State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

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

October 4, 2017

ATTENDANCE

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

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

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

Others Present:
Daniel Mitchell (KPMG)
Melissa Beedle (KPMG) *via telephone*
Norm West (ARMB trustee)

CALL TO ORDER
CHAIR ROB JOHNSON called the meeting to order at 9:00 a.m.

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

PUBLIC MEETING NOTICE
MS. ALEXANDER confirmed that the meeting had been publicly noticed.

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

APPROVAL OF MINUTES – June 21, 2017
MS. HARBO moved to approve the minutes of the June 21, 2017 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
No one in attendance at the meeting site had a comment, and there was no public comment by telephone.

REPORTS

A. Presentation: FY17 ARMB Audited Financial Statements
[A copy of the KPMG slide presentation, dated June 30, 2017, 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, appeared before the committee, and MELISSA BEEDLE, Lead Audit Engagement Manager, participated by telephone.

MR. MITCHELL began by saying that the audit is substantially complete. They are working through a few minor items and doing a final review of the financial statements they received this week. They have substantially completed the underlying contribution and distribution test work that is reflected in the schedules and are a good two weeks ahead of where they were last year in that regard. KPMG is close to issuance and expects to issue a clean opinion. There is one unadjusted audit difference.

MR. MITCHELL stressed KPMG's audit quality, adding that they look at the valuation of 100% of the marketable security portfolio, including the participant-directed investments, so there is nothing left on the table there. Because there is more risk around the valuation assertions in the alternative investments portfolio, KPMG sets the risk of misstatement higher, which means they go through robust procedures on a reasonably large sample of alternative investments. They also involve a KPMG valuation specialist, who does a deep dive into the test work. That specialist gave his sign-off a couple of weeks ago, completing the audit of all the investments with no valuation differences, other than the timing differences reflected in the report.

Regarding audit findings, MR. MITCHELL stated that two areas that KPMG identified as significant risks were management override of controls and valuation of the alternative investments. Management override of controls is always considered a significant risk on every engagement. Top-sided journal entries is where a lot of manipulation can happen, but there are not a lot of top-sided journal entries for these schedules. There are great reconciliations between the recordkeeper system (NRS) and the custodian. KPMG looks at the SAS 70 report that is provided over NRS (the recordkeeper) in that regard. They did not have any issues with respect to any management journal

entries that were posted. He said that valuation of alternative investments is really where KPMG spent a significant amount of their effort, and there were no findings related to that.
MR. MITCHELL next addressed outstanding matters as of September 15, saying that he, as the engagement partner, had probably reviewed 85% of the work papers. The concurring partner review would likely take place over the coming week. Still to be done is the management representation letter and finalizing and signing off on the audit report.

CHAIR JOHNSON mentioned that State Comptroller Scott Jones, at the last ARMB meeting, gave an excellent presentation on cyber-security. He asked, as KMPG does its test work on management override of controls, if the issue of cyber-security comes into it at all.

MR. MITCHELL replied that KPMG does not focus its audit on cyber-security. If something came up that they were concerned about, they would definitely bring it to the committee's attention. KPMG looks at the recordkeeping system, NRS, which has IT specific controls that include some cyber-security considerations. There were no findings related to NRS. Any finding would be a red flag because NRS has third-party access to the State's data. The same applies to State Street Bank: looking at their SAS 70 report, there is no indication of anything. He added that for this particular report the risk would be more in having access to PII (protected health information and private information) with the benefit plans. KPMG internally takes that very seriously, and he is often asked at these meetings what KPMG does to protect the data. He explained the rules and controls at KPMG that prohibit sending data containing personal information externally in emails. The phishing schemes are getting more and more advanced. Simply management taking the step of making the employees of Treasury Division and the Division of Retirement & Benefits aware that if anything seems a little odd, even if it appears that an audit team member is asking for the information, they should raise their hand and question if it is a legitimate request.

MS. ERCHINGER asked, when the State provides information for the audit, if it is downloading their entire activity and sending it to KPMG electronically, or if the audit team is looking at the actual data on site.

MR. MITCHELL replied that KPMG was doing a combination of both.

MS. BEEDLE added that the NRS (record-keeping system) reconciliation is done daily, and KPMG gets a copy of it from Mr. Jones. KPMG validates that information with on-site work as well.

MS. ERCHINGER commented that the evolution of the industry to providing auditors with everything electronically, and then auditors when they are on site looking at the paper records, is a much stronger assurance that the auditors are seeing everything and not just seeing things that people selectively want the auditors to see when they are on site. It is leaps and bounds ahead, in terms of the credibility of an audit.

