

**ATTESTATION REPORT
OF THE
NEBRASKA INVESTMENT COUNCIL**

JULY 1, 2002 THROUGH JUNE 30, 2003

**This document is an official public record of the State of Nebraska, issued by
the Auditor of Public Accounts.**

**Modification of this document may change the accuracy of the original
document and may be prohibited by law.**

NEBRASKA INVESTMENT COUNCIL
TABLE OF CONTENTS

	<u>Page</u>
Background Information Section	
Background	1
Mission Statement	1
Organizational Chart	2
Comments Section	
Exit Conference	3
Summary of Comments	4
Comments and Recommendations	5 - 8
Financial Section	
Independent Accountant's Report	9 - 10
Schedule of Revenues, Expenditures, and Changes in Fund Balances	11
Notes to Schedule	12 - 17
Government Auditing Standards Section	
Report on Compliance and on Internal Control Over Financial Reporting Based on an Examination of the Schedule of Revenues, Expenditures, and Changes in Fund Balances Performed in Accordance with <i>Government Auditing Standards</i>	18 - 19
Statistical Section	20
Investments at December 31, 2003	21
Closing Balances at December 31, 2003 (all categories combined)	21

NEBRASKA INVESTMENT COUNCIL

BACKGROUND

The Nebraska Investment Council was established under 1969 laws which provided for the centralization of the investment of State funds and addressed the types of investments authorized. Prior to the creation of a central State investing agency, State operating funds were invested by the State Treasurer and the trust funds were invested by the Board of Educational Lands and Funds.

The Governor appoints the five voting members of the Council to staggered five-year terms with legislative approval. The State Treasurer and the Director of the Public Employees Retirement Systems serve as non-voting members. The Council appoints a full-time State Investment Officer, subject to approval by the Governor and the Legislature.

In 1970 the agency was responsible for the investment of the state operating funds and three long-term funds: the Veteran's Aid Fund, State Patrol Retirement Fund, and the Judges Retirement Fund. In 1971, the Legislature transferred investment authority for the School Retirement Fund and the Permanent School Fund to the Council. In 1976 the Short-Term Investment Pool (STIP) was established to pool cash funds of all agencies except the Treasurer's Cash Fund into one account for investment efficiencies. In the same year the Time Deposit Open Account (TDOA) program for Nebraska banks and savings and loans was initiated. In 1986 the Treasurer's Cash Fund was merged into the STIP. Prior to 1997, the majority of the portfolios were managed internally. In 1997, the Council discontinued the internal management of most of the long-term fixed income portfolios and all of the equity portfolios. Also in 1997, the Council became responsible for asset management of the Defined Contribution investment options in the retirement plans for State and County employees, and the voluntary Deferred Compensation Plan for State employees.

The Council currently manages the State's general and cash funds; retirement plans for State Patrol, judges, and school employees (with the exception of the Omaha Public Schools); 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 and County employees retirement systems 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

June 1, 2004

Kenneth M. Green (Chairman)

John G. Maddux

Gail Werner-Robertson

Earl H. Scudder

Richard A. DeFusco

(non-voting)

Ron Ross State Treasurer

Anna Sullivan 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

AUDITOR

Ray Friesen

SECRETARY

Brandee Freauf

NEBRASKA INVESTMENT COUNCIL

EXIT CONFERENCE

An exit conference was held June 22, 2004 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
Gale Wrasse	Security Analyst III
Ray Friesen	Internal Auditor
Kathy Dawes	Business Manager

NEBRASKA INVESTMENT COUNCIL

SUMMARY OF COMMENTS

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

1. ***Nebraska Information System:*** Significant areas of concern or areas where improvement to the Nebraska Information System (NIS) is needed to ensure NIS integrity and operational efficiency were identified.
2. ***Fund 77500 Transactions:*** At June 30, 2003, the cash balance of fund 77500 was a negative \$4,736,707. This was due to the way the income was recorded and distributed in NIS. Additionally, the interest receivable recorded in NIS could not be completely reconciled to the interest receivable recorded by State Street Bank.

