State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

Captain Cook Hotel – Club Room II
939 W. 5th Avenue
Anchorage, Alaska

September 28, 2016

ATTENDANCE

Committee Present:	Rob Johnson *(chair)* Kris Erchinger Gayle Harbo
Committee Absent:	None

Department of Revenue Staff Present:
Jerry Burnett (deputy commissioner)
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)
Jim Puckett (chief operations officer, Retirement & Benefits Division) *on-line*
Kathy Lea (chief pension officer, Retirement & Benefits Division)
Kevin Worley (chief financial officer, Retirement & Benefits Division)
Melanie Helmick (senior audit and review analyst, Retirement & Benefits Division) *on-line*

Others Present:
Daniel Mitchell (KPMG)
Mike Hayhurst (KPMG) *on-line*
Melissa Beedle (KPMG)

CALL TO ORDER
CHAIR ROB JOHNSON called the meeting to order at 1:32 p.m.

ROLL CALL
All three committee members were present at roll call.

PUBLIC MEETING NOTICE
MS. HALL confirmed that appropriate public meeting notice had been provided.

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

APPROVAL OF MINUTES – June 23, 2016
MS. HARBO moved to approve the minutes of the June 23, 2016 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
No one present at the meeting site or listening by telephone indicated they wished to address the committee.

REPORTS

A. Presentation: FY16 ARMB Audited Financial Statements
DANIEL MITCHELL, KPMG lead engagement partner on the June 30, 2016 Treasury Division audit, started with the audit status. He said there were no significant changes to the audit plan that KPMG presented earlier in the year. They are substantially complete with the audit of the schedules, and are in the process of having the second partner review the financials and provide comments over the next week. There are a couple of components to finalizing documentation. KPMG uses their own investment valuation specialist to look deeper at the Alaska Retirement Management Board's alternative investment portfolio, and they are about 95% done with that test work. Mr. Mitchell has reviewed the majority of those work papers and is waiting for the investment valuation specialist's final sign-off. There are a few minor items they are working through with Treasury management to get that documented before KPMG issues the audited financial statements, but the audit is substantially complete. KPMG will obtain a management representation letter as they work through the last procedures.

Moving on to significant findings or issues from the audit, MR. MITCHELL stated that what KPMG considers to be a significant risk is around investment valuation, specifically on the alternative investment portfolio. KPMG takes a close look and samples those investments to ensure that the valuations are within the expectations of other benchmarks and other information in the marketplace, to make sure those investments are recorded at fair value as of June 30, 2016. The Treasury Division reports fair value of alternative investments on a lag-on basis because some of the funds report three months behind, which is no change from prior years. Management did an analysis on what the impact would be for that quarter laggard and has presented KPMG with an unadjusted audit difference. KPMG is finalizing their valuation to that, but it is not material or something they expect to be adjusted to the financial statements. Similar to prior years, there will be an unadjusted audit difference that will ultimately be attached to the letter to the Board.

MR. MITCHELL addressed uncorrected misstatements, saying that will be provided once KPMG finally issues the audited financial statements, related to the timing of the available information for the alternative investments. KPMG has not proposed any corrected misstatements during the course of the audit. The schedules were in good shape, and they did not find reconciling differences or items they felt needed to be corrected as part of the audit process.

As far as performance improvement opportunities and deficiencies, there were no material weaknesses identified as part of KPMG's test work, and no significant deficiencies identified. In fact, as KPMG expected when they came in, the books and records were in good shape. KPMG spends a lot of time looking at transactions and individual investment holdings. For the readily determined marketable portfolio, they look at 100% of the common stock and bond portfolios and have that individually priced with their pricing desk. They have a fairly significant sample size of funds they look at, including the reports that management provides and reconciliations back to State Street Bank. There were no deficiencies that KPMG needed to bring to the committee's attention.

Regarding the list of "other matters" *(slide 9)*, MR. MITCHELL said there was nothing to report. Since these are required communications, he read through the list on slide 9. Regarding communication with the firm's national office, he noted that the audit team works with the KPMG valuation specialists and is pending the final sign-off on the investment portfolio.

MR. MITCHELL addressed the responsibilities of the parties involved in an audit: management, the Audit Committee, management and the Audit Committee together, and KPMG. The details were outlined in slides 11-14, and he noted that none of the responsibilities have changed. He stated that the audit of the financial statements does not relieve management or the Audit Committee of their responsibilities. He added that KPMG expects to issue an unmodified, clean audit opinion of the schedules for the year ended June 30, 2016.

