State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

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

June 21, 2017

ATTENDANCE

Committee Present: Rob Johnson *(chair)*
Kris Erchinger
Gayle Harbo

Committee Absent: None

Department of Revenue Staff Present:
Pamela Leary (Treasury Division director)
Bob Mitchell (chief investment officer)
Scott Jones (state comptroller)
Stephanie Alexander (board liaison)

Department of Administration Staff Present:
Ajay Desai (director, Retirement & Benefits Division)
Kathy Lea (deputy director, Retirement & Benefits Division)
Kevin Worley (chief finance officer, Retirement & Benefits Division)

Others Present:
Daniel Mitchell (KPMG)
Melissa Beedle (KPMG) *via telephone*
Stuart Goering, ARMB legal counsel, Alaska Department of Law
Tom Brice (ARMB trustee)

CALL TO ORDER
CHAIR ROB JOHNSON called the meeting to order at 8:00 a.m.

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

PUBLIC MEETING NOTICE
MS. ALEXANDER confirmed that appropriate public meeting notice was given.

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

APPROVAL OF MINUTES – March 1, 2017
MS. HARBO moved to approve the minutes of the March 1, 2017 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
When opened up by the Chair, there were no comments from anyone present at the meeting location or listening by telephone.

REPORTS

A. Review Independent Auditors' Audit Plan
[A copy of the KPMG slide presentation is on file at the ARMB office.]
DANIEL MITCHELL, KPMG lead engagement managing director on the June 30, 2017 audits of the Department of Revenue Treasury Division and the Department of Administration Division of Retirement & Benefits, presented the audit plan. He noted there were few changes from what the firm executed last year. He started with the scope of the Treasury Division audit and the scope of the Division of Retirement & Benefits (DRB) audit *[slides 4 and 5]*. The DRB audit will include audits of the schedule of employer and non-employer allocations under GASB 68 and 75. This year, GASB 75 is applicable with respect to OPEB (other post-employment benefits), so KPMG will be performing audits of the equivalent schedules under GASB 75.

MR. MITCHELL reported that, with respect to GASB 68, KPMG is mostly finished with that test work and will be issuing their audit opinion over those schedules of pension amounts by employer and non-employer very quickly.

Slide 6 depicted KPMG's client service team for the upcoming audits. The team is very consistent from last year.

CHAIR JOHNSON asked who would be auditing the OPEB allocation schedules.

MR. MITCHELL replied that it would be a combination led by Melissa Beedle and him, but primarily the review would be done through Dennis Polisner from an actuarial standpoint on reviewing the OPEB assumptions that flow through to complete the reports. Then KPMG has a required Department of Professional Practice review when a new GASB is implemented, and Jeff Markert will lead that. Mr. Markert also looked at the GASB 68 schedules when they were put together for the first time. These are individuals who are dedicated to this discipline year-round for systems such as the State of Alaska retirement plans.

Addressing materiality, MR. MITCHELL stated that as of last week KPMG has gone through and determined materiality for all the reports that they issue opinions on. KPMG also has an unadjusted audit difference threshold, which is a lot lower than materiality. If there is a difference that

management has not posted, KPMG would report that at an Audit Committee meeting to say that it was a difference that was considered but was not posted, and they did not deem it to be material. One example is that management identifies those differences with respect to the lagged timing of the alternative investments portfolio valuations.

MR. MITCHELL presented a diagram of the deliverables and audit timeline, noting that the team was putting in some measures to work toward management's revised timeline. Last year, the concerns were around receipt of the health claims test work. Ms. Beedle has been working with Aetna and with Mr. Worley so that KPMG can perform the test work at Aetna. One of KPMG's biggest contingencies, as far as being able to meet the deadline, is the receipt of the actuarial data from Conduent. It is critical that KPMG have enough time to digest that data, challenge it, and get it through all their levels of review. They want to have a good planning meeting before that information is due so that everybody is on the same page as to when the actuarial data comes through and the weeks that KPMG will have available to get through the information. KPMG is currently getting PBC (provided by client) lists out to the clients so that they know what to prepare.

Responding to MS. ERCHINGER, MR. MITCHELL stated that last year there was a challenge regarding the sample sizes from Aetna, so KPMG will have to address that again this year. Once the sample has been picked, he suggested having a kick-off meeting with Aetna to stress that the auditor needs the entire sample. Claims testing is very challenging, and KPMG looks at many things – meeting deductibles, do they have the right support, the explanation of benefits, etc.

MS. HARBO asked if there was a specific sample size for PERS and one for TRS, because their use of Aetna is quite different. Specifically, PERS has a lot more accidents than TRS.

MR. MITCHELL said each plan has its materiality, so there are different sample sizes for the plans. KPMG tries to get everything out at the same time, rather than piecemeal samples. They get an entire sample that covers all of their opinions as Aetna relates to each of those specific reports.

