

**State of Alaska**  
**ALASKA RETIREMENT MANAGEMENT BOARD**  
**AUDIT COMMITTEE MEETING**

**Kodiak Boardroom - Anchorage Marriott Hotel**  
**Anchorage, Alaska**  
**November 27, 2006**

**ATTENDANCE**

**Committee Present:** Martin Pihl, chair  
Larry Semmens  
Mike Williams

**Committee Absent:** None

**Department of Revenue Staff Present:** Susan Taylor (state comptroller), Gary Bader (chief investment officer), and Judy Hall (board liaison)

**Department of Administration Staff Present:** Charlene Morrison (chief financial officer)

**Others Present:** Kathy Porterfield and Marie Marquardt (KPMG)

**CALL TO ORDER**

CHAIR MARTIN PIHL called the meeting to order at 1:35 p.m. on Monday, November 27, 2006.

**ROLL CALL**

All three committee members were present at roll call to form a quorum.

**PUBLIC MEETING NOTICE**

MS. HALL stated that the meeting was properly noticed.

**APPROVAL OF AGENDA**

MIKE WILLIAMS moved to approve the agenda as presented. LARRY SEMMENS seconded.  
The motion passed without objection.

**PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES**

There was no one present who wished to address the Committee.

**APPROVAL OF MINUTES**

MIKE WILLIAMS moved to approve the minutes of the October 2, 2006 meeting.  
LARRY SEMMENS seconded.

CHAIR PIHL asked that several references to "ARMB staff," starting at the bottom of page 2 of the minutes, be changed to "Treasury (Division) staff." He said this was to clarify roles and who the Alaska Retirement Management Board is.

Referring to the second paragraph on page 7 where Ms. Morrison had responded to the chair that the retention policy on the annual lists of employees was forever, MS. MORRISON said she had misspoke. She said there is data missing for the early years. From February 1996, when the Division of Retirement and Benefits converted from the old system to the new system for benefits, the data on any members who were no longer receiving retirement benefits at that time was dropped from the old system and is no longer available. She has been told that information from the earliest years of the system was kept in manual ledgers, and staff is not sure if those manual ledgers are available. She said she is not aware of anything that has been purged from the system since 1996.

The minutes were approved as amended.

#### **FY06 AUDITED FINANCIAL STATEMENTS**

MS. MORRISON reviewed the following audited financial statements and pointed out disclosure items that are different this year from last year. She said the Treasury Division provided all the investment data included in all of the financial statements.

*Supplemental Benefits System:* There are two plans reported on in this set of financial statements — the Supplemental Annuity Plan, which is a Social Security replacement plan for the participating employers, and the Cafeteria Plan, which is an optional insurance benefit and dependent care assistance plan in which members can choose to participate. There were 16 participating employers, one more than in the past year. Net assets for the supplemental benefit system at January 31, 2006, which is the year end for this plan, were \$115.8 million, up about 6% from the prior year. This is a plan where the members choose their own investment options, and returns for the various investment options are on page 6. There were 34,000 participants at 1/31/06, up about 1,000 from the prior year.

*Deferred Compensation Plan:* This is a 457 plan, which is a defined contribution plan for eligible state employees. The plan was amended in March 2006 to allow members of state boards and commissions to participate. The plan had 8,300 participants at 12/31/05, up about 200 members from the prior year. Net assets were \$476.9 million, up about 5% from the prior year. This is also a participant-directed plan, and the various investment options are listed on page 5.

*Judicial Retirement System:* Net assets were \$80 million at June 30, 2006, up about 8% from the prior year. Investment returns for fiscal year 2006 were 11.37% (gross of administrative expenses). The funding ratio was 77.1% at June 30, 2004, and the unfunded liability was 20.9%.

That data comes from the replication that Fox performed in 2006 — Fox had discovered an error in how medical benefits were valued. This plan received \$125,000 from the Retiree Health Fund, the plan's share of excess reserves that were transferred to participating pension plans.

CHAIR PIHL asked how each pension plan's share of the excess reserves of the Retiree Health Fund was determined. MS. MORRISON said she thought it was calculated on each plan's contributions into the Retiree Health Fund over the last three years.

Referring to page 8 of the Judicial Retirement System financial statements, MS. MORRISON pointed out the disclosure of the legislation that affected this plan: Senate bill 237 passed during the last legislative session, which increased salaries for judges by 50%, as well as increased the number of sitting judges by six. This is a plan where a retiree receives his or her benefit based on the salary paid for the position from which they retired. Whenever there are salary increases, it increases the accrued liabilities, so the next valuation will reflect a significant change for this plan. Page 8 also discloses the results of the valuation replication. Both the error in the valuation and the new legislation will lead to significant increases in future employer contributions. At June 30, 2006, there were 159 plan members. Referring to the 115.6% pension percentage contribution in fiscal year 2006 (shown on page 33), MS. MORRISON mentioned that in 2006 the Alaska Court System had excess funding available at the end of the fiscal year, and they chose to contribute approximately \$355,000 to the Judicial Retirement System over what was required.

