State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

Commissioner's Conference Room – 11th Floor
State Office Building, 333 Willoughby Ave.
Juneau, Alaska

February 11, 2015

ATTENDANCE

Committee Present: Martin Pihl, *chair*
Kristen Erchinger
Gayle Harbo

Committee Absent: None

Department of Revenue Staff Present: Pamela Leary (Treasury Division director), Gary Bader (chief investment officer), Scott Jones (state comptroller), James McKnight (senior compliance officer), Judy Hall (board liaison)

Department of Administration Staff Present: Jim Puckett (COO, Retirement & Benefits Division), Kevin Worley (chief financial officer, Retirement & Benefits Division), Kay Gouyton (division auditor, Retirement & Benefits Division), Melanie Helmick (internal auditor, Retirement & Benefits Division), John Boucher (newly appointed deputy commissioner)

Others Present: Mike Hayhurst and Melissa Beedle (KPMG), ARMB Trustee Sandi Ryan, ARMB Trustee Sam Trivette, Stuart Goering (board counsel, Dept. of Law), Mike Barnhill (Office of Management & Budget)

CALL TO ORDER
CHAIR PIHL called the meeting to order at 1:30 p.m.

ROLL CALL
All three committee members were present.

PUBLIC MEETING NOTICE
MS. HALL confirmed that public meeting notice requirements had been met.

APPROVAL OF AGENDA
<u>MS. HARBO moved to approve the agenda and MS. ERCHINGER seconded</u>. Without objection, the agenda was approved.

CHAIR PIHL noted that there were five or more follow-up items from the December 3, 2014 minutes that were largely incorporated into the agenda.

APPROVAL OF MINUTES – December 3, 2014
MS. HARBO moved to approve the minutes of the December 3, 2014 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
There were no communications or appearances.

REPORTS

A. Update September 2014 Report from DRB on Employer Audit Program
JIM PUCKETT, chief operating officer of the Division of Retirement and Benefits, announced that the division had hired Melanie Helmick to fill the internal auditor position vacated by Robert Gregg, and he provided a snapshot of her education and background.

MR. PUCKETT reported that the assistant attorney general who worked with the division is now putting together a regulations package that will clarify and strengthen the authority of the audit team to perform compliance audits. He hoped to have delivery of that package soon, and he would provide a progress report at the April committee meeting.

CHAIR PIHL said he hoped that whatever was done strengthens the ability of the Department of Administration to collect from employers. [An unidentified person said they would follow up with the assistant AG on that aspect of the regulations.]

KAY GOUYTON stated that the goal was to totally review everything that has been done over the years, in preparation for a new audit team coming in. They looked at the regulations and governing statutes, pulled notices received from different departments and different employers over the years, and worked at incorporating as much as they could into the changes, while acknowledging that a new audit team will need the latitude to put their own stamp on the whole process.

MS. GOUYTON reviewed what an auditor does in an employer audit in order to get issues from an audit report resolved. First, they make clear to the employer that the audit reports, once published, are available to the public. DRB has received requests for final audit reports from the IRS and the Social Security Administration, as well as attorneys in Alaska. If there are issues, the auditor talks to the management of the employer to make sure they are aware of them, and the ramifications that can bring (if they have court cases or benefit cases or hiring issues). There are past records on employers going back into the 1950s, and part of the issue has been to keep that database updated so there is a research tool for the next auditors. Records are archived electronically, both under the employer's file and topically.

MS. GOUYTON stated that when they do an audit and an employer does not respond, part of the audit report is to tell them what statutory or public law issues they are facing for non-response.

There have been employers that have ignored an audit, and the audit team always put those employers on the audit schedule for the following year. It is made clear to them that there is a benefit liability to them. Also, if an employer is not bringing in groups of employees that should be in the retirement plans, the auditors make sure that the employer understands that it could have federal ramifications as well. Some employers have ignored the audits for a couple of years, and ultimately they get a new manager who realizes the outstanding liability and everything is cleaned up. Approximately 95-97% of the employers will eventually fix the issues, so there is not a lot of stuff hanging out there. The audit team has ways of getting employers to respond that have proved effective, including notifying external auditors of the employers, and state and federal agencies.

MS. GOUYTON presented a draft audit schedule for now until she retires in the summer of 2015, which will include the University of Alaska as a large "everything available" audit that needs to be done before she leaves. The clean-up work will be done later. A sampling audit of the University was done within the last three years, so she is aware of some issues there already. Because the University is a major employer, that audit will cover a large portion of the PERS and TRS databases. Also on the schedule is a hospital, housing authority, some cities, maybe a municipality, and a couple of school districts, so the training base for the new DRB auditors is across the board of what they can expect in the field.