More detailed information on the above items is provided hereafter. It should be noted this report is critical in nature since it contains only our comments and recommendations on the areas 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 comments and recommendations included in this report. All formal responses received have been incorporated into this report. Where no response has been included, the Council declined to respond. Responses have been objectively evaluated and recognized, as appropriate, in the report. Responses that indicate corrective action has been taken were not verified at this time but will be verified in the next examination.

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

NEBRASKA INVESTMENT COUNCIL

COMMENTS AND RECOMMENDATIONS

1. Nebraska Information System

Good internal control requires a plan of organization, procedures, and records, designed to safeguard assets and provide reliable financial records. Without adequate training, written procedures, and controls, there is a risk that employees may unintentionally corrupt critical data, and that errors could occur and go undetected.

During the fiscal year ended June 30, 2003, the State of Nebraska implemented significant components of a new information system called the “Nebraska Information System” (NIS). Two major components were the Payroll component, which went live on January 3, 2003, and the Financial component, which went live on March 1, 2003. All Nebraska Accounting System (NAS) financial data from July 1, 2002 through February 28, 2003 (excluding payroll from January through February as NIS payroll went live January 3, 2003) was converted to NIS as of March 1, 2003. NIS affects all Nebraska State agencies.

A consultant hired by the Auditor of Public Accounts (APA) with expertise in studying large computer systems performed a study of NIS processes and controls prior to June 30, 2003. The APA also performed a preliminary examination of internal controls as of June 30, 2003 at all State agencies in July and August of 2003. In addition, while performing examination procedures the APA has identified other concerns related to NIS.

From these studies and examinations, the APA has identified concerns and areas where improvement to NIS is needed. The following are the more significant concerns or areas where improvement is needed to ensure NIS integrity and operational efficiency:

- a. The reconciliation between the State Treasurer’s actual bank statements and records, the NAS/NIS accounting records, and the related disposition of reconciling items was not completed for November 2002 through December 2003 in a timely manner. Subsequent to December 2003, the Department of Administrative Services (DAS) Accounting Division performed some reconciliation procedures. As of April 28, 2004, the June 30, 2003 reconciliation indicates an unknown variance between the bank records and the accounting records of \$3,654,783, with the bank being short compared to the accounting records. The monthly reconciliations during the audit period and subsequent months indicate fluctuations in the variance amounts. Complete and timely reconciliation procedures between bank records and accounting records provide control over cash and accurate financial information. The reconciliation procedures should be done timely and on a monthly basis to ensure all financial information is correct in NIS.
- b. Two key financial reports to be prepared and presented by the DAS Accounting Division were not completed in a timely manner. The Annual Budgetary Report as of June 30, 2003 was not completed until January 2004. The Comprehensive Annual Financial Report has yet to be completed for the fiscal year ended June 30, 2003. Timely reporting of the State’s financial information is key to all users of such information, especially State policy makers, when making informed policy decisions.

NEBRASKA INVESTMENT COUNCIL

COMMENTS AND RECOMMENDATIONS

(Continued)

1. Nebraska Information System (Continued)

- c. As of June 30, 2003 a comprehensive written NIS policy and procedures manual had not been prepared. Subsequent to June 30, 2003, DAS Accounting Division has made some progress in updating the prior Nebraska Accounting System (NAS) and Nebraska Employees Information System (NEIS) policy and procedures manuals to incorporate NIS policies. However, as of the date of this report these policy updates are not complete. With hundreds of users of NIS, it becomes imperative the State has a comprehensive policy and procedure manual to help ensure consistent and accurate accounting of the State's financial transactions.
- d. Labor distribution - The NIS payroll application is not allocating salaries and benefits appropriately to salaried employees who incur hours that are distributed across multiple business units. This applies to most agencies' funds, programs, and grants.
- e. A detailed analysis has not been performed to determine whether users received adequate training to enable them to appropriately perform their job functions. Training provided for the implementation of NIS was limited to navigational training and did not include explanatory informational training.
- f. A records retention policy has not been implemented to ensure an adequate audit trail is maintained for NIS information. The records retention schedules only states, "Obsolete with implementation of NIS."
- g. The payroll component is not designed to promote an effective segregation of duties.
- h. Critical function access rights - Access to sensitive General Accounting functions has been provided to individuals who may not require such access as a part of their job responsibilities.
- i. Information security procedures - The State has not documented or formalized comprehensive information security procedures for NIS.
- j. Business continuity planning - The State has not implemented a formal, comprehensive business continuity or disaster recovery plan that comprehends both NIS and its supporting infrastructure.