*National Guard and Naval Militia Retirement System:* This plan did not see many changes during the year. Net assets were \$15.6 million, up about 7.5% from the prior year. The investment return was 6.25%. The funding ratio was 67.8%, and the unfunded liability was \$6.4 million. That information came from the last valuation performed to June 30, 2004. The replication did not discover any significant errors, so the information did not change from the prior year. There are about 5,800 members, up 700 from the year before.

*Retiree Health Fund:* This fund had net assets of \$238.8 million, up about 1% from the prior year. The investment return was about 5%. A new disclosure item for this fund was included on pages 6 and 26, dealing with the Medicare Part D reimbursement. This plan is eligible for the Medicare Part D reimbursement program, which started in January 2006, so there was six months of activity. But the footnote on page 26 states that staff was unable to reasonably estimate what the receivable for that reimbursement would be, so it will be recorded in the next year's financial statements. Another disclosure item is the plan's share of the PERS net pension obligation. Because the staff that administer this plan are PERS members, a share of the net pension obligation was allocated to this plan, as disclosed in footnote #7 on page 25. The plan had approximately \$50 million of excess reserves, and footnote #6 on page 24 outlines how that excess was allocated back to the four participating retirement systems.

MR. SEMMENS said it looked like expenses for benefits in the Retiree Health Fund went up 13.6%, while premiums increased significantly less than that. He said he was interested that the

premiums have not risen as much as he sees in his world. He asked for any insight on that.

MS. MORRISON replied that the state has a benefit consultant who helps with the premiums, and the state is trying to be careful in not continuing to build the excess reserves. That allows the state to keep the premiums down. The state also wants to avoid huge fluctuations in the premiums one way or another. There has been very good experience on the health care side in the last couple of years, significantly lower costs than what the benefit consultant has seen elsewhere.

MS. MORRISON also reviewed the FY06 Public Employees' Retirement System (PERS) Comprehensive Annual Financial Report (CAFR) and the Teachers' Retirement System (TRS) Comprehensive Annual Financial Report for the fiscal year ended June 30, 2006. The CAFRs contain the audited financial statements, as well as other detailed information that is required by the Governmental Finance Officers Association. MS. MORRISON said KPMG has issued all the financial statements discussed earlier, but they are still in the process of reviewing these two CAFRs. The CAFRs for both retirement systems are substantially the same as past years. There was a new Governmental Accounting Standards Board (GASB) 44 implemented this year that deals with disclosures in the statistical section. For the most part, staff found that the state had already disclosed most of the data but did add some tables.

MS. MORRISON stated that the net assets for PERS at June 30, 2006 was \$9.4 billion, up 9% from the prior year. Investment returns were 11.74% (gross of administrative expenses). The funding ratio in the last valuation for June 30, 2005 was 65.7%, and the unfunded liability was \$4.4 billion. The PERS plan received \$34.6 million of the excess reserves from the Retiree Health Fund. Page 18 contains disclosure of legislation that affects the plan. Senate bill 46 provided employers some relief on the increase in contribution rates, so the plan received \$18.4 million. Senate bill 141 closed the plan at the end of this fiscal year and creates the new defined contribution retirement plan. Page 19 disclosed that the 5% cap on employer contribution rate changes was repealed effective July 20, 2006. The number of employers in the plan remained at 160, with 62,614 members, up about 2,000 from the prior year. The investment section and the actuarial section of the PERS financial report contain historical data. The statistical section (page 99) contains some new information: schedule of changes in net assets, health care coverage schedule, and schedule for principal participating employers.

Referring to page 99, CHAIR PIHL said he is a firm believer in stating the contributions and the investment returns separately and not combining them into net numbers. He added that when reviewing the financials he is alarmed by the comparison of contributions versus deductions. For PERS, TRS and Judicial, the contributions are only about 50-60% of the benefit outflows. That is why he thinks the financials should show the whole picture. For example, in 2005 and 2006 the outflow for PERS exceeded the contributions by \$499 million. In the case of TRS, the difference was \$406 million in those two years. The Judicial plan is similar. That means that investment income is the only thing that makes up the difference. The only plans where there is a near match is the National Guard and the Retiree Health Fund. That information should stand out

in the financials, and ARM Board members should be concerned about it. He said it confirms to him the board's decision to increase the employer contributions.