MR. PUCKETT provided the answer to a committee question on the September report, saying that, with administrative approval, DRB would go through the commissioner's office to contact school board members or city council members to get a non-responsive employer to respond to the audit team's requests. If the matter got serious enough, the division would actually contact some of the active employees of that entity to let them know the situation. DRB could follow up with Community & Regional Affairs to intercept some of the revenue sharing, if necessary. And the division could contact the external auditors of the employer to provide them with DRB's employer audit report and let them know about the situation, which could impact the financial statements of that entity.

MS. GOUYTON described how the audit section has pulled together all the audit work papers into a concise package so that everything is together for directing the scopes, objectives, and methodology formulae for a school district audit, for example. They have looked at bringing all of that forward into some concise templates for the future DRB auditors. They have been pulling historical documentation together as research tools for staff so they have a concise set of documents as backup for past decisions made. One can see how a program has matured and an issue has evolved over the years. External auditor KPMG also reviewed all the work papers, so DRB is comfortable with the direction it is taking. DRB has used the standard yellow book reporting formats and documentation standards since the early 1990s.

MS. GOUYTON stated that they have done policies and procedures books for both desk and field compliance auditing. They have also done system audits on the retirement system itself and the computer system. She is a programmer, so she has pulled the backup material for the code and looked at that.

MR. PUCKETT thanked Ms. Gouyton for her diligence and effort in getting everything laid out to make the transition for the new auditors as easy as it can be made. It has been a lot of work organizing and setting things up so information is easier to find. The committee had expressed concern at the prior meeting about knowledge transfer, and DRB has been focusing on that.

MS. GOUYTON said the trade-off is that she has not been doing any auditing for the last couple of months, but work on the knowledge transfer was necessary. With new staff coming on, she will be working with them in the field doing audits on a good cross-section of the employer database.

MR. PUCKETT said that the division is digitizing all its documents and converting microfiche into digital documents. DRB has recently been uploading the portal: for example, a defined benefit member can go onto "My RnB" online and look at their member statements. DRB has uploaded just as many documents over the last few days as the division has scanned for the last three years. All the audit team's historical information will be digitized and archived so that it will be available to any division employee when they are helping a member. Access to information will be much more efficient than it has been in the past.

MS. GOUYTON mentioned that archiving is important because there was an issue in the last year when the Social Security Administration requested proof for why all the police and fire members were being treated in or out of Social Security for every entity in the state. The audit team was able to go back and pull the original contracts with Social Security (182 of them) and look at subsequent modifications to those contracts. They were able to document for every political subdivision why these employees were being treated the way they were for Social Security purposes.

MS. ERCHINGER thanked Kay Gouyton for her years of service, noting that she has worked with her for 26 years and credits her for teaching her a lot of what she knows about the retirement system today. She said that Ms. Gouyton has a unique manner of teaching people by proposing different ways of doing things better and gently coaching people to make the changes. She said she was not surprised that Ms. Gouyton was working until the last hour to leave the job in a better position for the new auditors coming after her. She thanked her for her great career of service to all the communities of Alaska.

CHAIR PIHL commented that he had been alarmed when looking at the September 17 report of employer audit findings. However, he got the feeling from today's report that there was not so much cause for alarm.

MS. GOUYTON explained that the findings in the September 17 report were primarily for audits done on employers that were so small that no auditor had gone out to most of them in the past because of the cost involved. She said they always find something on any audit.

CHAIR PIHL referred to several employers from the September 17 report that had more than a few employees. He said that between the audit team's efforts and some more legal strength he felt they could address employer errors and non-compliance.

MS. ERCHINGER pointed out that the Department of Law currently was reviewing regulations to clarify and strengthen DRB authority to perform compliance audits. She asked if the intent of the review was to strengthen the state's ability to enforce the findings, for example, if an employer is not contributing or if employees are contributing but an employer is not forwarding those contributions to the state.

MR. PUCKETT said the regulation review was an incremental step to do a better job of being able to follow up the compliance audit findings. It would help clarify if an employer were to appeal or question the authority that DRB has.

MS. HARBO referred to an audit finding in the FY14 summary report and asked if eligible employees who were incorrectly excluded from PERS are notified that they have been excluded, because these people are losing out on their retirement. MS. GOUYTON replied that the employer is always liable for payroll costs upfront, and then whether the employer gets the money from the employee in the long run is between them and the employee. When she does an audit, she usually lists who it is pertinent to. In the past, if they do not get a response from an employer, they have gone out to the employees, but it depends on the wishes of the administration of the division. She added that it is not unusual for the auditor to find a deal in the employee's contract where the employee has signed away the retirement benefits. In most cases, they are a rehired retiree or someone who believes they are transient and does not want the benefits. She guessed that half the time the employee is aware of their exclusion.

MR. BADER took a moment to introduce JOHN BOUCHER in attendance as the newly appointed deputy commissioner of the Department of Administration.