MR. MITCHELL presented a list of audit reports that KPMG will be issuing. The only difference from the prior year are the GASB 75 schedules. KPMG also will be issuing a letter to this committee and a management letter.

CHAIR JOHNSON asked Mr. Worley if Aetna's contract included that it will deliver data that the auditor requests, or if the State had to pay extra for this exercise.

MR. WORLEY responded that providing this information is part of the Aetna contract. Aetna's push-back last year was largely on the size of the sample data. To fix the delay that happened last year in getting the sample selections, Aetna has offered KPMG going on-site this year so Aetna can quickly follow up on any missing or incomplete data. In addition, this year KPMG wants to iron out the process in advance regarding the timeline and identifying an Aetna contact for follow-ups.

MS. ERCHINGER expressed support for KPMG's willingness to work at Aetna's site, citing health information privacy concerns and the increased chance of errors when information is sent back and forth electronically between two entities.

MR. MITCHELL continued with the audit plan, stressing that KPMG's reporting relationship is with the Audit Committee, not with management. He referred to slide 10 and asked if the committee felt there were any areas that needed particular attention as part of the audit process.

CHAIR JOHNSON stated that bullet point #5 jumped out at him: "The nature and extent of communications expected with the Audit Committee about misappropriations perpetrated by lower-level employees." He asked if this was an issue.

MR. MITCHELL said it was not an issue. There is always an opportunity for employees to do something small, and there is somewhat of a materiality lens here. KPMG looks at a lot of transactions in its audit procedures, using north of 100 in most cases. They use a statistical sampling methodology that really drills into any claim payment and any benefit payment that went out. They look at everything from the approval to the execution for dollars that go out the door to ensure that these payments are accurate and also are not fraudulent (going out to a dummy employee, for example). Especially in a system this large, a potential risk is that something is going out to somebody that is fraudulent. He did think there was a fraud risk right up front that payments are going out fraudulently that would lead KPMG to believe going into these plans that that is a headline risk. However, their procedures would cover that specific attribute for the samples they look at, to ensure that payments are going to the intended people.

MS. ERCHINGER commented that software programs are very advanced, in terms of security. She imagined that KPMG has clients that are using more up-to-date programs that have the ability to lock people out so they do not have access to commit fraud. She asked what KPMG sees with Alaska's systems with regard to electronic security relative to other systems they see.

MR. MITCHELL replied that KPMG does limited test work over the IT (information technology) framework. He likes to go to the actual specific transactions, rather than rely on a system process to audit. An auditor tends to see if there is an issue in the IT systems if they have looked at a series of transactions all the way through to execution. Compared to other benefit plans, he thought the Alaska systems are very comparable and respectable for the size of the Alaska plans. Alaska has other recordkeepers and service providers for a lot of its systems. It is very important that management monitors the SOC-1 reports (service provider reports), because the control environment is not just within the Alaska systems themselves. For example, Aetna's control environment is very important, and KPMG does obtain Aetna's SOC-1 report. If that SOC-1 report was deficient – say, they had a qualified opinion – that would affect KPMG's sample size because they might want to do more rigorous test work. One item that management furnishes KPMG with, with respect to the service providers, is they go through the user-control considerations and evaluate the controls that the system has, in complement to the controls that are at the service provider, and provides KPMG a write-up that they can review. Across the systems, those management write-ups have been pretty robust. It is a good measure of the responsibility that management is taking, as far as the IT control environment. KPMG believes, with the size of the Alaska systems, and for economies of scale – because IT test work can be very time-consuming and not necessarily the best value from an audit perspective – that they prefer to look through the actual transactions.

CHAIR JOHNSON inquired if the time was coming in the audit world where someone would be called upon to make a written observation about the relative cyber-security of a particular system.

MR. MITCHELL said it was not something scoped into the services that KPMG performs, but he was very confident that there are services that KPMG performs where a client has called for that specifically. He would not call it an audit opinion: it would be a GAAP analysis or best practice, and more of an advisory project.

MR. MITCHELL stated that the committee has an open line to him throughout the year, if there was anything they want to discuss.

Regarding audit plan involvement of others, MR. MITCHELL said the audit engagement team uses alternative investment specialists to look at the valuations of the alternative investment portfolio and review the audit procedures over alternative investments, and actuarial specialists to look at the actuarial assumptions and calculations prepared by Conduent related to pension and post-employment benefit obligations. MR. MITCHELL also ran through the list of other providers that are involved in the Alaska control environment *[slides 12, 13 & 14]*. KPMG obtains the SOC-1 reports for these providers and does different procedures at each of them, depending on where KPMG feels the risks are. They spend a lot of time with Conduent, and also on the phone back and forth as they challenge actuarial assumptions. This year they will spend time at Aetna's location. State Street Bank is key in the custodial aspects of the upper plans. NRS is one of the SOC-1 reports where KPMG spends some time really drilling into the user control aspects because they are responsible for the unitization of how each plan picks up its respective portion of the investment portfolios. That is an important part of the control environment.