MS. MORRISON stated that page 100 contained a breakdown of the additions by source.

CHAIR PIHL complimented Ms. Morrison on all the statistics in the CAFRs.

MS. MORRISON said the financial report for the Teachers' Retirement System is very similar to that of PERS. At June 30, 2006 there were \$4.3 billion in assets, up slightly less than 7% from the prior year. Investment returns were 11.78%. The funded ratio was 60.9%, and the unfunded liability was \$2.5 billion, based on information from the last valuation of June 30, 2005. This plan received \$15 million in excess reserves from the Retiree Health Fund. There are 58 participating employers, and membership was up 200 from last year for a total of 10,083 members.

MR. BADER asked Ms. Morrison if the Division of Retirement and Benefits should explore investing the nearly \$300 million in Retiree Health Fund assets more aggressively. He noted that trustee Gail Harbo has mentioned investing the assets more like the ARMB portfolio. He added that the commissioner of the Department of Revenue has adjusted the asset allocation to be a bit more aggressive over the past year to get a higher return. MS. MORRISON said she has thought about it and at one time was under the impression that the Division was going to issue a memorandum to talk to Mr. Bader about that. She said she thought the division would support a more aggressive asset allocation.

MR. SEMMENS stated that the ARM Board has discussed this before and is interested in getting a higher return on the Retiree Health Fund. He said the Audit Committee could make such a recommendation part of its report to the Board, if it would be of any assistance.

CHAIR PIHL said that since there was consensus on the committee a motion was not necessary. He added that contributions and investment income were more than the outgoing benefits and deductions in the Retiree Health Fund, aided by \$50 million in investment returns in 2005. He said the cash flow coming in to meet the benefits ought to be invested wisely.

MR. WILLIAMS pointed out that the contributions to the Retiree Health Fund are actually coming out of the retirement systems because the retirement systems pay for the medical benefits of the retirees. That reinforces the point, to the extent that the contributions are overstated or the premium methodology needs to be looked at so that it more closely matches up.

MR. BADER stated that in light of an adjustment already made to the asset allocation of the Retiree Health Fund maybe the board ought to see what the returns are the first half of the current fiscal year, compare that to the cash flows in and out of the fund, and maybe revisit the question then.

CHAIR PIHL said that was a good point.

Noting that Ms. Morrison is not staff to the ARM Board, MR. SEMMENS inquired of her if there was anything that the ARMB could do to help her in the preparation of the financial statements. He said it was obviously a lot of work and wondered if she had enough staff to do it.

MS. MORRISON agreed that preparing the financial statements is a lot of work and said that she has the support of the Division management. She added that it is very difficult right now to fill any positions. She said she did not feel that she needed anything from the ARMB to get the necessary support.

MR. SEMMENS complimented staff on achieving a certificate of achievement for excellence in financial reporting from the GFOA, adding that he knows such recognition requires extra work and attention to detail. He asked if Ms. Morrison thought the FY06 financial statements would also qualify. She indicated she did.

### **FY06 AUDIT RESULTS**

MS. PORTERFIELD stated that KPMG issued unqualified opinions for all the financial reports. She clarified that the subset of the Comprehensive Annual Financial Report that represents the audited financial statements is complete and issued. KPMG issued a letter to the Audit Committee for each State of Alaska plan, and there were no significant transactions noted. The letters all talk about the valuation of investments because some of the amounts in the financial statements are estimated. Other estimates in the financial statements are the actuarial obligations for the pension plans, and the incurred but not reported in retiree health. KPMG specifically noted in the letter that the estimate for the Medicare Part D reimbursement is not recorded. There is a lot of give and take between the Division of Retirement and Benefits and Medicare to figure out what those numbers are, the range being anywhere between zero and \$7 million. The financial statements record the reimbursement at zero right now, but it will be recorded in the next year.

MS. PORTERFIELD said that KPMG did not ask for any audit adjustments from either the DOR Treasury Division or the DOA Division of Retirement and Benefits, so nothing rose to the level of materiality. There is a time lag on the alternative investments in real estate; there is 12 months of activity in the financial statements but it is on a quarter lag. The letters also stated that KPMG did not have any disagreements or difficulties with management.

MS. PORTERFIELD stated that several management letters (PERS, TRS, and Judicial) contained a comment regarding alternative investments. As discussed at the last Audit Committee meeting, there is new audit guidance with regard to alternative investments. KPMG had a recommendation to the Treasury Division to make sure they have a good understanding of the managers' valuation policies, to make sure they get audit reports on the underlying investments, that those audit reports are also unqualified and in accordance with GAAP, and to do a little more work in the valuation side at the end of the fiscal year.