The issues identified above are the responsibility of the Department of Administrative Services Accounting Division and NIS Functional Team as they relate directly to NIS; however, they directly affect all Nebraska State agencies' financial information and must be disclosed in this report. The results of the consultant's study of NIS were communicated in a separate report to

NEBRASKA INVESTMENT COUNCIL

COMMENTS AND RECOMMENDATIONS

(Continued)

1. Nebraska Information System (Concluded)

the Department of Administrative Services, who is responsible for NIS. Letters to each State agency communicated the results of the APA's preliminary examination of internal controls at the State agency level. Additional concerns identified by the APA were communicated to the appropriate State officials.

2. Fund 77500 Transactions

Distributive funds are used to account for assets held by the State as an agent for individuals, private organizations, other governments, and/or other fund types. Receipts and disbursements into distributive funds are recorded directly into an asset or liability account. Sound business practice requires distributive funds to have a zero cash balance or a cash balance that can be reconciled to zero. Good internal control also requires procedures and records to ensure amounts recorded on the accounting system agree to amounts actually held by the bank.

We noted the following related to the activity of Fund 77500:

- The Distributive Fund cash balance of Fund 77500 was a negative \$4,736,707 and it was not reconciled to zero. Income earned and distributed from the Operating Investment Pool is accounted for in NIS in Fund 77500. The NIC is responsible for the State Operating Investment Pool. Each month earned income from the previous month is distributed to all funds making up the Operating Investment Pool, including the State General Fund. Income to be distributed is taken directly from State Street Bank (the fund custodian) statements and represents income earned, but not necessarily received by the bank. Income was recorded in NAS/NIS when cash was actually received by the bank, which could differ from when it was earned. This method of distributing income as earned resulted in the income being distributed before it was received, and resulted in a negative cash balance for Fund 77500.
- The amount of interest receivable recorded in the State accounting system (\$8,647,614) at June 30, 2003, did not agree to the amount of interest receivable recorded by the bank (\$10,748,729). The bank records indicated the bank had recorded \$2,101,115 more in interest receivable than the accounting system had recorded. The DAS Accounting Division was able to identify \$1,829,730 of the variance, leaving an unknown variance of \$271,385. The DAS Accounting Division recorded the bank amount of interest receivable (\$10,748,729) for the State's financial statements at June 30, 2003.

Without adequate procedures to document any variance between the accounting system and the bank records, there is an increased risk the accounting system may not accurately reflect the financial status of the State.

NEBRASKA INVESTMENT COUNCIL

COMMENTS AND RECOMMENDATIONS

(Continued)

2. Fund 77500 Transactions (Concluded)

We recommend the Council obtain guidance from the DAS Accounting Division on the necessary entries to the accounting system so that the cash balance in Fund 77500 is zero or can be reconciled to zero. We also recommend the Council work with the DAS Accounting Division to ensure the accounting records and the bank records are in agreement.

Council's Response: *We fully agree that the procedures should be such that Fund 77500 has a zero cash balance or a cash balance that can be reconciled to zero and that the State accounting records and the custodian's records should agree. We also agree that alternative procedures need to be established. The procedures currently followed by the Nebraska Investment Council (NIC) for the Receipt Document and the Income Allocation Document have been in place since 1997 when State Street Bank became custodian for the NIC, and were put in place at the direction of DAS. Recently, the NIC met with DAS to work to remedy this reconciliation issue, caused primarily from distributing income to agencies before it is received. The NIC believes that the authority to change the procedures resides with DAS. Written instructions from them for completion of the two documents, incorporating any changes that assist them in their reconciliation, would be helpful. The NIC stands ready to cooperate with our colleagues in DAS.*