Moving on to risk assessment, MR. MITCHELL stated that the headline significant risk is over the valuation of alternative investments, specifically because of their complex nature. That is consistent with the prior year. Then there is a presumed risk of fraud due to risk of management override of controls. These are the top-sided entries that management could book. KPMG spends time looking specifically at journal entries and top-side entries after they have received the trial balances across each of the systems. That is not unique to the systems: KPMG has a presumed risk of fraud at every single entity that they audit.

Consistent with prior years, KPMG's significant areas of focus will be valuation of alternative investments, pension and post-retirement obligations, IBNR (incurred but not reported), the plan contributions and distributions, claims payments, valuation of publicly traded investments, and estimates through the valuation of investments. GASB 74 and 75 will be a new item to look at from an implementation standpoint this year. The engagement team will be looking at that with their Department of Professional Practice.

MR. MITCHELL noted that there have been no changes in the objectives of an audit, as it goes to KPMG's rendering of an opinion about the financial statements being fairly presented.

He referred to the section on the responsibilities of management, the Audit Committee, and KPMG. These are consistent with what has been communicated to the committee over the last few years.

MR. MITCHELL said that independence in an audit is obviously important. KPMG has a very robust reporting process to ensure that the engagement team is independent. That includes payment of fees on other services. If there was a need for a large advisory project that resulted in a significant fee relationship compared to an audit fee, KPMG would have to look at that carefully as it related to the audit to ensure that they were independent. KPMG has been fairly cautious in bidding on advisory work because of the independence connected to their audit.

CHAIR JOHNSON mentioned the "big four" audit firms and asked if KPMG found itself in any reportable conflict situations. He asked, for example, if KPMG was the auditor for Aetna or any of the major entities that Mr. Mitchell described as third-party service providers to the Alaska retirement plans.

MR. MITCHELL responded that they were, in some cases. The SOC-1 report is permissible. That does not trigger an independence issue because it is part of the control. He did not think that KPMG audited Aetna, but that would not be considered to jeopardize independence under professional standards. If the committee was interested in who audits each of the third-party service providers, he could furnish that information.

MR. MITCHELL next addressed the audit approach and methodology. He said that everything starts off with planning risk assessment and identifying the key areas that KPMG needs to focus on. They have certain procedures, like testing controls. Based on the control test work, they will measure the type of test work they do substantively. That largely consists of analytical reviews and looking at detailed transactions. There is a lot of time spent on detailed transactions for the Alaska plans. An analytical review of the benefit payments, for example, does not give the auditors a lot of comfort, and it is not a level of precision that he would feel comfortable opining at. They spend a lot of time in the detail to ensure that everything reconciles and that they have a representative sample of the transactions in the contributions and distributions realm.

MR. MITCHELL noted that audit fees have already been agreed upon with the Department of Administration, Division of Retirement & Benefits. The contract allows for a CPI increase this year, and KPMG waived that fee increase in light of budgetary pressures at the State.

CHAIR JOHNSON inquired what the obligation to report on OPEB allocations under GASB 74 and 75 does in terms of KPMG's workload.

MR. MITCHELL explained that it was a separate carve-out of an estimated fee that KPMG has looked at with Mr. Worley. It is very similar to the fee for auditing GASB 67 and 68, because they have a good understanding of the level of effort there. It is relatively inconsequential compared to the overall audit fee.

MR. MITCHELL drew attention to a section on KPMG's independence quality controls. He noted that the only non-audit service that KPMG performs for the Alaska plans that could err on independence – but does not – is financial statement preparation assistance. That is fairly limited, because management prepares the financial statements and schedules, and KPMG's assistance is in

the minor editing and word processing thereafter. If he felt there were any breaches of independence, he would communicate directly to this committee.

MR. MITCHELL wrapped up by mentioning KPMG's audit committee resources and an appendix on the new regulations and standards.

MR. MITCHELL mentioned that there was conversation prior to this meeting about the statements made with respect to investment risk disclosures that there is no policy, for example, interest rate risk. KPMG has had some healthy discussion internally and with the Department of Professional Practice team members, as well as with Scott Jones and the Treasury Division team, around what is happening in the field and what, if anything, should be done to address that statement. For many plans of Alaska's size and bigger, it is fairly common to have those disclosures. One of the reasons that drives that is that with the number of investment managers that plans can have, it can be very restrictive to have an interest rate policy disclosure set for every single investment manager.

