duties include “The keeping of general accounts and the adoption and promulgation of appropriate rules, regulations, and administrative orders designed to assure a uniform and effective system of accounts and accounting, the approval of all vouchers, and the preparation and issuance of warrants for all purposes.”

The Nebraska Information System (NIS) is the official accounting system prescribed by DAS for the State of Nebraska. Policies and procedures are detailed in NIS manuals and Nebraska Accounting System Concepts published by DAS and available to the public. The financial information used to prepare the schedule of revenues, expenditures, and changes in fund balances for the Council was obtained directly from the NIS. NIS records accounts receivable and accounts payable as transactions occur. As such certain revenues are recorded when earned and expenditures are recorded when a liability is incurred, regardless of the timing of related cash flows. The accounts payable liability recorded on NIS, and thus recorded as expenditures, as of June 30, 2005 includes only those payables posted to NIS before June 30, 2005 and not yet paid as of that date. The amount recorded as expenditures as of June 30, 2005 **does not** include amounts for goods and services received before June 30, 2005 which had not been posted to NIS as of June 30, 2005.

The Council had no accounts receivable at June 30, 2005. The NIS system does not include liabilities for accrued payroll and compensated absences.

The fund types established by NIS that are used by the Council are:

20000 – Cash Funds – account for revenues generated by specific activities from sources outside of State government and the expenditures directly related to the generation of the revenues. Cash funds are established by State statutes and must be used in accordance with those statutes.

70000 – Distributive Funds – account for assets held by the State as an agent for individuals, private organizations, other governments, and/or other funds.

The major revenue object account codes established by NIS used by the Council are:

Sales & Charges – Income derived from sales of merchandise and commodities, compensation for services rendered, and charges for various licenses, permits, and fees.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

1. Criteria (Concluded)

Miscellaneous – Revenue from sources not covered by other major categories, such as investment income and recaptured commissions. For further information on recaptured commissions, see Note 7.

The major expenditure object account titles established by NIS used by the Council are:

Personal Services – Salaries, wages, and related employee benefits provided for all persons employed by the Council.

Operating – Expenditures directly related to a program’s primary service activities.

Travel – All travel expenses for any state officer, employee, or member of any commission, council, committee, or board of the State.

Other significant object account codes established by NIS and used by the Council include:

Assets – Resources owned or held by a government that has monetary value. Assets include cash accounts, deposits with vendors, and receivable accounts. Cash accounts and deposits with vendors are included in fund balance and are reported as recorded on NIS. DAS Accounting Division records all interest and dividend income (received and earned) as accounts receivable on NIS (Object Account 134590) as part of the reconciliation of Fund 77500. Earned income that is not received increases the receivable and increases the liability account used to distribute the income. Received income decreases the receivable and increases cash. These receivables did not increase revenues.

Liabilities – Legal obligations arising out of transactions in the past that must be liquidated, renewed, or refunded at some future date. Accounts payable transactions normally increase expenditures and decrease fund balance. DAS Accounting Division uses a liability account on NIS (Object Account 215190) to record other income, realized gains and losses, and managements fees and to distribute the income to funds participating in the Operating Investment Pool. This liability account did not increase expenditures. The activity recorded in the liability account generally decreases cash. The net activity of this account each month is zero.

2. State Agency

The Nebraska Investment Council (Council) is a State agency established under and governed by the laws of the State of Nebraska. As such, the Council is exempt from State and Federal income taxes. The schedule includes the Nebraska Investment Council Cash Fund and the Operating Pool Distributive Fund.

The Nebraska Investment Council is part of the primary government for the State of Nebraska.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

3. **Totals**

The Totals "Memorandum Only" column represents an aggregation of individual account balances. The column is presented for overview informational purposes and does not present consolidated financial information because interfund balances and transactions have not been eliminated.

4. **Capital Assets**

Under NIS, capital assets are not capitalized in the funds used to acquire or construct them. Instead, capital acquisitions are reflected as expenditures. Capital assets, which would include property, plant, equipment, and infrastructure assets (e.g., roads, bridges, sidewalks, and similar items) would be reported for the State of Nebraska in the Comprehensive Annual Financial Report (CAFR). The Council values all capital assets at cost where historical records are available and at estimated historical cost where no historical records exist. Donated capital assets are valued at their estimated fair market value on the date received. Generally, equipment that has a cost of \$1,500 or greater at the date of acquisition and has an expected useful life of two or more years is capitalized, as well as all computers. Depreciation expenses would be reported in the CAFR in the funds used to acquire or construct them for the State of Nebraska. The cost of normal maintenance and repairs that does not add to the value of the asset or extend asset life is not capitalized.