STATE OF NEBRASKA AUDITOR OF PUBLIC ACCOUNTS



P.O. Box 98917
State Capitol, Suite 2303
Lincoln, NE 68509
402-471-2111, FAX 402-471-3301
www.auditors.state.ne.us

Kate Witek
State Auditor
kwitek@mail.state.ne.us

NEBRASKA INVESTMENT COUNCIL

Deann Haeffner, CPA
Deputy State Auditor
haeffner@mail.state.ne.us

Don Dunlap, CPA
Asst. Deputy Auditor
ddunlap@mail.state.ne.us

Pat Reding, CPA
Asst. Deputy Auditor
reding@mail.state.ne.us

Tim Channer, CPA
Asst. Deputy Auditor
channer@mail.state.ne.us

Mary Avery
SAE/Finance Manager
marya@mail.state.ne.us

Dennis Meyer, CGFM
Subdivision Budget
Coordinator
dmeyer@mail.state.ne.us

Mark Avery, CPA
Subdivision Audit
Review Coordinator
mavery@mail.state.ne.us

Robert Hotz, JD
Legal Counsel
robhotz@mail.state.ne.us

INDEPENDENT ACCOUNTANT'S REPORT

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, 2003. 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.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants, and the standards applicable to financial-related audits 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.

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, 2003, based on the accounting system and procedures prescribed by the State of Nebraska Director of Administrative Services as described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 22, 2004, 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 grants. That report is an integral part of a financial-related audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our examination.

A handwritten signature in black ink that reads "Don Dunlap CPA".

June 22, 2004

Assistant Deputy Auditor

NEBRASKA INVESTMENT COUNCIL
SCHEDULE OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES
For the Fiscal Year Ended June 30, 2003

	Nebraska Investment Council Cash Fund 27510	Operating Pools Distributive Fund 77500	Total (Memorandum Only)
REVENUES:			
Sales & Charges	\$ 662,782	\$ -	\$ 662,782
Miscellaneous	197,902	-	197,902
TOTAL REVENUES	860,684	-	860,684
EXPENDITURES:			
Personal Services	431,741	-	431,741
Operating	429,221	-	429,221
Travel	11,009	-	11,009
Capital Outlay	14,465	-	14,465
TOTAL EXPENDITURES	886,436	-	886,436
Excess (Deficiency) of Revenues Over (Under) Expenditures	(25,752)	-	(25,752)
OTHER FINANCING SOURCES (USES):			
Sales of Assets	129	-	129
TOTAL OTHER FINANCING SOURCES (USES)	129	-	129
Net Change in Fund Balances	(25,623)	-	(25,623)
FUND BALANCE, JULY 1, 2002	182,118	-	182,118
FUND BALANCE, JUNE 30, 2003	\$ 156,495	\$ -	\$ 156,495
FUND BALANCE, JUNE 30, 2003, CONSISTS OF:			
Cash	\$ 156,131	\$ (4,736,707)	\$ (4,580,576)
Deposits with Vendors	504	-	504
Due to Vendors	(140)	-	(140)
Operating Pool Income Receivable	-	4,736,707	4,736,707
	\$ 156,495	\$ -	\$ 156,495

The accompanying notes are an integral part of the schedule.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

For the Fiscal Year Ended June 30, 2003

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 R.R.S. 1999, 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, 2003 includes only those payables posted to NIS before June 30, 2003 and not yet paid as of that date. The amount recorded as expenditures as of June 30, 2003 **does not** include amounts for goods and services received before June 30, 2003 which had not been posted to NIS as of June 30, 2003.

Prior to the implementation of NIS, the State utilized the Nebraska Employees Information System (NEIS) and the Nebraska Accounting System (NAS) to record transactions. NEIS was converted to NIS effective January 1, 2003, and NAS was converted to NIS effective March 1, 2003.

The Council had no accounts receivable at June 30, 2003. The Council had accounts payable for services received but not yet paid of \$140 included in expenditures. 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.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

1. Criteria (Continued)

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.

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 8.

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.

Capital Outlay – Expenditures which result in the acquisition of or an addition to capital assets. Capital assets are resources of a long-term character, owned or held by the government.