MR. MITCHELL explained that KPMG has a very strong data and analytics division, which the firm is on the cusp of using much more aggressively to look for outliers. With the State audit report, there are so many checks and balances with custodial statements that things should come together in a very logical way. KPMG is probably a year or so away from running data and analytics on healthcare payments, looking for outliers and things that do not quite fit the usual parameters. The audit team would then focus on those. Artificial intelligence is another tool that in the future will be able to analyze in seconds data that now takes hours to review manually.

MR. MITCHELL reviewed the in-depth procedures that KPMG performs over the valuation of alternative investments *(details on slide 5)*. These procedures are very similar to what they have performed in previous audits. Ultimately, the valuation specialist on the audit team looks at everything, and there may be some follow-up with the Treasury Division team before he signs off on the investment test work. This year, there were no exceptions, other than an audit difference related to the timing of recording alternative investment values that occurs from year to year.

Addressing significant accounting policies and practices, MR. MITCHELL said those are disclosed in Note 2 to the schedules. There was no change there. KPMG found no indication of any management bias in the selection of the accounting policies.

MR. MITCHELL distributed a one-page summary chart of uncorrected audit misstatements *(on file at the ARMB office)*. The chart showed the effect on the income statement of recording investments lagged one quarter. Management prepared the summary, and KPMG audited the amounts to verify they were correct. From year to year, the net effect for 2017 was $25 million. Compared to the $3.5 billion in total investment income, the amount represents a 0.73% misstatement. Even though $25 million seems like a large number, in the scheme of the investment income, it is not material – and it has not been material since the lagged recording of alternative investments has been tracked. KPMG is required to report this to the ARMB because it breaches their reporting threshold.

CHAIR JOHNSON asked if “breaching their reporting threshold” was the same definition that would be applied to the concept of materiality.

MR. MITCHELL replied that it is a component of materiality. KPMG has what is called an unadjusted audit difference posting threshold. It means that they start to gather differences if they are over a certain amount. The above difference of $25 million is not considered material to the financial statements. But if there were a number of those differences, KPMG would collect them and look at them in aggregate. That is why they have a reporting threshold, which is 5% of materiality. Standard materiality for all investment companies is $700 million.

MR. MITCHELL reported that KPMG did not identify any material weaknesses or significant deficiencies in internal controls in 2017. He added that there was no significant difference in KPMG’s fees from fiscal year 2016 to 2017.

He stated that KPMG was independent with respect to the Alaska Retirement Management Board and the reports that are issued. The only non-audit service KPMG performs is assistance with financial statement preparation, which is not a prohibited service that they can perform, but it must be reported.

MR. MITCHELL ran through the list of required communications and other matters (details on slide 11). There was nothing remarkable to report. He noted that there were no difficulties or disagreements with management as KPMG went through the audit. The management team was very cooperative, and there was very good communication this year. There was some debrief from last year and some efficiencies this year based on the debrief that resulted in being earlier with the audit report this year. He also mentioned that the KPMG team and management sometimes have some healthy conversation in the procedures that the team performs, but nothing difficult or contentious that the committee needed to be aware of.

MR. MITCHELL drew attention to a list of resources available to the Audit Committee, and specifically the Audit Committee Institute website link that will give a list of the hot topics in front of audit committees today. Risk is one of those topics.

In closing, MR. MITCHELL said KPMG was working to get the audit report out as soon as possible, once they complete a few final documentation items and finalize the review of the report.

B. Update: DRB Audits (informational)

KEVIN WORLEY, Chief Financial Officer in the Division of Retirement & Benefits (DRB), Department of Administration, gave a progress report on the audit process. He mentioned that the on-site audit of health claims data at Aetna went really well this year. Part of the debriefing process that followed last year's audit, which Mr. Mitchell reported earlier, was how to improve the audit of the health third-party administrators. DRB is on track to provide four financial statements by early next week (two of which are not under the ARMB). The Division will also be providing financial statements for the Supplemental Benefit System and the Deferred Compensation Plan early next week, and the other financials later on next week.

MR. WORLEY reported that DRB staff made an on-site visit to the National Guard on Tuesday, and there would be a discussion about that next week.

CHAIR JOHNSON asked if the question of Aetna wanting additional payment for providing the data the auditors wanted was still an issue.

MR. WORLEY replied that the Division considered the matter of an additional fee resolved since KPMG went on-site at Aetna to acquire the data. Aetna's concern previously was about having their staff spend time gathering the data, and then more time PDFing the data, and back-and-forth time taken up by emails and phone calls.