MR. MITCHELL stated that, in KPMG's professional judgment, they are independent with respect to the Alaska Retirement Management Board, as that term is defined by the professional standards. They are not aware of any independence issues that the engagement team or KPMG has with respect to the opinion that they render.

MR. MITCHELL drew attention to the last section that listed some of the resources that are available to audit committees through KPMG's Audit Committee Institute. He encouraged committee members to use the links to access some good material: one of the trending issues is what committees and boards are looking at in today's environment.

CHAIR JOHNSON asked if there were one or two hot-button issues that Mr. Mitchell would recommend.

MR. MITCHELL mentioned that information technology (IT) and cybersecurity are generating a lot of discussion right now with audit committees and boards that he presents to, especially with investment portfolio information and the phishing schemes that are out there.

KPMG's client service partner, MIKE HAYHURST, participating by telephone, said he agreed. Taking it to fruition through the retirement and benefits, it is becoming a discussion topic for non-state retirement plans around the country because there is so much personal information that is retained within companies around benefit plan information and census data. There is definitely heightened security about cybercriminals getting to that data somehow.

CHAIR JOHNSON asked if KPMG, in the process of the audit, observed any flaws or issues on the part of the state agencies with respect to cybersecurity awareness.

MR. MITCHELL replied that the audit does not focus on cybersecurity, but if they saw any concerns while looking at transactions and the year-end values they would certainly bring it to everyone's attention. Because KPMG does so much test work over the portfolio, if there was something untoward, they would notice it. They are not sampling but looking at the majority of the portfolio when doing their test work.

MR. HAYHURST added that the test work would bring up if data was manipulated, and KPMG would see the reconciliation differences, but not necessarily if there was a breach and data was stolen from the system. Not unless management was aware of it and KPMG became aware of it through conversations with management.

MR. MITCHELL said that KPMG does in-depth inquiries with management, where they ask questions about those kinds of situations. If there was a scheme that went on, it would be very difficult for KPMG to know that data went out undetected, just because of the nature of those kind of schemes. There are ways to train employees and things management can do to send out tests on employees to see if they respond, to give a perspective of how employees deal with those kinds of schemes.

Department of Administration Deputy Commissioner JOHN BOUCHER stated that the State of Alaska does have a program that goes out in phases with more sophisticated phishing attempts. Should employees be found susceptible to the test phishing, they can be educated. The Department of Revenue has been very active in that.

Treasury Division Director PAM LEARY said that directors get a listing with metrics that talk to that and indicate how many people "fell" for the phishing exercise, how many opened it but did not respond, how many did not open it, etc.

CHAIR JOHNSON asked if, based upon all this cumulatively, it was felt that the systems were fairly resourceful and fairly well secured.

An unidentified male said yes.

MS. LEARY remarked that it is a very scary topic that comes up at every national conference. It is hard to know for certain, but if the State has everything in place and is testing, she hopes that is doing the job.

MR. MITCHELL said a lot of it is communicating, having those discussions with counterparts on what they are doing, and having the resources. If something does not seem quite right, it probably isn't.

MS. ERCHINGER sought comment on the nature of the practice of auditing and how it has changed from the days when auditors were doing a lot of test work and sampling to the days when they are getting detailed transactional data from the entity being audited and sampling data anomalies as opposed to just random transactions.

MR. MITCHELL replied that KPMG is on the cusp of doing that right now. That is a big initiative in the auditing industry overall, and all the big audit firms are racing to that end result. At KPMG, they have a data and analytics division that specifically focuses on coming up with new and best practices around data analytics. He was recently tasked with heading up the Pacific Northwest KPMG's audit innovation group for their section, which will be looking at how they can be more effective, not only timewise, but to do a higher value audit procedure as a result of that. KPMG has developed a Masters in accounting and data analytics, in conjunction with Ohio State and Villanova Universities, that has 50 students intake a year. Two students from Alaska have been accepted into that program in its first year, one from UAA and one from UAF.

MR. HAYHURST stated that KPMG auditing 100% of the marketable securities is part of the data and analytics initiative. One of the first things they looked at was if there were areas where they could expand their scope and use all the data that is available. It is not a lot more time to run 100% of the data through the pricing desk. What will be interesting on the innovation side over the next handful of years is how people in the profession start designing better audit tests or better analytics and thinking around the data that they can get to, instead of just auditing more of what they typically do.

