



## NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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December 18, 2024

Ellen Hung, State Investment Officer  
Nebraska Investment Council  
1526 K Street, Suite 420  
Lincoln, Nebraska 68508

Dear Ms. Hung:

We have audited, 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, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Nebraska (State), as of and for the year ended June 30, 2024, and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated December 18, 2024. In planning and performing our audit of the financial statements, we considered the State's system of internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted a certain internal control or compliance matter related to the activities of the Nebraska Investment Council (Council) or another operational matter that is presented below for your consideration. The comment and recommendation, which has been discussed with the appropriate members of the Council's management, is intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control was for the limited purpose described in the first paragraph 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, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

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. We consider the following comment (Issues with the Transition to Northern Trust) to be a significant deficiency.

This comment will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

Draft copies of this management letter were furnished to the Council to provide management with an opportunity to review and to respond to the comment and recommendation contained herein. The formal response received has been incorporated into this management letter. *Government Auditing Standards* require the auditor to perform limited procedures on the responses. The response was not subjected to the other auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it. A response that indicates corrective action has been taken was not verified at this time, but it will be verified in the next audit.

The following is our comment and recommendation for the year ended June 30, 2024.

### **Issues with the Transition to Northern Trust**

Under Nebraska law, the State Treasurer is the custodian of State assets, who in turn retains a global custodian to sub-custody the investments. The Council manages the State investments. In November 2023, upon express approval of the Council, the State Treasurer and the State Investment Officer signed an agreement with the Northern Trust Company (Northern Trust) to maintain the custody account for the State's assets, ending a nearly 30-year relationship with State Street Bank and Trust Company, the prior custodian.

The custodian transition occurred on April 1, 2024, three months prior to the State's fiscal year end, at a time when the Council managed \$35 billion in assets, including the defined benefit retirement assets, the cash balance retirement assets, the State Trust and endowment assets, and the State's Operating Investment Pool.

The Auditor of Public Accounts (APA) found concerns related to this enormous and time-consuming undertaking, as detailed below.

**Reconciliation of Assets:** One of the most important, if not the most important, tasks with this transition required the Council staff to ensure the complete and accurate transition of all activity from the former custodian to the new custodian. Not only did this require procedures to make sure all investment holdings transitioned properly, but also the procedures included a review to ensure all cash activity, receivables, and payables transitioned properly.

Northern Trust provided the Council with files showing its reconciliation of assets held at State Street Bank to what was transitioned to Northern Trust, which included \$24 billion for the endowment and pension accounts. The Northern Trust files included \$38,201,363 in variances between the transition activity at the two banks, with explanations for the variances.

The Council then performed its own separate review of the Northern Trust reconciliation files, which included tracing the balances between the records of the current and former custodians. The Council did not include documentation to support its verification of Northern Trust's explanations for the \$38 million in variances. However, during the APA's separate review, we found that many of the variance explanations were observable in other support provided by Northern Trust.

The APA reviewed all funds with transition activity variances greater than +/- \$50,000, which covered 99% of the variances. The APA was unable to obtain documentation to support variances in five funds, totaling \$940,697. Though requiring a considerable amount of time by the APA, this review process was necessary due to the lack of documentation to support the explanations for the variances.

**Improper Endowment Income Distribution:** Because the custodian transition included a change from how income had been reported, Council staff spent a significant amount of time determining the proper amount of endowment income to be distributed to the various State funds. This was further complicated because some of the endowment and trust fund statutes have slightly different definitions of the income to be distributed.

During its review, the Council discovered that the activity for two fund managers had been omitted subsequent to their hiring. The Council calculated preliminarily that it had failed to distribute approximately \$17,600,000 in income to State funds, which is a significant amount that could have been used by those funds. The Council intends to make an entry to distribute this income during fiscal year 2025.

**Delays in Providing ACFR Documentation:** Annually, the APA and the Department of Administrative Services – State Accounting Division (State Accounting) agree to a list of items that are necessary for the timely completion of the State’s Annual Comprehensive Financial Report (ACFR). The list includes strict timeframes for which documentation should be provided to ensure the APA has enough time to issue its opinion on the State’s financials by the statutory deadline.