State Comptroller SCOTT JONES stated that GASB 40 requires disclosure of a policy on major buckets like interest rate risk and credit risk, for example, if a plan has such a policy. If the plan does not have a policy, then it has to disclose that it does not have a policy. In cases of an investment portfolio as large as the ARMB's, it might not make sense to limit its credit risk because the Board, through its asset allocation, wants to own securities from Treasuries down through high-yield type securities. To have an overarching policy that would limit the credit risk to only AA or AAA securities, for example, might overly limit the ability to invest. The ARMB could set a broad policy, as is seen in some cases, but his discussion with KPMG indicates that to comply with the letter of the GASB it would require starting to disclose credit risk or interest rate risk terms in each of the investment manager contracts. The size of the financial statements would explode. It is not uncommon for a board with investments the size of the ARMB's to not have a policy because they do not want to limit themselves.

CHAIR JOHNSON said his question was if saying the ARMB did not have a policy on credit risk carried with it an implication that perhaps it should. If the standard is to not have a policy, then so be it. He asked if there was any adverse reaction to that position.

MR. MITCHELL said absolutely not, particularly because it is system practice across the country. It is not deemed to be a red flag or subject to someone saying that a report is deficient or that the investment management function is deficient.

MR. JONES added that Oregon PERS is set up substantially like Alaska's and is much larger than Alaska. They have disclosures regarding no policy that are very similar to Alaska's in many cases.

MS. ERCHINGER asked if KPMG has seen verbiage that says that a retirement system has examined the issue and determined not to establish a policy because of the limitations, so that it did not appear it was an oversight that there was no policy.

MR. MITCHELL replied that he had not seen that language in a disclosure, but he was willing to explore that approach because it makes clear that the board has considered it and it is not an

oversight. He added that those kinds of statements are not in notes to the financials: that type of clarity would belong more in an MD&A (management discussion and analysis).

MS. ERCHINGER stated that the primary actuary and the review actuary audit the assumptions that drive the actuarial estimates of retiree benefits system-wide. She asked about auditing the calculations of individual retiree benefit payments, in light of the different retirement plans and different tiers within those plans.

MR. MITCHELL said that KPMG samples benefit payments across all the plans and each of the tiers. They take the entire population and reconcile it back for its completeness. They go through and test everything that goes into that calculation, including the base formula. That is why last year they had a concern over the calculation of the National Guard System payouts, which ended up actually being correct. Benefit payments is one of the significant audit areas. He would not regard it a quality audit if they were not drilling into the calculation of an individual's benefit payment.

MR. WORLEY stated that when the KPMG team is testing the benefit payments, if there are questions about the computation of the payment they will go to the retirement supervisor and get their questions resolved.

MR. MITCHELL commented that sometimes there are some unique aspects to an individual's benefit calculation, and the audit team has to fully understand it. Sometimes they find a difference, but it has already been caught by management and made up and rectified in a subsequent period. That is not an error because it was caught by a control environment. That test work is as complicated as the claims test work and where a lot of time is spent. That is where it is nice to have an audit team that is familiar with the people who make those calculations and familiar with the terms of the plans.

B. Discussion of Division of Retirement & Benefits June 30, 2017 Audit Schedule

MR. WORLEY reported that he received notification from the Government Finance Officers Association last week that the Alaska PERS received a certificate of achievement and excellence in financial reporting. PERS was found proficient in all areas that were rated. The Division has a plaque that shows the years it has received the honor.

MR. WORLEY reviewed the four-page spreadsheet in the meeting packet that laid out the June 30, 2017 audit calendar. He said there will be a teleconference meeting with Aetna to make certain they have received the sample selection request, that they know what week KPMG will actually be on site doing the test work, and to go through each of the items that are typically provided to KPMG for a claim. The claims testing process for Moda and CHCS will remain the same, using a secure site upload server.

He noted that KPMG is scheduled to be on site at the Division in the first week of September, and the last day of field work there is September 29.

MR. WORLEY had also provided a 2-page written explanation of Governmental Accounting Standards Board (GASB) statement numbers 74 (plan) and 75 (employer) financial reporting for

post-employment benefit plans other than pension plans. GASB 74 will be disclosure of the net OPEB liability and then additional required supplementary information for net OPEB liabilities as well. GASB 75 is the financial reporting requirements for employers to report a liability for the other post-employment benefits that they provide on their financial statements.

He stated that in the last two years the State of Alaska has been going through a statewide finance and payroll upgrade. The Division of Finance has a statutory deadline of December 15 to issue their State CAFR (comprehensive annual financial report). They were unable to meet that deadline for the last two years, but this year the Division of Finance plans to get back on track and have the audited CAFR out by December 15. In order to meet that deadline, the Division of Retirement & Benefits has to provide its audited financial statements the week before the last week in November. DRB has had to move up its schedule a couple of weeks as a result of that. Therefore, he was proposing an Audit Committee teleconference to discuss the financial statements on Friday, November 10. Based on that date, he planned to provide the draft financial statements to the committee two weeks prior to that teleconference meeting. It will be a push to get things done to meet these dates.

