State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE TELECONFERENCE MEETING

Treasury Conference Room, State Office Building
333 Willoughby Avenue
Juneau, Alaska

October 15, 2015

ATTENDANCE

Committee Present: Martin Pihl, *chair*
Kristen Erchinger (joined 8:55 a.m.)
Gayle Harbo

Committee Absent: None

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

Department of Administration Staff Present:
John Boucher (deputy commissioner)
Kevin Worley (chief finance officer, Retirement & Benefits Division)

Others Present:
Mike Hayhurst (KPMG)
Melissa Beedle (KPMG)
Kim Brook (KPMG)

CALL TO ORDER
CHAIR PIHL called the meeting to order at 8:36 a.m.

ROLL CALL
Two committee members were present at roll call, and Ms. Erchinger joined the meeting at 8:55 a.m.

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

APPROVAL OF AGENDA
MS. HARBO moved to approve the agenda and CHAIR PIHL seconded. The agenda was approved without objection.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
There was no one who wished to address the committee, and MS. HALL reported that she had received no communications to the Audit Committee.

REPORTS

A. Review of Draft Financial Statements:
CHAIR PIHL stated that committee members had received the following draft financial statements over the weekend and had reviewed them:

1. Public Employees' Retirement System (PERS)
2. Teachers' Retirement System (TRS)
3. Judicial Retirement System (JRS)
4. National Guard and Naval Militia Retirement System (NGNMRS)
5. Supplemental Benefits System (SBS)
6. Deferred Compensation Plan

He emphasized the effort at the Division of Retirement & Benefits to advance the timeline to get the financial statements out earlier this year. He thought there has been too much pressure put on chief financial officer Kevin Worley and his staff, and he characterized the financials as rather early stage drafts without enough time for review. Committee members have submitted review comments in advance *(on file at ARMB office)*, in an effort to be constructive. He suggested reviewing the committee review comments at this time, getting Mr. Worley's responses, and then presenting any questions to KPMG. He invited Ms. Harbo to start.

MS. HARBO pointed out instances where she thought certain wording on the PERS and TRS financial statements should be the same. MR. WORLEY explained that at the time staff was preparing to send the draft financials out to the committee last Thursday he was able to update only the PERS financials. He said staff is aware of the differences, and they have to go through and update everything on the valuation reports. MS. HARBO said she did not need to go over each instance if staff was going to be making those changes.

MS. HARBO asked if staff was going to remove the references to the 80% to 120% corridor.

MR. WORLEY explained that that part was taken out of the PERS and TRS defined benefit plan reports. However, those are still in there when he looked at the defined contribution reports. He needs to discuss that item with Buck, if the intent was actually to take those out of not just the PERS and TRS defined benefit plans but the defined contribution occupational death and disability and retiree medical plans.

Continuing with her review points, MS. HARBO indicated that half way down page 48 of PERS she thought the date should be 2014 instead of 2013.

MS. HARBO asked if "no payroll growth" should be part of the assumptions in the draft. MR. WORLEY responded that he would confirm that with Todd Kanaster at Buck Consultants.

MS. HARBO said page nine of the Judicial financial statements indicated an increase from FY12 to FY14, but she maintained that it was a decrease. MR. WORLEY agreed with her and said staff would rewrite that.

Still on the Judicial financials, MS. HARBO pointed out a reference to the corridor again on page 29 and said she assumed staff would check that. MR. WORLEY said yes.

MS. HARBO referred to the NGNMRS financials and said that page 8 would read better if it said "two changes, first…and, second…" MR. WORLEY accepted that change.

MS. HARBO turned to page 7 of the SBS financial statements, the second paragraph below the chart, and asked Mr. Worley if he had a chance to look at the second line, "The decrease is due to…" to see if the next three words were correct or an error. MR. WORLEY indicated it was a mistake and he would ask staff to check it and rewrite that line.

MS. HARBO went on to the top of page 15 of the SBS financials and asked if the year 2015 was needed as part of the date. MR. WORLEY agreed that the year should be there.