Equipment is depreciated using the straight-line method with estimated useful lives of 3 years.

Capital asset activity of the Council for the fiscal year ended June 30, 2005 was as follows:

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Capital assets				
Equipment	\$ 38,871	\$ -	\$ -	\$ 38,871
Less accumulated depreciation for:				
Equipment				<u>32,228</u>
Total capital assets, net of depreciation				<u>\$ 6,643</u>

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

5. Operating Investment Pool Activity (Fund 77500)

The activity recorded in Fund 77500 is the recording and distribution of income on the investments in the Operating Investment Pool and Time Deposit Open Account funds. Prior to March 2005, Council staff recorded income received into NIS on a weekly basis. Monthly, DAS Accounting Division distributed the income earned proportionately to all funds designated for investment. Effective March 2005, DAS Accounting Division began to record the income earned on NIS and continued to distribute the earned income to all funds designated for investment.

The Operating Investment Pool income transactions are recorded directly to the fund's accounts receivable and liability accounts, rather than through a revenue or expenditure account. These accounts offset the cash account. These transactions represent income earned on the funds, which are owed and distributed to funds making up the Operating Investment Pool. The cash account is negative since income is distributed when earned, before it is received. The following table shows the activity of the cash account. The balance represents dividends, interest, and net amortization receivable from the custodial bank.

<u>Balance</u> <u>July 1, 2004</u>	<u>Net Earned</u> <u>Income Received</u>	<u>Net Earned</u> <u>Income Allocated</u>	<u>Balance</u> <u>June 30, 2005</u>
<u>\$ (6,120,212)</u>	<u>\$ 55,109,926</u>	<u>\$ 63,462,683</u>	<u>\$ (14,472,969)</u>

6. Fees on Investments

There are several fees that are charged against all investments. They are external manager fees, State Street Bank (SSB) fees, investment consultant fees, Treasury Management Fees, NPERS fees, and the Nebraska Investment Council fees. The Nebraska Investment Council fees are the only fees shown on the Council's financial schedule. Investment income is recorded net of these fees on the State of Nebraska's financials statements. (Investment transactions and balances are not recorded on the Council's financial schedule.) The Council's fees are recorded on the financial schedule of the Council and were reported as Sales and Charges. The following schedule shows the fees charged against investments for the fiscal year ended June 30, 2005:

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

6. Fees on Investments (Concluded)

External Manager Fees	
Alliance Bernstein Institutional Investment Management	\$ 1,053,841
Ariel Capital Management, LLC	653,750
Baillie Gifford	742,858
Barclays Global Investors	678,050
Blackrock Financial Management	907,213
Dimensional Fund Advisors, Inc.	1,107,782
Goldman Sachs Asset Management	36,594
Grantham, Mayo, Van Otterloo & Co., LLC	814,711
Heitman	35,930
Husic Capital Management	830,141
JPMorgan Investment Management, Inc.	922,463
PIMCO	1,383,593
State Street Global Advisors	497,144
T. Rowe Price Associates, Inc.	1,630,203
UBS Global Asset Management (Americas), Inc.	770,012
Total External Managers' Fees	<u>12,064,285</u>
SSB Custodian Fees	1,034,044
SSB Cash Management Fees	183,709
SSB Securities Lending Fees	563,732
Ennis Knupp Consultant Fees (1)	264,882
Wilshire and Associates - Final Consultant Fee (1)	18,417
Nebraska Investment Council Fees	<u>714,008</u>
Total Investment Fees	14,843,077
NPERS Fees	780,981
State Treasurer - Treasury Management Fees	388,577
Total Fees Charged Against Investments at June 30, 2005	<u><u>\$16,012,635</u></u>

(1) The consultant fees shown on this schedule are paid from the Commission recapture fund. The remaining consultant fees are paid for through the Council's operating budget and shown under Nebraska Investment Council fees.