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

Assets – Resources owned or held by a government that have monetary value. Assets include cash accounts, deposits with vendors, and receivable accounts. Cash accounts and deposits with vendors are included in fund balance. Interest received and distributed in the distributive fund 77500, Operating Investment Pools, is accounted for in NIS as accounts receivable. The receivables did not increase revenues. The net activity will increase or decrease the cash account. Prior to July 1, 2002, this activity was recorded in a liability account.

Liabilities – Legal obligations arising out of transactions in the past that must be liquidated, renewed, or refunded at some future date. Accounts payable transactions increase expenditures and decrease fund balance.

Other Financing Sources – Proceeds of fixed asset dispositions.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

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 all funds of the Council.

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

3. Beginning Balance

As noted above, the official accounting system of the State was converted during the fiscal year from NEIS and NAS to NIS. NEIS and NAS were strictly cash basis accounting, except certain liability transactions in the distributive fund were recorded to an account titled Investment Pool Interest. In NAS at June 30, 2002, the Investment Pool Interest was handled as a liability account. At June 30, 2002, the liability account had a debit balance. After the implementation of NIS, the Investment Pool Interest was handled as a receivable account, since the amount represented interest receivable from the bank. The activity from July 1, 2002 was converted from the liability account to the receivable account. Therefore, the July 1, 2002, beginning fund balance does include the liability/receivable account noted above that was recorded in NAS and does NOT represent the cash balance of the fund.

4. 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.

5. 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 in governmental funds. 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). Depreciation expenses would be reported in the CAFR 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.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

5. Capital Assets (Concluded)

Capital asset activity of the Council for the fiscal year ended June 30, 2003 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets, being depreciated:				
Equipment	<u>\$ 19,053</u>	<u>\$ 14,465</u>	<u>\$ -</u>	<u>\$ 33,518</u>

6. Operating Investment Pool Income Activity (Fund 77500)

The activity recorded in Fund 77500 is the recording of income received and the distribution of income earned on the investments in the Operating Investment Pool. The income received was recorded on the Council's records daily and recorded into NAS/NIS on a weekly basis. The monthly income earned on the investments was distributed proportionately to all funds designated for investment on a monthly basis. The amount distributed was net of Council fees and State Street Bank custodian fees. The method of distributing income as earned results in income being distributed before it is received and results in a negative cash balance for Fund 77500.

At the direction of DAS, the Investment Pool income activity transactions are recorded directly to the fund's accounts receivable accounts rather than through a revenue or expenditure account. These transactions represent funds received by the Council, which are owed and will be distributed to the funds that make up the Operating Investment Pool. This is a change from how the transactions were handled in NAS. Prior to the implementation of NIS, the activity was recorded as a liability account. At conversion, the NIS Team converted the activity in the liability account to a receivable account back to July 1, 2002.

The following table shows the beginning and ending accounts receivable balances and the activity recorded in Fund 77500:

Object Account	Balance			Balance June 30, 2003
	July 1, 2002	In	Out	
Operating Pool Income Receivable	<u>\$ 12,826,143</u>	<u>\$ 61,280,664</u>	<u>\$69,370,100</u>	<u>\$ 4,736,707</u>

7. Investment Fees

There are three types of investment fees that are charged against investments. They are outside manager fees, State Street Bank custodian fees, and Nebraska Investment Council fees. The outside manager fees and the custodian fees are not recorded on the Council's financial schedule. Investment income is recorded net of these fees on the State of Nebraska's financial statements (Investment transactions and Investment 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 schedules show the investment fees for the fiscal year ended June 30, 2003.