MS. PORTERFIELD said the second management letter comment (PERS, TRS, Judicial and National Guard), which was not discussed previously, has to do with compliance audits on the retirement and benefits side. Due to lack of staffing, the coverage of auditing employers is not what KPMG would like it to be. The American Institute of Certified Public Accountants actually recommends a four-year rotation for auditing multi-employer plans. She speculated that the Division of Retirement and Benefits was at about a 15-year rotation of auditing the employer group, at the current rate of four audits per year. The audits need to look at employee count, contribution rate, and all sorts of compliance issues to make sure the plan is getting what it is due and that the employee data is recorded properly (also for actuarial purposes).

MR. WILLIAMS asked about the feasibility of contracting out part of the audit function to a local CPA firm for some of the smaller jurisdictions.

MR. MORRISON replied that she has thought about it but has not pursued the idea, so she didn't know the feasibility of external audits. She is also trying to find ways to get more of a global coverage without actually having to go to the employers. This would require asking employers to provide information, and the Division of Retirement and Benefits could look at its data and see what looked out of sync. If there were discrepancies, the Division would ask an employer to provide an explanation.

CHAIR PIHL said the question should be on the table, and he hoped the committee could really explore this at the February or April meeting when the compliance group makes its presentation. He indicated he had a list of concerns that he would give to Ms. Morrison so the compliance group could come prepared. He said he intended to include the concern about the employer audits in his report to the full board tomorrow.

CHAIR PIHL asked if the two DR&B auditors had any other duties. MS. MORRISON said they are also the Social Security administrators, but that is not a significant body of work. She agreed that the two auditors are not getting enough audits done in a year to meet the cycle that KPMG recommended. Further responding to the chair, she said audits take so long because the auditors do a 100% review. So maybe the division has to refine its audit procedure such that the division is getting accurate and complete information without having to look at everything.

MR. SEMMENS observed that there are risk areas, such as misclassifications, that the auditors could target.

MS. PORTERFIELD stated that the Division of Retirement and Benefits does not have a risk-based approach right now, which it needs to do. Also, in this electronic age there must be some kind of reporting that can be designed for employers to spot problems. And if the division needed more people to go out to employers, it could contract with local CPA firms to do the audits. Between those three things, the division could make some headway.

CHAIR PIHL recalled that the committee talked last month about comparing the employers' reported payrolls with the 941 report. The comment had been made that there are lots of employees in the 941 report that are not covered by the pension plan. His recommendation, for the purpose of contributions, is that the state require that employer participants report everyone.

MR. BADER stated that the Division of Retirement and Benefits auditors have enough time to do more audits than what is being accomplished. He added that as a prior employer that has been audited he knows that auditors do not want an employer reporting an employee that is not eligible for PERS/TRS. He said auditors are not just auditing the financial part of things but are also doing a programmatic review (for example, does a person in the TRS have a current teaching certificate?).

MR. SEMMENS said he did not think many employers would have trouble with a reconciliation between what they are reporting to the Division of Retirement and Benefits and their 941 report.

CHAIR PIHL said the state could require it as part of employers participating in the pension plans.

MS. PORTERFIELD indicated that she had concluded her high-level report on the FY06 audit results, having covered more of the details at the October committee meeting.

CHAIR PIHL referred to KPMG's reference to audit adjustments or uncorrected misstatements of \$4.1 million in administrative expense netted against investment income in the Supplemental Benefits System plan. He asked if the same thing was done in all the plans.

MS. PORTERFIELD said no, just the SBS and Deferred Compensation Plan. The investment expenses are broken out separately for all the other plans and separately disclosed in the financial statements.

CHAIR PIHL noted that there are some court cases to more fully require disclosure of administrative expenses and other charges to a pension plan. He thought those challenges in court might indicate that the netting ought not be done.

MR. SEMMENS commented that the netting of expenses is usually generated by a budgetary reluctance to trot out the true expenses in order to get a budget approved. He indicated that although he encounters this problem in his own work, he thinks it is a good idea not to net expenses.

MS. PORTERFIELD agreed that there is no reason not to report administrative expenses separately because they are known figures.

MR. SEMMENS stated that there were immaterial, uncorrected misstatements in PERS noted on page 3 of the KPMG letter. MS. PORTERFIELD confirmed that the items noted should have

been reported in the financial statements but weren't because of the time lag in reporting real estate and private equity investments. There were four quarters of investment information used but it was lagged one quarter.