MR. MITCHELL added that there was some additional billing on KPMG's part last year because of the inefficiencies in getting the required data from Aetna. That has totally gone away this year. The process this year has been smooth, and the questions on the data have been a lot more manageable to follow up.

MR. WORLEY stated that, in addition to the six audit reports that the Audit Committee reviews, the Division also does the comprehensive annual financial reports (CAFRs) for Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). Typically, the CAFRs are done around mid-December for review and are then submitted to the Government Finance Officers

Association for their certificate of achievement in financial reporting. DRB just received the TRS award for last year, having received the PERS award certificate earlier in the year.

MR. WORLEY reported that DRB staff has been working very well with the KPMG audit team. It is not just an accounting audit: the auditors look at people coming into the systems, people cashing out of the system, people who are retiring, healthcare eligibility, and more, so every section within the Division is impacted by audit work. Everything has been moving along smoothly and on time.

MS. ERCHINGER asked for some idea of the time schedule with respect to GASB 68 and now the new standards that will be implemented for the healthcare component of the unfunded liability allocation to the employers.

MR. WORLEY replied that, as part of the regular audits underway right now, Conduent is working on GASB 67, which is the pension liability for each of the plans impacted, and then GASB 74 for the OPEB (other post-employment benefits) plans. He anticipated getting the GASB 67 reports from Conduent on Friday of next week and forwarding them to KPMG. With GASB 74 being new, he expected a two- to three-week review by KPMG's actuarial team. In the meantime, the Division will be finishing the financial statements. The next step after releasing the audit reports will be GASB 68, which is the allocation of the net pension liability, and GASB 75, the allocation of the net OPEB liability. The timing will be similar to what was done this year. Conduent will be given the information in November, they will work on it in December and January, and then KPMG's audit process will start. The Division has indicated that it will be issuing those reports in June 2018.

MS. ERCHINGER said she was trying to get a sense of timing for her employer, the City of Seward, and other similar employers, because in her case they actually have a provision in the charter that mandates they have the CAFRs done six months after the calendar year end.

MR. WORLEY stated that Conduent had indicated that the methodology for implementing GASB 74 will be identical to what was instituted for GASB 68.

MS. ERCHINGER said the delay is not a State of Alaska issue or a reflection on the work the Division does. This is something that the Government Finance Officers Association has recognized is a nationwide problem. As a result of that, the GFOA did not deny employers the ability to submit late to the certificate program.

C. Internal Audit Report

DRB Director AJAY DESAI drew attention to the three-page report in memo form in the meeting packet, which summarized the activities of the DRB Audit Unit for the first quarter of fiscal year 2018 *(on file at the ARMB office)*. As of September 15, 2017, 16 employer audits have been completed, representing about 9,000 employees. Of that total, 4,085 were PERS employees, about 1,720 were from TRS, and 2,159 were SBS employees. Another three audits have been completed since September 15.

MR. DESAI said 16 employers were selected to receive a desk audit in FY18. None of those have been completed yet.

The common audit findings in FY17 and FY18 so far have been retiree rehires, SBS eligibility, SBS participation agreements, temporary employees, seasonal employees, and 49% teaching contracts/lack of PERS part-time enrollment.

MR. DESAI said the Division has been providing this quarterly report of employer audit progress, and this is the third report since he became director. Looking back at a complete picture of the DRB, he feels like there is a bottleneck the way the process has been set up. The auditors bring this information to him. Once he has reviewed the information and gone through the questions-and-answers of the audit process, then Mr. Worley's group reviews the audits from the finance and pension perspectives. When those two sections have reviewed the audits, then the auditors bring the employer audits back to him. To improve this process, the audit section will first work closely with both the pension section and the finance section. About 80-90% of the interactions are with Mr. Worley's group, which is the way it used to be years ago. The redesign of the process will have the Audit Section reporting to Mr. Worley. As director, he will continue to oversee the audit reports and work closely with them and hold the routine weekly meetings. But to expedite everything, he believes that reversing the process will help to release the audit reports to the employers earlier and maybe increase production in the future.

MR. WORLEY explained the process for issuance of the regulations for the Audit Section.

CHAIR JOHNSON asked about the source for the questionnaires that some employees have been receiving.

MR. WORLEY said it was basically looking at PERS eligibility or TRS eligibility, if the employee was rehired in any capacity, looking at the participation agreement that PERS has with the employer to see if people are properly classified within their payroll, and looking at part-time hours versus full-time hours, etc. This is a sample selection for the auditor.