B. Update: Legislation re Employer Compliance
GASB 68
DRB Audit Staff

CHAIR PIHL stated that the update on legislation for compliance had already been covered.

He asked staff for an update on GASB 68 and follow-up from the December 3rd meeting about DRB audit staff.

KEVIN WORLEY reported there was a flurry of activity surrounding implementation of GASB 68. The division will be issuing its schedules showing the state's on-behalf-of contribution as a "special funding situation" as defined in GASB 68, and external auditor KPMG is in agreement with that.

MR. HAYHURST of KPMG added that KPMG was asked to put together a position paper for the Department of Administration as well, so all the factors that were considered as to why KPMG is comfortable with the division's position are documented

At CHAIR PIHL's request for more explanation, MR. HAYHURT said it matters because the schedules that DRB prepares and that would be audited by KPMG would show the state's contribution on behalf of the employers as a special funding situation, as defined in GASB 68, and therefore, a portion of the net pension liability would be allocated to the state through that process.

Then what the employers would pick up to report in their financials would be proportionately reduced because they do not have the liability for the special funding situation portion of that pension liability. Conceptually, the state in its financials would pick up that portion on its CAFR (comprehensive annual financial report) as well. That is the second piece of what the state is working out.

CHAIR PIHL asked if the employers would pick up as their liability what the statute says they will pay, which is 22% of their payroll. MR. HAYHURST said it is a little bit more complicated than that, but effectively the employers' pro rata share will represent that for which they are statutorily obligated.

MR. WORLEY said in that case the state will be meeting GASB 68. The other side of it is how the state would be reporting it: the state believes that it is not legally liable, and therefore the higher on-behalf-of dollar amount should not be on the state's CAFR reporting. Over the last few days the thought has been that it would become more of a discussion between the state and GASB on the definition of the special funding situation, and that the state would just pick up its net pension liability allocation without the special funding but disclose it in the footnotes. That would become a non-GAAP disclosure that would be worked out with the state and legislative audit.

MS. ERCHINGER said she thought it was a good solution that accomplishes what both the state and the employers are trying to accomplish.

Regarding DRB audit staff, MR. PUCKETT said that Melanie Helmick took the position formerly held by Robert Gregg. At the appropriate time the division would be recruiting for the vacant position that will be created when Kay Gouyton retires. There may or may not be any overlap for training purposes, depending on budget constraints.

CHAIR PIHL asked what the audit staffing objective was a year or two down the line. MR. PUCKETT replied that there are two positions on the audit team, and he was unaware of any movement to increase that number.

Referring to a follow-up item on page five of the December 3, 2014 minutes, CHAIR PIHL asked if there was a health plan yet for the new defined contribution plan.

MR. PUCKETT stated that there was not a definitive plan yet, but it was on the hot-button list.

CHAIR PIHL mentioned the difference in the payroll numbers that DRB develops each year and what Buck Consultants has been using to develop the actuarial reports, which was a topic raised at the December committee meeting. He said he heard Buck's David Slishinsky state at the board meeting that Buck would update the payroll numbers to match DRB's numbers annually. He expressed hope that the ARMB could rely on Mr. Worley to make sure that Buck uses the DRB payroll numbers because those numbers are absolutely fundamental to the actuarial reports.

MS. ERCHINGER said it was important when talking to the actuaries that the ARMB do a deeper dive on that and question the salary projection numbers, especially with low oil prices and the potential for a significant decline in employees. There is a multitude of possible consequences to the retirement system funding scheme when one starts looking at the long-term payroll growth projections, especially now that level percentage of pay is the actuarial methodology to be used going forward. It is important to get a better handle on understanding how the payroll growth assumption is being factored into the overall numbers.

Responding to Ms. Erchinger, MR. BOUCHER said the University of Alaska is a political subdivision and is subject to the 2008 salary floor, and he would be surprised if the state as an employer was not subject to the floor, given what he knows about the university. He said he would check into it.

MR. WORLEY said that at a meeting yesterday the Alaska Municipal League had made a statement that the state was exempt from the salary floor. DRB's chief pension officer Kathy Lea had clarified in a subsequent discussion that the state as an employer is subject to the salary floor, just like any other employer.

MR. WORLEY recalled a discussion at a prior meeting about the possibility of getting together with the actuary in a work session to delve into some questions, including the assumptions. He said it was a matter of setting a date and time and inviting all the appropriate people.

C. Compliance Report and Update

Senior compliance officer in the Treasury Division, JAMES MCKNIGHT, presented an investment compliance update for 2014 *[See slide packet dated February 11, 2015 on file at the ARMB office for details]*. He reviewed the compliance monitoring systems used, including internal testing, as well as the funds and plans that are tested and the frequency of testing. He explained a list of other compliance checks that are done daily and monthly for ARMB funds and the instances of exceptions found in 2014. He noted there were three instances of an investment manager mistakenly purchasing a stock on the Iran list in 2014, and he has now created a rule in Bloomberg so he sees this right away if it happens.