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

7. Investment Fees (Concluded)

Manager	Manager Total
Alliance Capital Management Corporation	\$ 1,470,986
Ariel Capital Management, Inc.	426,907
Ballie Gifford	133,815
Barclays Global Investments	261,570
BlackRock Financial Management	842,928
Dimensional Fund Advisors	669,145
Grantham, Mayo, Van Otterloo & Co., LLC	143,392
Husic Capital Management	742,611
J.P. Morgan Investment Management, Inc.	923,138
PIMCO	1,396,528
State Street Global Advisors	181,447
T. Rowe Price	1,993,642
UBS Global Asset Management	687,957
Westridge Capital Management	535,882
Total Outside Managers' Fees	<u>10,409,948</u>
Custodian Fees	<u>1,055,487</u>
Nebraska Investment Council Fees	<u>662,782</u>
Total Investment Fees for the Fiscal Year Ended June 30, 2003	<u><u>\$ 12,128,217</u></u>

8. Recaptured Commissions

Some of the Plans 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 the commissions, they recorded the disbursements on NAS/NIS. The following schedule reconciles the recaptured commission account for the fiscal year ended June 30, 2003:

Beginning Balance, July 1, 2002	\$ 761,204
Recaptured Commission Earned	400,768
Recaptured Commissions used for Expenses	(190,466)
Recaptured Commissions returned to Plans	(416,458)
Ending Balance, June 30, 2003	<u><u>\$ 555,048</u></u>

NEBRASKA INVESTMENT COUNCIL

NOTES TO THE SCHEDULE

(Continued)

9. Pending Litigation

There is a pending lawsuit against the Nebraska Investment Council, its members individually (at the time of the lawsuit in 2001), and other defendants in the District Court of Lancaster County, Nebraska. The plaintiff sued arguing that a certain investment by the Council in 2001 violated State statutes and was a breach of fiduciary duty. The plaintiff claimed that the State lost \$40 million as a result of the investment, and sought to have that amount returned to the State. A Motion to Dismiss is pending in the lawsuit.

In February 2004, the Investment Council voted to terminate the investment with the manager, which had regained its value since the lawsuit was filed. The original investment of \$200 million was invested in an enhanced S & P 500 Index Fund. The Council felt the investment had not met expectations because of the low interest rate environment. The Council also expressed concern about whether there was sufficient management depth with the firm based on comments from their investment consultant.

Upon termination of the investment, the following were realized: a short term investment fund worth \$75,930,244 when it was transferred to an S & P 500 Index account on March 8, 2004; and United States Treasury Bills with an original face value of \$14,550,000 that were allowed to mature in May 2004. Notice of termination has been given on an investment in a limited partnership with a market value of \$154,291,428 at February 28, 2004. The market value was \$11,441,428 more than the original cost of the limited partnership at February 28, 2004. This limited partnership, by contract could not be terminated for a six month period after notice was given by the Council.

It is the Council's opinion that resolution of the lawsuit should not have an adverse effect on the Council's ability to administer current programs. The Plaintiff is not seeking monetary damages from the Council or the State, meaning any judgment arising out of the lawsuit would not place the assets of the plans at risk.

STATE OF NEBRASKA AUDITOR OF PUBLIC ACCOUNTS



P.O. Box 98917
State Capitol, Suite 2303
Lincoln, NE 68509
402-471-2111, FAX 402-471-3301
www.auditors.state.ne.us

Kate Witek
State Auditor
kwitek@mail.state.ne.us

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

Deann Haeffner, CPA
Deputy State Auditor
haeffner@mail.state.ne.us

Don Dunlap, CPA
Asst. Deputy Auditor
ddunlap@mail.state.ne.us

Pat Reding, CPA
Asst. Deputy Auditor
reding@mail.state.ne.us

Tim Channer, CPA
Asst. Deputy Auditor
channer@mail.state.ne.us

Mary Avery
SAE/Finance Manager
marya@mail.state.ne.us

Dennis Meyer, CGFM
Subdivision Budget
Coordinator
dmeyer@mail.state.ne.us

Mark Avery, CPA
Subdivision Audit
Review Coordinator
mavery@mail.state.ne.us

Robert Hotz, JD
Legal Counsel
robothotz@mail.state.ne.us

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, 2003, and have issued our report thereon dated June 22, 2004. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to financial-related 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 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 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 examination, 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 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 assurance

on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. 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. The reportable conditions are described in the Comments Section of the report as Comment Number 1 (Nebraska Information System) and Comment Number 2 (Fund 77500 Transactions).