MR. WORLEY pointed out that after the audited financial statements for all the plans are done, the Division has the supplemental schedules for GASB 68, for which this will be the third year, and the new GASB 75 schedule for the net OPEB liability. The Division was proposing getting the GASB 68 and 75 reports issued by the middle of June 2018. That timing will be good for fiscal year-end employers, but it will really push the calendar year-end employers. Some employers have already requested an extension on their GFOA application. If the Division can get the schedules done sooner than June, they will issue them sooner.

MS. ERCHINGER remarked that the June date was a problem for her employer. She was currently going through this with her elected officials, who do not buy the excuses for why the financial statements are late. Last year it was helpful when the State issued a letter saying there were delays due to implementation of new GASB standards. This year she was going forward with a presentation of their CAFR before the CAFR is actually final, in order to address the concerns that the municipality is constantly missing the statutory deadline. The justifications are there for why delays are happening, so it is a matter of packaging it in a way that people can better understand. If GFOA is willing to allow employers to extend, clearly the delays are happening nationwide and it is not only an Alaska issue.

MR. WORLEY stated that he was willing to write an explanation about the upcoming schedule to have on the Division's website. He added that switching over the accounting system was a bit difficult, but the implementation of the new forward-looking payrolls was a significant change. Now that that is in place, he thought that Conduent was applying the same thing to the OPEB piece, and he expected a shortened delay on the issuance of the GASB 75 report.

MS. ERCHINGER urged the Division to under-promise regarding the estimated timeline, otherwise, people's expectations are too high. If the State over-promises on the timeline and then under-delivers, then the employers have all under-delivered on their deadlines as well. She added that if the Division believes the additional GASB reporting is inherently going to add significant

time to the future deliverables, it would be good to know that, too. If this is the timing that employers can expect going forward, then maybe they all need to consider whether they need to change their statutes on when the financial statements are due to reflect the new reality.

C. Forfeiture

MR. WORLEY had provided a one-page written explanation of PERS and TRS defined contribution retirement plan forfeitures *[on file at the ARMB office]*. Trustee Harbo had requested this information at the April committee meeting. He said two statutes (PERS & TRS) contained subsections regarding exclusive benefit.

MR. WORLEY stated that in statute members of the PERS and TRS DCR plans vest into percentages of the employer contributions, until after five years they reach 100% vesting of employer contributions for the money that goes to their Empower Retirement account. If a member leaves prior to five years and then withdraws their funds, they would only be able to withdraw a portion of the employer contributions to their account, and the remaining employer contribution would go into a forfeiture bucket. According to the statutes, that money cannot be used for anything other than employer contributions. The Division understands that to mean that the money in the forfeiture account can be applied against future employer contributions for that 401(k)-type account.

Because it had been so long since that provision had been applied to employers, the Division talked to the Department of Law. DOL requested that the Division work with its tax counsel Ice Miller. Ice Miller recommended that the Division work with the Internal Revenue Service through its voluntary compliance program and let them know how the State was going to apply the forfeitures to make sure it was okay. The review process was estimated to take a year, which would be around November this year. The Division has a plan in place for how it will do this through the payroll processing, once it has the approval to go forward. The Division will be notifying employers of their balance in the forfeiture bucket so they can send the proper amount of funds. The Division will then apply the forfeiture balances just to the employer match of the DCR plans. No other plans can use that forfeiture fund. As of last November, it would take most employers about one year to use the funds that are currently in the forfeiture account. There are a few medium and smaller size employers that would take a little under two years to use their forfeiture funds.

MS. HARBO inquired as to the size of the forfeiture bucket. MR. WORLEY indicated he could provide that amount.

MS. ERCHINGER asked if the statute required to consider the buckets by individual employer. She thought the alternative would have been easier and more defensible if the forfeiture money was used to reduce the overall employer contribution rate next year so that everybody maintained the same rate.

MR. WORLEY said he looked at it as money that was contributed by an employer that an employee was, in a sense, giving back to that employer to use for others.

MS. ERCHINGER said her concern about doing it by employer was the potential of an employer, through deliberate staff turnover, making sure that none of their employees ever get vested, so that the employer can get their contribution money back.