7. Recaptured Commissions

Some of the assets managed by the Council received recaptured commissions from investment managers. The amount rebated was based on a certain percentage of the brokerage costs of trading and was negotiated between the Council and individual investment managers. The recaptured commissions were transferred into and subsequently held in a separate account at State Street Bank. As the Council disbursed money from this account to pay for expenses related to the Plans generating

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

7. Recaptured Commissions (Concluded)

the commissions, they recorded a revenue and a disbursement on NIS and also increased their appropriations by submitting the expenses to DAS Budget Division. The following schedule reconciles the recaptured commission account for the fiscal year ended June 30, 2005:

Beginning Balance July 1, 2004	\$ 930,024
Recaptured Commissions and Interest Earned	508,146
Recaptured Commissions Used for Expenses	(375,488)
Recaptured Commissions Returned to Plans	(447,384)
Ending Balance June 30, 2005	<u>\$ 615,298</u>

8. Lawsuit Against Council Dismissed by District Court; Appeal Pending

In 2001, a taxpayer filed a lawsuit against the Nebraska Investment Council, its members, the State Investment Officer, and other defendants in the District Court of Lancaster County, Nebraska. The plaintiff alleged a certain investment made by the Council in 2001 violated State law.

The matter involved an investment in an enhanced S & P 500 Index fund. Because of a downturn in the U.S. stock market in 2001, there were periods when the investment resulted in an unrealized loss. Subsequently, the market rebounded and the investment was sold at a gain.

The District Court dismissed most of the claims in July 2004 and dismissed the remaining claims in March 2005. The taxpayer appealed the case to the Nebraska Court of Appeals. The Nebraska Investment Council and their legal counsel believe the District Court's decision will be affirmed.

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**NEBRASKA INVESTMENT COUNCIL
REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
EXAMINATION OF THE SCHEDULE OF REVENUES,
EXPENDITURES, AND CHANGES IN FUND BALANCES
PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Nebraska Investment Council
Lincoln, Nebraska

We have examined the accompanying schedule of revenues, expenditures, and changes in fund balances of the Nebraska Investment Council for the fiscal year ended June 30, 2005, and have issued our report thereon dated September 22, 2005. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our examination, we considered the Nebraska Investment Council's internal control over financial reporting in order to determine our procedures for the purpose of expressing our opinion on the schedule of revenues, expenditures, and changes in fund balances, and not to provide an opinion 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 Nebraska Investment Council's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial schedule. A reportable condition is described in the Comment Section of the report as Reconciliation of Bank Records to the Nebraska Information System.

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 schedule being examined 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 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 described above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Nebraska Investment Council's schedule of revenues, expenditures, and changes in fund balances, is free of 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 schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our examination, 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*.

This report is intended solely for the information and use of the Council and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