MR. MITCHELL said that for the report before the committee today KPMG could identify maybe anomalies between benchmarks and rates of return from a portfolio standpoint. Thinking about all the data that KPMG is bringing from all their various client sources, they have an incredible amount of pricing data at various points in time. They also have access to all the different benchmarks. So, they can run algorithms that will spit out data on specific funds, and whether the rates of return are reasonable, and if State Street is doing what it should be doing. Generally, they have not seen a lot of differences in his history, but there have been some. That is something they would like to tap into, and they can do it in minutes, as opposed to keying data into Excel spreadsheets. It means running routines in a secure environment that looks at data in the state's system, and not taking data out to put into KPMG's system. Of course, they would still have to evaluate the results.

MR. HAYHURST added that the hard part is tracking back to know that the data is relevant and reliable, especially in a number of private companies, and even in the State of Alaska, where KPMG really does not go into the IT system all the way through to validate all of the connections. They are really doing other source document tests on the input side of it.

MR. MITCHELL said that is largely an efficiency measure for keeping audit costs reasonable. They can spend a lot of hours in the IT environment, but if they can do another procedure that is just as effective to address existence, accuracy, valuation, and financial statements of subaccounts, they will take that route because the value-add is there.

CHAIR JOHNSON referred to page 5 of the State of Alaska Retirement and Benefit Plans Invested Assets (with Independent Auditors' Report), under custodial credit risk deposits, which read "Custodial credit risk is the risk that deposits may not be returned in the event of a bank failure. The Board does not have a policy in relation to custodial credit risk for deposits." He asked if that was an observation that should be remedied, and what the Board would need to do.

MR. MITCHELL explained that this is driven by a GASB 40 disclosure, where, if there is no policy about custodial credit risk for deposits, the financial statements must disclose that there is no policy. He recalled a similar disclosure for the University of Alaska a decade or so ago, that it did not have a policy either. It is really a determination of how much risk the Board thinks it has there, and if it believes there should be a policy above a certain dollar amount because there is concern about risk in the event of a bank failure. He could not recommend that the ARMB put a policy in place necessarily, but management could certainly evaluate whether there is so much exposure that it would be good to have such a policy in the overall investment policies.

MS. LEARY stated that the Treasury Division has a mechanism at State Street Bank where deposits are very few. Anything that is left over at a certain point in time gets swept into another investment vehicle, so deposits are limited. As the division has gotten more daily accounting information and more sophisticated in understanding what money there is to invest or not, they have been able to really limit the amount of deposits.

CHAIR JOHNSON asked her if the ARMB should or should not have such a policy. He inquired further about another line on page 5 of the State of Alaska Retirement and Benefits Plans Invested Assets report that read: "The Board does not have a policy to limit interest rate risk for its collective investment funds." He asked if Ms. Leary would recommend that the ARMB needed such a policy.

MS. LEARY replied that staff could look into any situation where there is a disclosure requirement from the GASB and present a report at the next meeting about whether the Board needed to have any of those policies.

MR. MITCHELL stressed that the disclosure was not necessarily a failure on the Board's behalf. The requirement is to disclose whether the ARMB has or does not have a policy. The failure on the audit side would be if the Treasury Division did not disclose whether it has a policy or not. Using custodial credit risk as an example, he said total ARMB assets are $24 billion, and $13 million of that has exposure. That amount is very, very small in the scheme of the entire invested assets. So, the question is, relative to the size of these investment assets, does the ARMB need to have a policy. The ARMB could argue that it does not have a policy for a good reason, because it has another mechanism in place that sweeps the deposits into another investment that is covered.

CHAIR JOHNSON suggested that attention be given to this within the next couple of board meetings.

MS. LEARY said staff could do that. It has not been looked at specifically within the context of whether the Board should have a policy on some of these items or not.

MR. MITCHELL made it clear that this was not something new in the financial reports and was not an audit finding or deficiency by KPMG. It is a statement of fact relative to the risk exposure.

CHAIR JOHNSON stated that the agenda had time set aside for the committee to ask the auditors questions without staff being present. He asked if any committee members thought it was necessary to do that.

MR. HAYHURST recommended that the committee do this at least one time a year, and the final audit results discussion is a good time to do it. It is a good best practice. The final audit presentation is in December.

CHAIR JOHNSON indicated that the committee would have questions with the auditors outside the presence of staff at that time.

B. Update: GASB 68

KEVIN WORLEY, Chief Financial Officer for the Division of Retirement & Benefits (DRB), said he had hoped to release the June 30, 2015 GASB 68 report today, but the target release date is now October 21. He apologized for the delay.