Director of DRB, AJAY DESAI, stated that the Division will be following legal advice. He offered his historical perspective, where his previous employer had a defined contribution plan that had two different types of forfeiture. If the employer contributed to the plan, and an employee left without being vested, then those monies at the end of the year would get rewarded back to the rest of the participant pool and did not go back to the employer. That is how the plan was designed. The only thing that could not be put back into the plan was if an employer contributed over the limits. That over-contribution had to go back to the employer, but not directly as a refund. It is supposed to be credited back against the future contributions. There is a specific guideline and design how the IRS requires the private sector to manage those funds. The plan that he administered for the past 14 years pretty much used that forfeiture money, which amounted to about $3-$4 million each year. So, the Division will work through legal and bring the information back to the committee.

CHAIR JOHNSON asked where the forfeiture money was invested.

MR. JONES replied that the forfeiture account sits in a T. Rowe Price money market fund, and the State gets an additional report on it from Great-West. They are using the money market building block account that is used for the Target Date and balanced funds, which is also available to plan participants as a direct option.

D. Committee Requests: Areas of interest/review

CHAIR JOHNSON asked where the issue of proper, and maybe even audited and reviewed, apportionment of costs would fall – if it would be an audit issue or actuarial issue. He recalled that at a previous meeting Commissioner Fisher had mentioned a study that was ongoing to allocate costs by the Department of Administration to the pension funds versus the general fund. His question also included the Department of Revenue.

MR. WORLEY responded that the Division has a cost allocation plan whereby it is under an umbrella with the Department of Administration, Division of Finance, which has a contract for a cost allocation system through Maximus. He clarified that the cost allocation included time expended by employees on different plans. KPMG then looks at the Division's administrative costs in relation to the audit process when they look at materiality. The biggest costs are the benefit payments that are made for pension and healthcare. KPMG looks at the administrative expenses that the Division breaks down in a supplemental schedule into payroll costs, benefits, travel, consulting, etc. He mentioned a presentation he made a couple of meetings ago where he talked about indirect costs versus direct costs and which ones are allocated out to plans (either pension systems, health, or general fund). A cursory review or audit of that would be done through the audit process.

CHAIR JOHNSON asked if it was reported anywhere in the audit documents, or if it did not rise to the level of materiality.

MR. WORLEY said it was a matter of materiality. He added that the Division's administrative costs in relation to the total plan costs are very minor, probably less than 1%, maybe 2%.

CHAIR JOHNSON said he would like to see a study from DRB on the one hand and from Treasury from DOR on just how much of their total costs incurred are assigned to the pensions and how much to the general fund.

Treasury director PAM LEARY stated that DOR did a presentation longer than a couple of years ago. She added that Revenue's is a bit different because it is based mostly on investments. They also do a staff survey, which they are going through right now. Things have been changing quite a bit, in terms of where the funds are, so they are trying to make an accurate estimate of where people's time is going to be spent under the new structure.

CHAIR JOHNSON said he would like to see an analysis of relative proportions, if Treasury and DRB could do that without expending too much effort and in a time frame that was convenient to both divisions.

E. Review Legal Matters

ARMB legal counsel STUART GOERING indicated that any information he had about matters that might impact the financial statements was necessarily preliminary because the actual process that is observed for getting that information from the Department of Law (DOL) is not in motion yet. That is set in motion by a letter from Scott Jones to the DOL asking for any matters that may affect the financial statements of the plans. That letter will go out in July, and an assistant attorney general is assigned to make the response. That assistant AG will in turn send a letter to every attorney in the DOL to request that they supply any information that they may have on matters that could affect the plans.

MR. GOERING said this year, in order to streamline the process, he has asked Mr. Jones to explore the possibility with the auditors of changing the wording of the auditors' request. One area is that the request address only claims *against* the funds (instead of all matters *affecting* the funds). The other area is that there currently is no materiality threshold. Many requests from auditors have a materiality threshold in the request, and that makes it easier for attorneys when they are reviewing to determine how deeply into their records they need to inquire to decide whether or not to report a particular matter.

MR. GOERING stated that he was not aware of anything that would affect the retirement plans or the audit. However, there is an Alaska Supreme Court case that was decided in November that did not directly involve the pension plans. It was an action brought by Peter Metcalfe against the State of Alaska. Initially, the claim was for damages against the State. When the State changed from defined benefit to defined contribution plans in 2006, there was a period of time during which former employees, who had not yet vested in the defined benefit plans, could seek and obtain re-employment, and if they had withdrawn their fund balances they could buy service credit back at that time by repaying the amount with interest. Then they would become eligible for the defined benefit plan and, if they had the appropriate service credits, could then vest in the defined benefit plan. The five-year window for doing that closed in 2011. Mr. Metcalfe claimed that under the

constitution he was entitled to re-employment, even if in 1981 he had withdrawn his balance, understanding that he would no longer be a plan member. He claimed that he was entitled to re-employment rights, and this change in the statute had essentially violated his constitutional rights, and he wanted damages.