September 22, 2005



Assistant Deputy Auditor

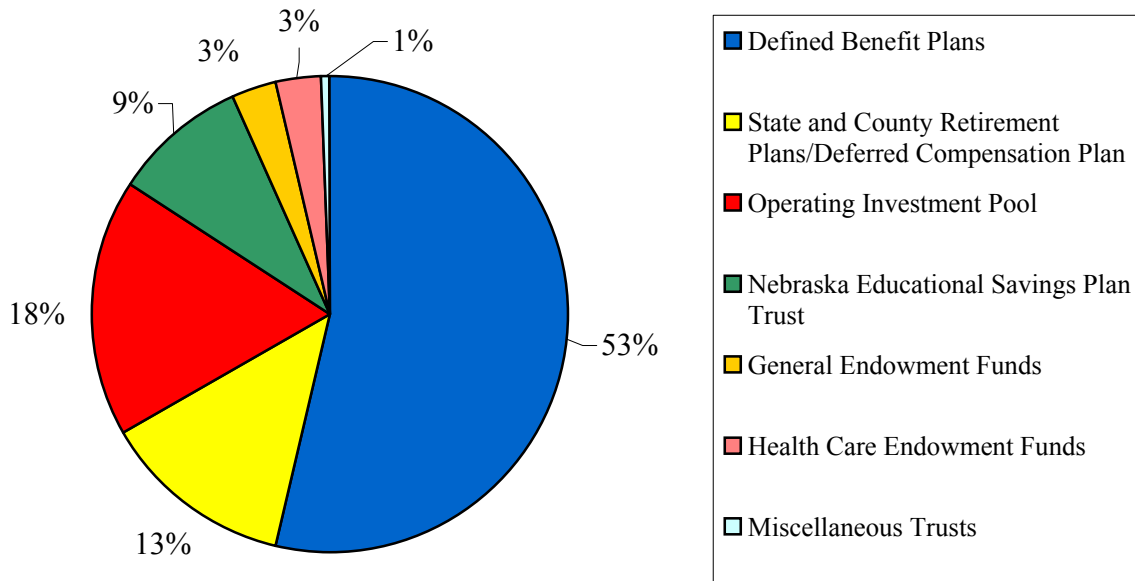
NEBRASKA INVESTMENT COUNCIL

STATISTICAL SECTION

Our examination was conducted for the purpose of forming an opinion on the schedule of revenues, expenditures, and changes in fund balances. Statistical Section information is presented for purposes of additional analysis. Such information has not been subjected to the procedures applied in the examination of the schedule of revenues, expenditures, and changes in fund balances, and, accordingly, we express no opinion on it.

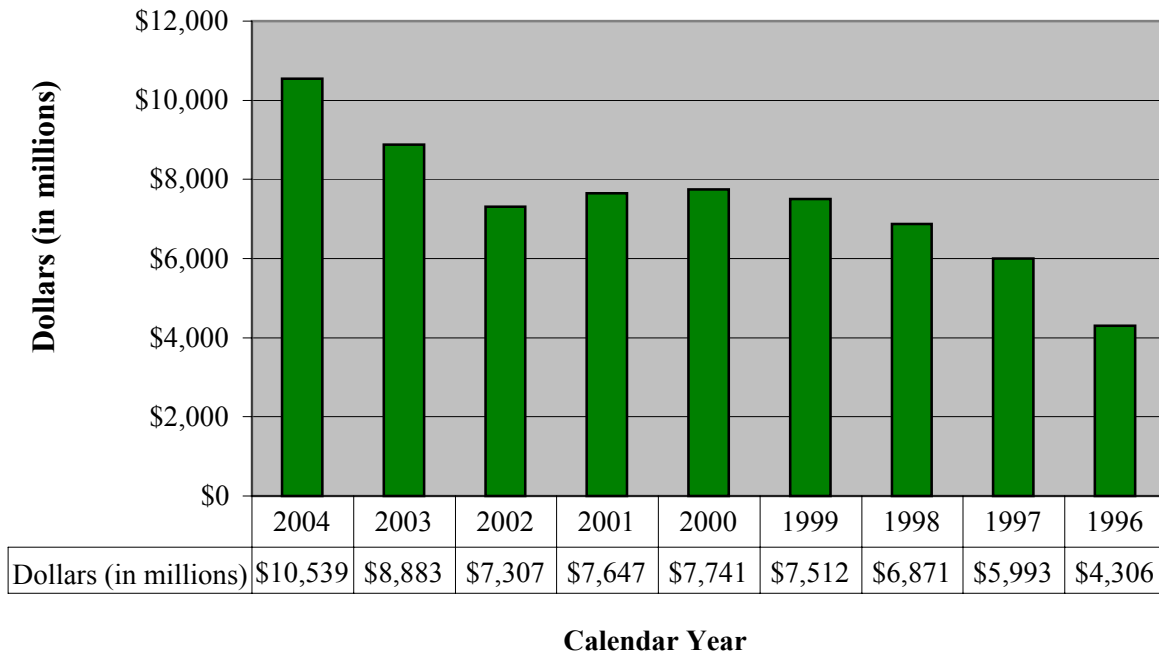
NEBRASKA INVESTMENT COUNCIL

Assets Managed as of December 31, 2004



The Nebraska Investment Council (NIC) manages the investments of 21 different entities, not counting the many separate departments of State government included in the Operating Investment Pool. These entities fall into seven major categories displayed above. For all these entities, the Council's responsibilities are primarily related to asset management. It does not determine the amount of funds contributed to or disbursed from the funds it manages.

Closing Balances at December 31st



Source: Nebraska Investment Council Calendar Year 2004 Annual Report.