Responding to the Chair's suggestion to take up the GASB 68 report at the November 3 teleconference committee meeting, MR. WORLEY said that meeting is primarily for the June 30, 2016 audited financial statements for all the plans that the ARMB oversees, and he could fit the GASB 68 report into that agenda.

MR. WORLEY reported having received the final release of the Buck report, which KPMG audits. That will be going out on the division website, as well as to all the employers so they have their numbers to work with and incorporate into their financial statements. DRB will be submitting a letter to the employers explaining the new process of the allocation that was talked about at the last meeting, and what impact that has to the employers. The process has gone from an actual contributions methodology to the preferred future contributions methodology. That is present-valued back to determine the allocations to employers.

MR. BOUCHER said the department was disappointed that it could not meet the October 21 deadline for releasing the June 30, 2015 GASB 68 report. He said at last September's meeting there was discussion about which methodology to use going forward, because of the large $3 billion legislative deposit that was going to affect the allocation this year. At that time, both Trustee Pihl and Trustee Erchinger were worried about what they described as a whipsaw effect on the municipalities because of the large contribution, if the state continued to use the contribution method it had used. The department went into this cycle sort of agnostic as to which method to use going forward. The department was aware that using the previous contribution method versus the prospective contribution method made a significant difference to the municipalities, and wanted to discuss it with the municipalities. As the discussion unfolded with KPMG, however, the options to choose one or the other were foreclosed. KPMG more or less advised the State that, should it use the historical contribution method and project forward based on a year in which the State made such a large contribution, it could be materially misstating the allocation for the State as an employer, as well as all of the employers. That is how the State wound up with the prospective forward allocation, and why a letter is going out to the stakeholders to explain the change in the allocation methodology in advance of the allocation report going out.

When queried for his comments, MR. HAYHURST stated that Mr. Boucher had provided a very good overview of the situation. He added that because of the 2015 excess contribution to the retirement systems, continuing to use the historical method for allocating the net pension liability would create a whipsaw. KPMG ultimately reached the conclusion that that would significantly increase the risk that both the State's and employers' CAFRs (comprehensive annual financial reports) would be materially misstated, first by moving a lot of the liability to the State in the 2015 year, and then whipsawing it back the other way and removing the liability from the State in subsequent years. This will have one year of change where there is a difference, but after that it should stay relatively stable through the projected period – absent other changes in actuarial numbers and investment returns.

MS. ERCHINGER thanked the auditors and staff for their work on the allocation issue. She thought consistency in financial statements is important, as opposed to just looking at what the impact was on the State, or what was or would have been the impact on the municipalities. This is a situation where one of the auditor's guiding principles is "always consistency." The results make sense, at least from her employer's standpoint. She acknowledged that it was probably a hard decision for the State to come to because there is more complexity in doing the calculations when they are based on estimates, as opposed to actual numbers. It will be more work, but in the end it is probably a more consistent result for all the employers, including the State. She thanked staff and management for hearing the concerns and being proactive in addressing them.

MR. HAYHURST said that was partly what got tied up in the delay. He was also disappointed that KPMG had not issued an opinion by September 30. After getting past this hurdle, he was fairly confident going forward that the net pension liability allocation will be a relatively smooth process and much more timely for all employers.

MS. ERCHINGER stated that one of the biggest challenges from a municipal standpoint is that without getting their financial statements issued by a specific date – in her case, September 30 – they then become a high-risk auditee for future federal single audit purposes. There are no excuses for missing a deadline. Once a high-risk auditee, a municipality is subject to much more stringent audit requirements in the subsequent year, which is fine, but the public perception of a municipality becoming a high-risk auditee makes it sound like they did something wrong. If the State's letter could somehow acknowledge that, by default, this may cause some employers to be deemed high-risk auditees simply because this deadline was missed, it would go a long way to helping those employers who have to defend themselves against elected officials and newspaper reporters, to be able to say that this is a system-wide issue and really nobody's fault.

MR. HAYHURST indicated that he could weigh in on the DRB's letter to employers, but there is no way to do it in KPMG's opinion, specifically.

MR. BOUCHER made the commitment that the letter to employers is intended to communicate why the State is late as well, so they would do that and engage with Ms. Erchinger) and/or others who have been part of an engagement group on the GASB issue) to see how the State can help in this area.

MR. HAYHURST excused himself from the meeting at this point.