The Superior Court granted the stay in summary judgment. It went up to the Supreme Court. The Supreme Court issued a very unusual decision and decided that the Superior Court was correct that there were no damages available against the State. But they sent the case back to the Superior Court for class certification and to determine whether or not it was possible that this class of people who terminated and withdrew their balances has the right to be re-employed. There is a possibility that there will be people who were previously ineligible for defined benefit plan participation – if a lot of contingencies are met, like they have to be re-employed, they have to repay their balances with interest, and they have to then vest – there could be some new members of the defined benefit plans. Right now, everyone believes the defined benefit plans are closed and there are not going to be any new members. The Department of Law has no idea what the probability of success is. The Supreme Court decision was a 2-1 decision, with two justices not participating. The one dissenting justice is no longer on the court. DOL has no idea what impact it would have on the plans if the Superior Court were to rule in favor of this class of claimants. The State is going to move for summary judgment again against the class.

MR. GOERING stated that, at least in theory, it should be a wash for the plans if people are re-employed and buy back in. Their contributions should be sufficient to cover any future liabilities, and the interest on the amount of past service credit that they purchase should be sufficient to bring the assets up to their liabilities. However, it is not known if that is actually going to work out in practice, and it is too soon to know.

MR. HARBO commented that the issue is not so much the salary benefit: those people who vest are going to get healthcare for life. That is the liability.

MR. GOERING said he agreed that that could be an impact on the plans, which is part of the reason he wanted to make sure the committee was aware of it. Before November 4, DOL did not know that this case was even about the pension plans. They believed it was really about getting damages from the State of Alaska, which would not have been paid from the pension funds if Mr. Metcalfe had won.

Responding to Ms. Harbo, MR. GOERING stated that this case was not a class action at the time it went to the Supreme Court. It is now, so whatever gets decided through the remaining legal proceeding will be binding on all potential people. He was informing the committee because he did not want any future decisions to be a surprise to the ARMB.

CHAIR JOHNSON raised the prospect that someone in this class of folks could say that if they had known this was the case they would have re-upped with the State 15 years ago. Meanwhile, they have incurred a lot of medical costs in that 15-year period that would have been covered by the health plan.

MR. GOERING stated that the theory the Supreme Court used would not be consistent with that reasoning. The case is not about anything that was incurred in the interim and is not, in fact, explicitly about medical at all. It remains to be seen what the Superior Court says, once the case is back on remand, but he had no reason to believe that that would happen. However, as Ms. Harbo pointed out, it will have a collateral impact on medical.

MR. GOERING said it is the theory that is important. There is no way to put numbers on this at this point because the decision has not been made. Even after the decision is known, it will be difficult to know how many people will seek re-employment, if there will even be jobs available for those people, how many of them will have the resources to be able to repay their balances with interest, and whether any of those people will become vested.

F. DOR – Treasury

1. SSAE16 – Reporting on Controls at a Service Organization

MR. JONES referenced a June 1 memorandum to the Audit Committee in the meeting packet, which covers the AICPA AT Section 801 reports, also known as SOC-1s. Two of these SOC-1 reports are issued by State Street, whose auditors are E&Y. Another SOC-1 report comes from Berry Dunn, which audits the Northeast Retirement Services group (which does plan accounting and unitization for the funds). When staff was doing a due diligence review at State Street in November 2016, he went through the SOC-1 report with State Street staff, exception by exception. The most common item found was that a reviewer did not put their initials on the page that they were reviewing.

MR. JONES reported that he has since received the two March 31 SOC-1 reports from State Street that were once again unmodified opinions. There was nothing exceptional to report. He has not gone through the reports exception by exception with State Street staff to get the underlying detail, but much of it looks like the same type of thing he has seen in the past.

MR. JONES offered to provide the committee with a copy of the SOC-1 reports if anyone was interested in reading the details.

2. Accounting/Financial Personnel Succession (organization chart)

MS. LEARY drew attention to the current Treasury Division organization chart in the meeting packet. There have been three retirements this year. The chief investment officer position has been filled by Bob Mitchell, the board liaison position has been taken by Stephanie Alexander, and interviews are underway for the vacant accountant III position.

MS. LEARY stated that the Treasury Division participated in the transfer to having IT (information technology) serviced department-wide so there are no longer IT-specific professionals within the division. There is a position in the realm of IT that has been vacant and has been transferred into a business systems analyst, so more of a bent toward data analysis. The person that was hired has an IT background as well, so he is the interface to the department. That frees up Mr. Jones, who had been filling that function for the last year.

MS. LEARY said there have been changes within the portfolio management structure, including a desk rearrangement so that the investment people now sit together, improving communication. Changes in terms of who is doing what have also happened. Mr. Hanna has been named as deputy chief investment officer, in addition to his other role in the alternative investments space. Steve Sikes is the manager of the internal public equity group. There are quite a number of people working in that group, and two candidates have accepted offers for vacant positions. There is still one vacancy in the fixed income group, which is now headed by Victor Djajalie. The real assets group is now being managed by Nick Orr.