A material weakness is a 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 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. None of the reportable conditions described above are considered to be material weaknesses.

June 22, 2004



Assistant Deputy Auditor

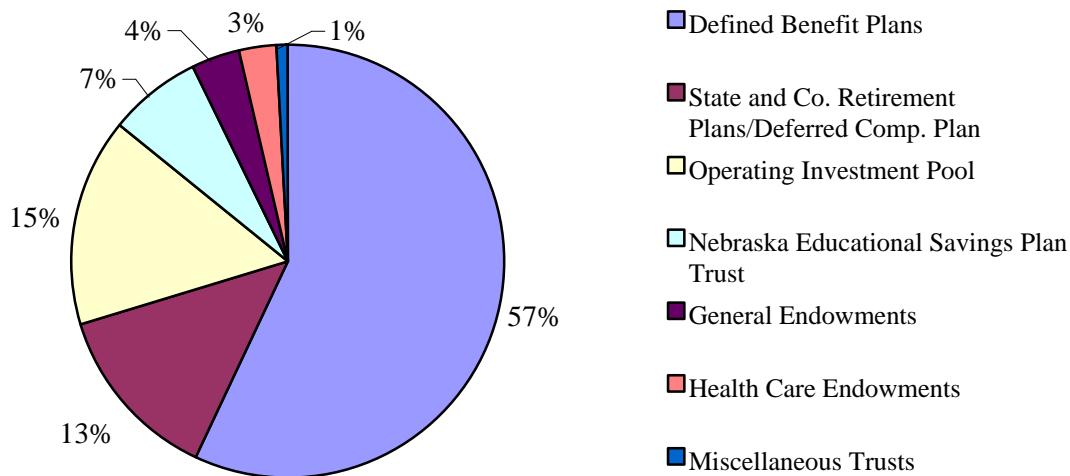
NEBRASKA INVESTMENT COUNCIL

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.

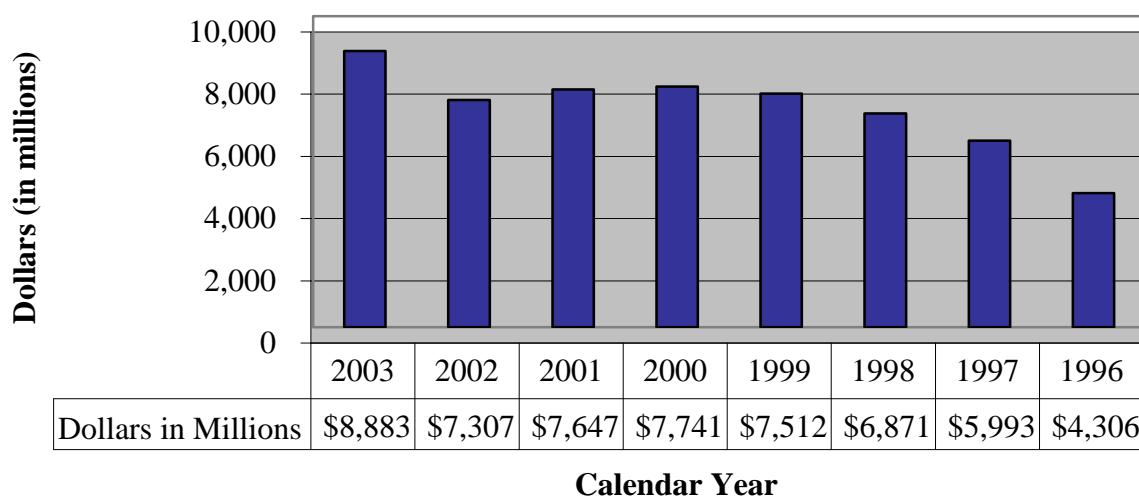
NEBRASKA INVESTMENT COUNCIL
SUMMARY OF INVESTMENT ACTIVITY
For the Fiscal Year Ended June 30, 2003

Investments at December 31, 2003



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
(all categories combined)**



Source - Nebraska Investment Council Calendar Year 203 Annual Report. For more information on the individual activity of each category, see the Annual Report.