MR. WORLEY next addressed the timeline for GASB 68 reports and the audit of the June 30, 2016 net pension liability allocation *(timeline included in the meeting packet)*. He said there was talk at the last two committee meetings about changing the timeframe for working on this report so that it can be issued in the spring. Then, employers that are September 30 or calendar year-end would have the report in time to meet their federal audit timelines, as well as any other regulatory or statutory timeframes that employers have. This is a combination of the DRB, Buck Consultants, and the consulting actuary preparing the report, and KPMG auditing the report.

MR. WORLEY said the plan is for the Division of Retirement & Benefits to provide Buck with the data they need in order to begin the report and process all the schedules that DRB needs and provide them to DRB and to KPMG by the first part of December. Buck will actually try to get that done before Thanksgiving. Once the Division and KPMG have received the Buck report for the GASB 68 allocation, there will be discussions, KPMG will continue to audit, and Buck and the Division will answer any questions. The intent is to have a complete report from Buck by the end of January. In February, KPMG will provide a draft of the PERS and TRS GASB 68 audited schedules to the Division. DRB will have an opportunity to review those and clear up any questions, and then provide those to the Audit Committee for discussion by March 1, 2017. That will be the time to answer questions and clear up any issues. The target date to issue a final audited net pension liability schedule is March 31, with the intent of distributing the report to the participating employers shortly thereafter.

CHAIR JOHNSON asked if the discussions the Audit Committee planned to have at the November 3 meeting would have any effect on any of the target dates, particularly the date for getting the GASB 68 PERS and TRS data to Buck Consultants.

MR. WORLEY said not for the June 30, 2016 report.

C. Update: DRB Audits

DRB Chief Operations Officer, JIM PUCKETT, highlighted a few items from the three-page September 6, 2016 DRB Audit Unit Report to Management *(included in the packet and on file at the ARMB office)*. As of September 6, eight employer audits had been completed. Since that date, four more audits have been completed: the City of Thorne Bay, the North Slope Borough School District, the City of Kodiak, and the Special Education Service Agency in Anchorage.

MR. PUCKETT drew attention to page 2, which reported that the revised audit regulations have been public noticed. A public hearing was held September 22, and no comments were received. There was one email during the public notice period, which asked for a minor clarification. The

Division will be proceeding through the remainder of the process to get the audit regulations finalized.

On page 3, MR. PUCKETT pointed out the common employer audit issues to date, in the order of prevalence. The audit team will be doing an informative training session to the employers who attend the Division's employer conference October 5-7, 2016, and these common employer audit issues will be discussed at length.

MS. HARBO referred to the list of common employer audit issues and asked if the "49% Teaching Contracts" was on purpose so the employer does not have to provide benefits.

MELANIE HELMICK, Senior Audit & Review Analyst, replied that the audit team finds a lot of teaching contracts at 49% so the school districts do not have to enroll the employee in TRS. The auditors find that a lot of these employers are part-time PERS participation employers, so they need to put their teachers in something, because, if they are part-time participating employers in PERS, then these teachers on 49% contracts are working enough to be enrolled in PERS. She has been finding this across the state.

MS. HARBO said she was impressed by the audit schedule, and she thanked the audit team for what they are doing.

MR. WORLEY commented that, as an employee of the Division, he sees the work that is coming out of the internal audit group as a result of some of the changed regulations that are going on, and then having Ms. Helmick on the audit team with prior audit work experience, the reports coming through have been phenomenal. There are two auditors working, and the amount of work they are doing, and the quality of the work, is wonderful. The issues they are identifying and how the Division and staff are working with the employers to help resolve those issues has been significantly improved.

MS. HARBO asked if the Social Security problem at the University of Alaska involved just the adjuncts.

MS. HELMICK said it was primarily adjuncts who were improperly enrolled in Social Security. They were PERS and TRS rehired retirees.

MR. PUCKETT said he hoped the shorter reports on a quarterly basis were proving helpful in keeping the committee more up-to-date with what is going on.

D. Future Audit Committee Topics

There were no items added to the list. An update on GASB 68 was added to the November 3 agenda earlier.

E. Further Meeting Schedule

MS. HALL noted that the 2016 schedule was attached. The next meeting was the November 3 teleconference meeting, followed by the December 7 meeting in December.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE
There were no other matters.

PUBLIC OR COMMITTEE MEMBER COMMENTS
There were no comments.

ADJOURNMENT
MS. HARBO moved to adjourn the meeting. MS. ERCHINGER seconded. The committee concluded its business at 2:25 p.m.

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.

Confidential Office Services
Karen Pearce Brown