MS. HARBO said she had the same comment for page 16 of the Deferred Compensation Plan financial statements.

CHAIR PIHL next offered his review comments, starting with page 3 of the PERS financial statements, where he said the decrease was not $2.4 billion but $1.9 billion. He said this kind of thing does not crop up as much if a table is used for comparison instead of using the narrative format.

CHAIR PIHL said he always tries to compare the numbers with the Department of Revenue (DOR) and the Department of Administration (DOA) June 30 reports. He recognized that accruals are done in these statements and wanted it confirmed that everything has been reconciled. He looked at net investment income between DOR and what is shown in this report, and there is quite a difference. Some investment expense is netted against income by DOR, but that was something like $32 million, and this difference is quite a bit more than that.

MR. WORLEY indicated he had been working with state comptroller Scott Jones on the reconciliations.

CHAIR PIHL suggested standardizing the language for the terms "state assistance" and "non-employer contributions" that are used interchangeably. He said the statute refers to "state assistance." The assistance is not a non-employer contribution because the State of Alaska is an employer that is making the payment.

MR. HAYHURST said the State plays two roles: one as an employer and one as a non-employer contributor. He wanted to talk to Mr. Worley about this further to make sure the references are correct.

CHAIR PIHL suggested calling it state assistance for what it really is. MR. HAYHURST agreed it could be called state assistance and not indicate employer or non-employer. He reiterated that he thinks of the State as an employer differently than he thinks of the State as a non-employer contributor providing additional assistance beyond what the employers are providing.

MR. WORLEY said he and KPMG's Melissa Beedle would talk about it tomorrow when he was back in the office.

CHAIR PIHL proposed a rewrite on page 7 of the PERS financials, saying that this year was dealing with a different situation in that the State contributed $1 billion to the PERS system. He had submitted a proposed explanation to make that clearer in his October 13 email to staff and the committee.

Moving on to page 10 of PERS under Legislation, CHAIR PIHL remarked that he thought the paragraph was not that well done. He listed the following changes: (1) the percentage was 12.56%, not 22%; (2) it was not just "enacted one law"; (3) the $126 million is a forward number, and he wondered if it was normal to get into forward numbers; (4) the $1 billion in state assistance is part of the reduction, but more of the reduction is due to the legislation requiring the Alaska Retirement Management Board to go to percent of pay and extending the amortization period by nine years; (5) a table format would make the investment income comparisons much clearer; (6) when comparing the stellar investment performance of over 18% in 2014 with anything else, it should be made clear how high the return was at 18% plus and that markets do what they do; (7) third paragraph from the last, he did not think it was necessary because the $1 billion contribution sort of trumped the situation and the ARC (actuarially required contribution) rate for the year was not used; and (8) last paragraph, the decline in the ARC rate had more to do with the legislation requiring use of percent of pay and the extended amortization period than anything else, which is not in the explanation.

MR. WORLEY made note of those comments.

CHAIR PIHL stated that on page 9 relative to funding, he thought it should start out that it is the ARC (actuarially required contribution) rate. And something could be said about following the statute and legislative direction, rather than best actuarial practice.

CHAIR PIHL noted that page 39 was not there but he assumed that Buck was preparing the net pension liability development.

MR. WORLEY confirmed that he had requested the GASB 67 information from Buck for PERS, TRS, Judicial, and National Guard, and he had not received it yet.

CHAIR PIHL drew attention to pages 42-43 of the supplemental information and asked if those were prepared by Buck as well. MR. WORLEY indicated he was waiting for that information. CHAIR PIHL urged that someone take another look at the retiree health care on page 42, where the actuarial accrued liability numbers vary dramatically, and he would not expect that to be the case. The numbers dropped by $2 or $3 billion.

Lastly, CHAIR PIHL mentioned updating the pages in the table of contents.

CHAIR PIHL asked if Mr. Worley or KPMG wished to make any comments on the review of the draft financial statements.