Because the transition had occurred three months prior to the end of the fiscal year, and the State’s custodian is responsible for several items on the list, the APA had concerns about whether the Council or its custodian would be able to provide documentation timely. The APA emphasized to the Council, therefore, the importance of meticulous adherence to these timelines. Nevertheless, the Council and its custodian failed to meet some of the ACFR deadlines, which significantly delayed our auditing procedures and put the timely completion of the ACFR at risk.

The Council or its custodian were tardy in providing information on 17 different items on the APA’s and State Accounting’s list. The following table lists the most egregious items, ranging from 33 to 49 days late.

| Description   | DAS Expected Completion Date | Date Received | Days Late |
|---|------------------------------|---------------|-----------|
| Journal entries relating to the fair value adjustment of the Operating Investment Pool are dependent on the monthly statements from the custodian. Due to the custodial bank’s delay in providing the June 30, 2024, monthly reports, the entries were late.  | 9/13/2024                    | 11/1/2024     | 49        |
| The custodian is responsible for providing a holdings report identifying various information for each security held by the State. The information is used to prepare certain footnote disclosures required by the Governmental Accounting Standards Board (GASB), including the disclosure related to fixed income durations. The initial holdings report received failed to include the information needed to accumulate the durations disclosure. | 10/4/2024                    | 11/13/2024    | 40        |
| Another GASB disclosure requirement relates to derivative instruments and their classifications by type, including the fair value, changes in fair value, and the notional value of the derivative instruments. This is a separate report produced by the custodian.  | 10/4/2024                    | 11/13/2024    | 40        |
| Journal entries relating to interest and dividends receivable and investment receivables and payables are prepared using monthly statements from the custodian. Due to the custodial bank’s delay in providing the June 30, 2024, monthly reports, the entries were late for both the miscellaneous trust and retirement funds.   | 9/13/2024                    | 10/18/2024    | 35        |
| Additional GASB footnote support related to the classification of the fair value hierarchy of alternative investments. Although the initial information was received on November 7, 2024, the APA received a revised copy on November 18, 2024.   | 10/4/2024                    | 11/7/2024     | 34        |
| The delay in the receipt of the holdings report, as described previously, delayed three different items on the list: 1) the actual holdings report; 2) disclosures related to the concentration of credit risk; and 3) the allocation of the retirement assets working papers.  | 10/4/2024                    | 11/6/2024     | 33        |

Some of the items included above were delayed due to the custodian’s untimely production of the monthly account reports. The following table describes the delays:

| Month      | Dates Reports Published | Number of Days after Month End |
|------------|-------------------------|--------------------------------|
| April 2024 | 8/6/2024                | 98                             |
| May 2024   | 8/21/2024               | 82                             |
| June 2024  | 9/5/2024                | 67                             |

In addition to the delays encountered, the APA found errors related to the information provided by the custodian, such as the incorrect classification of assets on the holdings and other GASB-required reports and inaccurate information on a GASB-required report due to mathematical errors in the file. More details pertaining to these errors can be found in the Department of Administrative Services ACFR management letter on the APA's website (<https://auditors.nebraska.gov/>).

These delays and errors caused a delay in State Accounting's preparation of the draft financial statements, which were to be provided as part of the audit on a specific date.

A proper system of internal controls requires procedures to ensure: 1) adequate documentation is available to support the reconciliation of accounts and activity and identified variances related to the transition of the custodian; 2) all endowment income is properly identified, the allocation is calculated correctly, and income is properly distributed to the various funds; and 3) the timelines set forth by State Accounting and the APA are observed, allowing the ACFR to be completed by the statutory deadline.

Without such procedures, there is an increased risk for loss or misuse of State funds, for material misstatement of the financial statements and related footnote disclosures, or noncompliance with State statute.

We recommend the Council implement procedures to ensure adequate documentation exists to support the custodian transition reconciliation process, including all identified variances, all endowment income is calculated and distributed properly, and necessary items are provided in accordance with the deadlines prescribed by State Accounting and the APA.