There was a brief discussion between the committee and staff about whether the committee had to accept and/or approve the FY06 audit results. After consulting the Audit Committee charter, the committee took the following action.

MR. SEMMENS moved that the Audit Committee report to the Alaska Retirement Management Board that it reviewed and accepted the auditor's FY06 audit report and financial statements and recommends that the Board accept the audit reports. MR. WILLIAMS seconded.

The motion was approved without objection.

To clarify the procedure for next year, MS. TAYLOR said Treasury Division staff would present the asset reports in draft form at the first meeting, and then at the second meeting the Audit Committee would recommend acceptance of the combined audit reports of the assets and liabilities to the full board.

CHAIR PIHL stated that what the committee saw in October has now been finalized and will be issued as a separate and final report to the Department of Revenue.

#### **EXTERNAL AUDIT CONTRACT UPDATE**

MS. MORRISON reported that she has begun discussions with KPMG about an audit amendment that would rule in changes that are expected in the coming year. There will be a new set of statements for the defined contribution retirement (DCR) plan's retirement medical plan and the health reimbursement arrangement plan. Information related to the individual accounts for the DCR plan, as well as the occupational death and disability piece, will be rolled into the existing PERS and TRS financial statements. Those were items that were not part of the original contract with KPMG. The discussions with KPMG were started a while back for budget purposes. It looks like for 2007, which is when fiscal year 2006 financial statements will be audited, the audit contract increase will be between zero and \$75,000. That will cover implementing both GASB 43 and 45, as well as the changes brought about by SB 141 to both the Treasury Division and Division of Retirement and Benefits financial statements. KPMG has agreed to keep track of the hours spent on the new items and then bill at the lower of either the hours spent times the hourly rate in the existing contract or limited to the amount KPMG quoted (\$75,000 in 2007 and \$62,000 in 2008 — the first year is non-recurring implementation of a new standard).

#### **FUTURE AUDIT COMMITTEE TOPICS & MEETING SCHEDULE**

MS. TAYLOR stated that it has been necessary for the committee to meet often this year in order to have input on the scope of the audit, etc. It may be that the committee will not need the spring meeting in future years.

MS. TAYLOR pointed out Ms. Hall's work in cross-referencing the items on the committee's agendas with the guidelines in the charter. She asked the chair for his opinion on when State Street Bank should make their accounting and compliance presentation to the committee.

The committee's consensus was the April 25, 2007 meeting.

CHAIR PIHL asked both financial officers and Ms. Porterfield to help the committee identify intelligent questions about risk areas to ask State Street Bank. He suggested providing those questions to State Street before the April meeting so they are prepared with answers.

Regarding the compliance update, CHAIR PIHL asked Ms. Morrison to provide a list of the audits and the dates for the last three years. He requested a summary of any significant findings in those audits, particularly any findings that are common or recurring among the employers. He asked that the report include the follow-up and resolutions of significant findings. Then, if there is a need for the Audit Committee to recommend some strengths to the compliance process, he'd like to hear those. He said he'd like the report to cover whether the findings impact or reduce contributions and have any impact on funding ratios, and particularly whether they result in increased or unintended benefits.

MR. WILLIAMS reiterated his earlier comment to hear more about whether the Division of Retirement and Benefits' audit section has the ability to achieve its mission.

MR. SEMMENS said he'd like to hear about how the whole compliance audit process works and who has the final say.

CHAIR PIHL said it is no secret that the committee is concerned about the 15-year rotation for auditing employers.

Regarding the draft schedule, CHAIR PIHL said he felt four meetings were needed next year because the committee is still forming and working on the scope of its work.

MR. SEMMENS asked the auditor if there was anything this committee should be doing that it is not doing. MS. PORTERFIELD said no, just that there are some things that the committee has not gotten to yet, for example, meeting with the custodian, State Street.

MS. TAYLOR reported that the Treasury Division has filled a compliance officer position and an accountant III position. She is still recruiting for a senior compliance position. She echoed Ms. Morrison's earlier comment that it is very tough to get good people in the accounting/auditing field. As people retire or move on, it is imperative to get people cross-trained. She doubted the Treasury Division could get by with fewer asset accounting staff, in light of the additional tasks.

## **OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE**

CHAIR PIHL recommended to KPMG that the audit reports for the assets be addressed to the Alaska Department of Revenue and that the other audit reports be addressed to the Alaska Department of Administration, instead of to the Alaska Retirement Management Board.

**PUBLIC/COMMITTEE MEMBER COMMENTS** - None.

**ADJOURNMENT**

There was no further business, and the meeting adjourned at 3:05 p.m., on a motion made by MR. SEMMENS and seconded by MR. WILLIAMS.