MR. WORLEY said he appreciated all the help from KPMG, and they had an email conversation about getting together to go through all the comments and get everything updated. Staff is going through the final valuation reports to update all the information they have. He had provided the committee with a list of notes related to the draft financial statements, including the items the Division of Retirement & Benefits is missing. GASB 67 information was one of the things, and he was hoping to get those final reports by tomorrow to incorporate them. Regarding the Chair's early comments about the division's effort to get the financial statements out earlier, he stated that a couple of weeks further into October would actually be optimal for staff next year. He would work with Mr. Kanaster on this, but Buck needs really good final numbers from DRB, and staff has to go through [few words inaudible….] items to Buck so they can finalize the reports. It is important to include in the financial statements, but it is a little difficult with the time frame they are currently on. He suggested discussing the timeline at the December audit committee meeting, when staff has had time to look back and also work with Buck to see how DRB getting its financial statement numbers to them would impact their schedule.

Addressing the KPMG people, CHAIR PIHL drew attention to the auditor's opinion at the top of page 2 (PERS) under the emphasis matter paragraph and said he assumed they were referring to note 2 of the management discussion and analysis.

MR. HAYHURST responded that it should not be referring to the management discussion and analysis. He added that KPMG still had to work through some drafting in its final reviews, and that emphasis may come out because GASB 67 was adopted in the prior year. MS. BEEDLE indicated she agreed that paragraph would probably come out. KPMG only has to reference a new accounting standard in the year of adoption.

MR. HAYHURST explained that it was in there last year. All the emphasis matter is doing is calling people's attention to something that was important to a reader's reading of the financial statements. When KPMG says they have not modified the opinion, it means it did not change their opinion as to whether or not the financials were reported in accordance with GAAP. They just wanted to call attention to something the reader might want to read, but they still have a clean opinion.

CHAIR PIHL asked whether these financial statements have to deal with GASB 68.

MR. HAYHURST said GASB 68 is actually the employer's standard for adoption, so the State will not have to deal with that in the pension financials. KPMG will be dealing with that in the schedules that will be issued, and then the employers will have a similar emphasis matter in their financial statement opinion calling attention to the fact that they have adopted GASB 68.

CHAIR PIHL stated that there has been a fairly large drop in investment returns – roughly 5% -- since the June 30 financial statements. He asked if that was a subsequent event that should be reported in a footnote.

MR. HAYHURST said it would not necessarily be a subsequent event; however, he and Mr. Worley could discuss whether it might be a good disclosure for the readers. Where he sees a disclosure around that is in the risks and uncertainty area, where it can talk about the fact that the investments are subject to market changes and, therefore, can have large impacts if the value of the investments has gone down substantially. He did not usually see it in a subsequent event footnote.

MS. ERCHINGER said she had looked at the footnotes to the required supplementary information, specifically about the changes in actuarial assumptions. She asked if the ARMB's action that approved a reduction in the payroll growth assumption to be based on 0% population growth was going to be rolling into the next valuation and not this valuation.

CHAIR PIHL told her that Ms. Harbo raised that same question on her list of review points. He understood that the division and Buck Consultants were taking another look at that.

MS. ERCHINGER stated that the Chair had asked some good questions, some of which she also had on her list.

B. Update on GASB 68

CHAIR PIHL stated that, after discussion at the Fairbanks meeting of how the historical contributions approach works, he gathered that the State would be taking another look at it. Following that, he understood the Division of Legislative Audit said they disagreed with the Department of Administration as to whether the State's on-behalf contributions for PERS and TRS are special funding. Next, he understood that at least some of the auditors for the municipalities have advised a revision is forthcoming, and that the Department of Law memo is being challenged and tested. Lastly, he thought there was an appeal procedure. The big question is if there is a special funding situation or not. His understanding is that KPMG believes there is.