CHAIR JOHNSON asked if the Departments of Revenue and/or Administration would be making a presentation at the board meeting tomorrow about what happens if there is no state budget passed by fiscal year-end.

MS. LEARY stated that all of the departments issued press releases indicating generally what is and what is not going to be functioning within the State. Treasury, along with the other divisions, has provided information on working with a smaller team going forward. Treasury will have personnel available to do work in the cash management and the investment areas. The administrative department is working, in consultation with the Department of Law, on exactly how things will run if there is no budget approved by July 1.

G. DOA – Division of Retirement & Benefits

Director AJAY DESAI had also provided a division organization chart in the meeting packet. He stated that last year there were four section directors reporting in a chief capacity directly to the commissioner's office. That decentralized structure was changed to bring it back under a single DRB director, and since January he has been working with all four chiefs. There have been no major changes in personnel at the higher levels. Mr. Worley remains in the chief financial officer position. Kathy Lea is now the deputy director responsible for the pension side. Michele Michaud now has the title of deputy director of health plan administration. Emily Ricci is the chief health policy administrator.

MR. DESAI said that after joining the DRB team he had observed that there was a lot of decentralized management. As a result, the operational staff who reported before under the operation chief were sort of working in a silo manner. Now that they are working as a single team, it appears that they have been working strongly together. They are trying to assess all the projects within the division together and trying to prioritize them. Not long ago, they started to look at the resources from different operational areas so that most of the teams now understand exactly which processes takes priority and which processes are required to work simultaneously. He hopes to establish very strong partnership relationships with the Department of Revenue. Similarly, he would like to bring more information to the board level about what the Division does.

MR. DESAI said that the management IT position was vacant at last year's reporting. Today, the situation is basically the same but with a different story. The Division was able to hire an IT manager in the November/December 2016 timeframe. After working for about 4-1/2 months, the person decided to go back to their original position. His personal portfolio includes a very

strong IT background, and he sees things differently than the way it was structured. Rather than keep facing the same situation of no IT manager, he is reorganizing IT under the different supervisor or manager, rather than have separate IT project management under a separate manager. The IT project manager would be working closely with all the chiefs within the Division so that each of the resources under the chief would be able to work directly with the IT manager through him as the director, and together they can determine the priority of the projects, thus having equal attention and required resources that they can fulfill. Even though the IT manager position is still open, they are not feeling that big of a gap because he is working very closely with it and trying to keep it as stable as possible. His long-term vision is to find the appropriate person to bring into the IT position.

MR. DESAI stated that minor changes have occurred in the different sections because of people retiring, and they are filling those positions. The Division has been working on the re-engineering process to assess how many processes there are within the Division that can be improvised and that can also be correlated with the existing system and the new system.

MR. WORLEY commented that Mr. Desai's oversight of the chief/deputy positions has been wonderful. He is glad to have a director back to go to on a day-to-day basis.

CHAIR JOHNSON asked if the trend Ms. Leary reported (that IT is being addressed in the Department of Revenue on a department-wide basis) was coming to the Department of Administration as well, or if the Division of Retirement & Benefits was able to maintain its discreet operations within the division.

MR. DESAI explained that the IT resources are paid through the trust funds, which is a little different. He understands that the IT function on the DRB side will remain in the same structure and under his management. However, they will work closely with the CIO as far as following the policies and security. The Division will be following many of the statewide policies, rules and regulations for IT.

MS. LEARY added that the move toward centralization of the IT function in DOR has more to do with the "vanilla" IT items, like getting the computers out, having the same systems and making it more uniform within each department. So, any division that has specialized IT needs, such as programming, that tends to stay within the divisions.

H. Committee Performance – Self-assessment (per charter)
CHAIR JOHNSON asked for comments on the committee's performance.

MS. ERCHINGER stated that the committee does a good job of sticking with the topics that are to be covered every year, as required by the committee charter.

I. Review Committee Charter and Action Plan
When the Chair opened comments on the committee charter and action plan, there were none.

J. Further Meeting Schedule

The DRB review of the audited financial statements with the committee was set for Friday, November 10, 2017, while trustees were attending the Education Conference. MR. WORLEY said the Division would provide the PERS and TRS financials the week before the teleconference, and the remaining six sets of financials would be sent out two weeks before November 10.

Other future committee meetings for the year are October 4 and December 6, 2017.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC OR COMMITTEE MEMBER COMMENTS

There were no comments.

ADJOURNMENT

MS. ERCHINGER moved to adjourn the meeting. MS. HARBO seconded. The committee concluded its business at 10:02 a.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