*Council Response:*

*Issues with the Transition to Northern Trust*

*The Council acknowledges that transitioning to a new custodian bank is a lengthy and challenging process. This was made especially difficult after a 30-year relationship with State Street that required multiple workarounds to ensure accuracy. The decision to transition to a new custodian bank was not taken lightly and was made after an extensive search and thorough review of the leading custodian banks. The Council's decision in 2023 to switch to a new custodian bank was driven by the need for improvements in several critical areas. The transition was delayed from January 1 to April 1, 2024, with the new date agreed upon by the Directors of APA, DAS and the Council during a meeting on February 14, 2024.*

*Reconciliation of Assets*

*Staff reviewed all reconciliation files provided by Northern Trust and compared it with files from State Street to ensure all assets were transitioned properly. Staff also reviewed and concluded that the \$38,201,363 in variances were clearly explained and documented by Northern Trust.*

*Improper Endowment Income Distribution*

*During the custodian bank transition reconciliation process, staff found that two out of 19 accounts were missing from the income distribution report produced by State Street. Both accounts are structured as commingled trusts and do not report monthly income like the other separately managed accounts. Staff found a solution to the lack of reported monthly income and distributed the past income on December 30, 2024. Staff has updated its procedures to ensure all manager accounts are accounted for in the income distribution.*

*Delays in Providing ACFR Documentation*

*Staff met with DAS on June 27, 2024, to discuss ACFR deadlines and was told of two: GASB 72 and manager fees. Both deliverables were sent to DAS on November 14, 2024, a day before the deadline. Staff was not aware of other DAS deadlines but worked diligently and responded, or worked with Northern Trust to respond to all DAS inquires in a timely manner. The Council acknowledges that some issues took more time due to the complexity of the accounts.*

Other Delays

The Council acknowledges that the transition to Northern Trust and the subsequent reconciliation process were extremely time-consuming and required a significant amount of amount of work by the Council, DAS and APA. A transition of custodial bank is complicated and even more so with Nebraska having 86 accounts across seven programs for a total of \$35 billion. The process is further complicated when the seven programs have subaccounts that all need to be accounted for.

The Council agrees proper internal controls are critical to the success of the investment program by ensuring no loss or misuse of State funds or misstatement of the financial statements and related footnote disclosures or noncompliance with State statute. In our continuing pursuit of this, the Council formalized and adopted the Audit Committee Charter on March 7, 2024. The Council also has a draft of an Internal Auditor Charter that is being updated due to hire of a new internal auditor.

**APA Response:**

**Reconciliation of Assets:** The APA’s finding is related to the lack of documentation provided by the Council to support some of the variances. It is important to maintain documentation to support the explanation for those variances.

**Delays in Providing ACFR Documentation:** In the table included in the finding above, two of the six findings related to the delay in producing the monthly bank statements to accumulate the necessary accounting entries for the period April to June 2024 – which is a normal part of the custodial bank’s process and not included in the ACFR deadlines. As noted in the finding, those bank statements were significantly delayed. The other four findings from the table are related to items provided by the custodial bank for preparation of the investment disclosures in the ACFR. These are not new reports and have been the responsibility of the custodial bank to provide at year end for many years. It is also important to consider that each of the year end reports provided by the custodian had inaccuracies that required further time to not only uncover but resolve.

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It should be noted that this letter is critical in nature, as it contains only our comment and recommendation and does not include our observations on any strengths of the Council.

Our audit procedures were designed primarily to enable us to form an opinion on the Basic Financial Statements. Our audit procedures were also designed to enable us to 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* and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Council and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to the Council.

The purpose of this letter is solely to describe the scope of our testing of internal control over financial reporting and compliance and the result of that testing, and not to provide an opinion on the effectiveness of State’s internal control over financial reporting or compliance.

This communication is intended solely for the information and use of management, the Governor and State Legislature, others within the Council, Federal awarding agencies, pass-through entities, and management of the State of Nebraska and is not suitable for any other purposes. However, this communication is a matter of public record, and its distribution is not limited.



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