MR. WORLEY reported that the Division of Finance had provided an email to the Division of Retirement & Benefits, after they had met with Legislative Audit, because, as Mr. Hayhurst pointed out earlier, GASB 68 is an employer reporting of the net pension liability. So the State Division of Finance is responsible for the State's CAFR (comprehensive annual financial report) and reporting the appropriate share of net pension liability. Legislative Audit had read through the Department of Law memo opinion and they basically disagreed with the State's assertion that the on-behalf contributions is non-special funding, and instead indicated it is a special funding situation and went through various pieces of GASB 68, as well as the implementation guide. Throughout the discussion, Mr. Barnhill, who is a special project coordinator for the Department of Administration, had inquired if Legislative Audit had checked with their legal counsel. The legislative auditor had indicated that she had not, and she was basing her decision on GAAP and GASB standards and looking at it from an accounting perspective and trying to take the legal part out of it. It was a good discussion. Ms. Leary brought up a point about the implementation guide, that there is a matter of the word "could" be a situation. Everyone agreed it was a good point. However, when they left the meeting he thought that Legislative Audit still believed that it was a special funding situation and would look at it once the Division of Finance had issued their financial statements, which is around the end of this month. The legislative auditor had also indicated that, because of the component units that are reported in the State's CAFR that are audited by other firms, she contacted them and notified them of the Division of Legislative Audit's position on the special funding and the GASB 68 reports. While they cannot say you have to do it this way, they were suggesting using professional judgment, and that Legislative Audit had come to the conclusion that it is a special funding situation.

Treasury Division director PAM LEARY added that the point was emphasized that this was a legal issue and that the GASB even stated legal responsibility of the payment. Therefore, the legality should also be looked at, in addition to the accounting rules on a strict reading. That was a big part of the discussion.

Deputy commissioner JOHN BOUCHER remarked that whether this is in the purview of accounting or in the purview of legal has been at the core of the difference of opinion between the State and KPMG from the very start. That is the fundamental difference of opinion.

CHAIR PIHL posed the expectation that municipalities are going to follow the accounting interpretation. MR. BOUCHER said he did not know; he could not speak for the municipalities. He added that municipalities are definitely providing feedback to the Department of Administration and at higher levels about this particular interpretation. He has been asked to revisit this with the Alaska Municipal League and other people.

CHAIR PIHL stated that this is dealing with a liability, and it is not the legislature dealing with a choice of funding this project or that project. Following that thinking, revenue bonds or general obligation bonds would not be a liability because the payment has to be funded by the legislature.

MR. BOUCHER said the department is in total agreement that this is a liability. The fundamental issue is who reports it. It appeared to him that the situation is like the process where a bill has arrived, and there is an effort to try and allocate to the public what is owed.

CHAIR PIHL remarked that for nine or ten years the State has never failed to make the state assistance contribution.

MR. BOUCHER said he understood that the State has tried to put some efforts into forward thinking, based upon the concerns that were expressed at the September meeting. But it is fair to say that for this particular cycle the State is basically committed to this path at this point in time.

MR. HAYHURST indicated he thought that was a fair statement. As far as the schedules themselves, the plan is to still show the pension liability allocation information on two lines for each employer, the way it was originally drafted. That is appropriate because the State is still working through this. The information is there so that the various employers can make the decision as to what components to pick up and how.

Addressing the Chair, MR. HAYHURST stated there were a couple of discussions on how the information is presented and how it is pulled together and allocated as it relates to historical versus pro forma. The decision is that it is still most appropriate to use the historical contribution method. Even if you did pro forma, you would get an interesting curve as you look out, with the additional contributions. KPMG validated two specific items. One is that you cannot look to a subcomponent of the actuarially determined contribution (that being the contribution that specifically relates to past service cost for unfunded liability) and ignore all the rest of the contributions and just do the allocation percentage based on that. So it is dealing with the full contribution by the employers, of which the State then makes up about 50% as a non-employer funder, and then the employers make up about 50% for this year. Going forward, after the $1 billion appropriation to PERS and $2 billion to TRS goes in, that shifts a bit more to 75% to the employers and 25% to the State as a non-employer entity, depending on which plan you are looking at. KPMG is looking at the 2015 schedules to figure out how to neutralize the impact of the $1 billion and $2 billion, so there is not the case where the State all of a sudden is 99% (going from 50%) and then down to 75%. Those are being drafted so KPMG can see how that flow looks before issuing the 2014. Unfortunately, the way that GASB drafted the standard, they clearly did not contemplate the very unique situation that the State of Alaska is, and there is not a lot of leeway within the standard to be able to take into account that unique situation. So there is going to be some movement in the employers and in the allocation schedules over the next three years, but then that should stabilize.