MR. MCKNIGHT showed a graph of the results of ARMB investment compliance checks for the years 2012-2104. He noted that the higher number of cash overages in 2014 was largely because there were some new funds started in the year. Most of the other non-compliance findings have been trending downward, especially the trade errors by State Street and asset allocation drifts.

MR. MCKNIGHT next reviewed a summary of the commission recapture program for 2014. The amount of commissions rebated declined about $65,000 for the year. That was because a higher percentage of the trades are automated trades, and there is not much room for commission recapture in that type of trade. Staff has not yet received a breakdown by manager from State Street and, once that is in hand, they will review it and come to some conclusion.

MR. BADER stated that when the former Alaska State Pension Investment Board put the commission recapture program in place many years ago commissions were six cents per share. Three cents per share was rebated back to the investment manager in what was called soft dollars, which the investment manager could legitimately use for research. ASPIB preferred to take that three cents a share to create its own commission recapture program. Over time, commissions have gone from six cents down to one cent, and there is nothing there to recapture anymore. He suspected that by compelling the managers to show the ARMB some recapture dollars there might be incentive to go to a place that has something that can be recaptured. He said it is incumbent upon him and staff to look at the whole program de novo to see if it is something that makes sense now. He will be reporting to the board once staff has completed its analysis.

MR. MCKNIGHT reported that all the investment managers provided a statement indicating that they had voted all the proxies in accordance with ARMB policy.

Lastly, he presented a list of investment compliance goals for fiscal year 2015. Accounting staff are going to use Bloomberg more often, and they will be trained on using that tool. They will also receive training on Yield Book, a tool used for fixed income analytics and that will be useful for them to use in the financial statement audit process. Compliance is continually adding more spreadsheets that are set up to check the rules automatically. Also, Compliance will start looking at the global investment performance standards that some other public funds are using to see if that holds any potential for the ARMB.

CHAIR PIHL thanked Mr. McKnight for the monthly compliance reports to the Audit Committee. He thanked Ms. Leary for developing the investment compliance program over the years, saying it is a very important effort.

MS. LEARY stated that Mr. McKnight has made a lot of enhancements to the program in the last two years, including that he can almost immediately see something that might go out of bounds when a trade happens and notify the trader. That decreases the non-compliance in the system.

D. Future Audit Committee Topics

MS. ERCHINGER commented that she was still unclear on what the practical actions would be against employers that are not paying contributions properly. Her particular concern was about the impact on employees who should be in the retirement system and are not getting credit because their employers are not reporting that to the state until the error is caught in an audit. She wanted to make sure that all employers are playing by the same rules and are not just let off the hook because they are not forwarding their contributions. She said she understood there were employers that literally did not have the money to pay, and those would have to be looked at differently than an employer that is choosing not to pay or collect and remit. It is different than a defined benefit plan when the contributions for defined contribution plan employees are not being submitted on their behalf, because that money is all that ends up in a defined contribution plan employee's account for retirement. She wanted to understand how that will all work out.

CHAIR PIHL remarked that there are limits on what the Audit Committee can do, so it was important that Ms. Erchinger's comments at least be on the record as the committee strives to do its job.

MS. ERCHINGER thanked Ms. Gouyton and Mr. Puckett for their work on the employer audits and in helping the committee to better understand the transition plan in the division. She said it sounds like they are well on the way to coming up with a system that is going to work after Ms. Gouyton has retired, and that alone gives her more comfort than if there is just two people on the audit staff – which she continues to think is woefully inadequate. At least having good policies in place and a good training manual for new people will pave the way for them to hit the ground running. At the last meeting she did not have any comfort as to how the transition was going to progress, but she felt a lot better from what she heard today.

MS. ERCHINGER suggested that when an employer audit is completed it might be a good idea to send the final audit report to the elected body of the employer, instead of just to the administration of the employer.

MS. GOUYTON said DRB has done that in the past when the employer in question is a habitual offender. Most cases are resolved by working with the employer, but elevating it after 30 days if there is no response is a good hammer. This could be added to the written procedures.

E. Further Meeting Schedule

The next meeting is Wednesday, June 17, 2015 in Anchorage.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC/COMMITTEE MEMBER COMMENTS

There were no comments.

ADJOURNMENT

The meeting adjourned at 2:37 p.m., on a motion made by Ms. Erchinger and seconded by Ms. Harbo.

Note: An outside contractor prepared the summary minutes from staff's recording of the meeting. For in-depth discussion and presentation details, please refer to the recording and staff reports and written presentation materials on file at the ARMB office.

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