CHAIR PIHL remarked that when the state assistance drops to $79 million, the allocation will really get messed up.

MR. HAYHURST said he thought when he ran the numbers that the State, as a non-employer assistance provider, ends up covering about 25% of the total contributions, as opposed to what they have been doing. He agreed that it will create some movement in those allocations.

MS. ERCHINGER said she shared the Chair’s comments, but at this point the legislature has done what it has done, and the administration helped craft the legislation that would increase the municipalities’ share of the unfunded liability by 85% by shifting those costs to the municipalities. There is nothing the ARMB can really do today to affect that. It is another example of what happens when the State acts not in concert with the municipalities, but the State and the municipalities are looking out for their own interests, without recognition that it is all one state. In shifting the costs from the State, it will take some time for the education to trickle down to the people who will be impacted, and then more people than just the ARMB will be expressing serious concern about that cost shifting. She said she appreciated the Chair continuing to bring that up. It is important, but clearly it is not going to make an impact because now the legislature has put in statute the things that the ARMB used to be able to make a decision about, in order to affect those employer contribution rates. That was done deliberately, and things are where they are now.

MR. BOUCHER said he understood Ms. Erchinger's perspective, in terms of the cost shift, but he asked her to consider, for instance, in the funding of the current year budget the constitutional budget reserve, which is the property of the citizens of the State of Alaska, is funding a significant portion of this budget. It is earnings from oil that have been saved and deployed by the citizens. So to say that this is all a cost shift to local taxpayers through their local taxes does not take into account the drain that this is placing on the people's savings accounts.

MS. ERCHINGER said it would be a little bit different than when the State has been writing the checks from its checkbook. Now it is going to be taxpayers throughout the state writing the check from their checkbooks to pay the bill. So while theoretically she understood what he was saying, there is a very real difference. It is shifting the cost from the oil taxes, and because of the extension of the amortization period we are not able to have investment earnings paying the lion's share of employer contributions in the future. It will be the contributions by the employers; 85% of it is shifting to the municipalities, and their money is going to come from their local taxpayers in the form of property taxes and sales tax. It is a real cost shift, and it is really going to take real people writing checks out of their checkbooks, not money that previously was coming from the state coffers, which was from oil funds. She said she understood what Mr. Boucher was saying theoretically, but it is a very real difference.

C. Further Meeting Schedule

The next regular meeting is Wednesday December 2, 2015 in Anchorage. The Chair said the committee would be reviewing the completed financial statements at that meeting.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC/COMMITTEE MEMBER COMMENTS

MS. ERCHINGER thanked staff for all their help. It has been a lot of work for them to get things done on time, especially with all the uncertainty surrounding how to address the net pension liability allocation. People have worked hard to come to reasonable decisions, and she appreciated everybody working together on this.

CHAIR PIHL said he echoed those comments and particularly thanked Mr. Worley and his staff, saying he understood what he has been up against. He also hoped the committee review comments would be helpful and constructive.

MR. WORLEY replied that the comments were very helpful and he appreciated those.

CHAIR PIHL commented that he hoped to get away from being proofreaders down the line. MR. WORLEY said that was a hope of his too.

MR. BOUCHER also thanked the committee for helping to improve the department's product.

ADJOURNMENT
The meeting adjourned at 9:30 a.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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Karen Pearce Brown