CHAIR JOHNSON asked if the beneficiary eligibility questionnaire that has been contracted out to a third party to administer is in process.

MR. DESAI stated that one questionnaire sent to the retiree group was to verify the eligibility of dependents for healthcare benefits. A previous campaign was conducted for the eligibility of dependents of active employees.

MR. DESAI reported that, as part of looking at the entire division as a modernization process, they are also developing a comprehensive document on the steps it takes to go through the audit process for each employer. For example, some employers have SBS and some do not, so employers could be lumped into three or four groups, depending on what steps the auditor has to perform for each employer. He planned to provide the committee with information on that change at a future meeting.

MS. ERCHINGER addressed the recent proposed regulation changes that have been sent out to employers, specifically with respect to rehired retirees. She felt, as the employer representative on the Alaska Retirement Management Board, that it was important to state that employers do not move quickly to understand those regulations, or, in many instances, even have people in place who can understand what they are reading when they read the proposed regulations and understand the impact of the regulation changes on their organization, looking down the road. She suspected that the regulation changes will go into effect because people will not have had time to really examine the potential impacts of them. Then there will be some significant blow-back, once employers recognize what the impact of the proposed changes is.

MS. ERCHINGER gave the example of someone in a small town retiring from a local government entity with a full pension. It is not uncommon for those people to come back in a part-time job that is not a PERS-covered position, and it does not affect their retirement at all. An employer such as the State of Alaska has a large pool of qualified people for other jobs to pull from, but the proposed restriction will have a significant effect on some smaller employers. And those are the employers who are unlikely to read and really understand the proposed regulations and what the downstream impacts are going to be. She said she also wondered if it was overreach of the State to say to an employer that it is going to change how they hire people, in that they will not be allowed to hire anybody who is a retiree, even in a temporary job that has no PERS. As an employer, she thought that was State overreach. She wondered if the State would be put in the position of having to defend overreaching and infringing on the protected rights of employers to hire whomever they choose if it does not affect the retirement system.

MS. ERCHINGER said that, rather than the State saying that a person retired from PERS or TRS could not come back to work for that employer for six months, the regulation change could say that the retiree could not come back to work for that employer for whatever period of time the IRS (Internal Revenue Service) has decided they cannot. Then the State would be consistent with the IRS and it would not be a State-imposed change. It would be an IRS-imposed change; therefore, the State would not be defending something it was doing that was different than the IRS. She did not want the employers to be in a position of challenging the State on that, if the true impetus for the change is to be consistent with the IRS regulations.

MS. ERCHINGER requested an update on the proposed regulation at the next meeting.

MR. DESAI said he would certainly bring more details. He added that it is a federally mandated rule having to do with the age of retirement recently being redefined from 65 to age 62 for any government plans. Alaska, because of its geographical location, and many other states made the argument that their employers will have trouble finding talent. He thanked Ms. Erchinger and said the Division will add at the beginning part of the communication to employers that the change is IRS mandated and not coming from the State.

MS. ERCHINGER said that if there is some wiggle room to provide some flexibility for Alaska's unique situation, the State should seriously look at that.

MS. HARBO mentioned that the school districts have a hard enough time finding teachers for positions. If teachers retire and then want to work immediately as substitutes, it seems like the proposed regulation would prohibit them from even doing that. School districts, in some cases, are desperate to find substitute teachers, so it is not a very good rule.

MR. DESAI stated that he and Kathy Lea, the Chief Pension Officer, have been studying this proposed regulation very closely and trying to find a way that allows keeping the current rules, rather than changing it.

D. Future Audit Committee Topics

MS. ERCHINGER said she would like a presentation on the general methodology that is used for estimating future employer salaries that are used to allocate the unfunded pension and healthcare liabilities. Any time in the next year would be fine.

E. Further Meeting Schedule

The schedule for committee meetings for the remainder of 2017 and 2018 was included in the packet.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

Treasury Division Director PAM LEARY stated that the Division sent out a compliance report for August that everybody should have received. While almost everything said "satisfactory," one item said "unsatisfactory." Compliance Officer James McKnight works on a daily basis and notices anything that is triggered. He works with the investment officers to identify any potential issue and to determine what is causing the issue or tripping one of the compliance rules. By the time the monthly compliance report is sent out, any issues have been resolved. In the instance she mentioned, this issue had not been resolved. It had to do with Mackay Shields tripping the unrated securities guideline of 5%. The Treasury group talked about what was causing this.

Chief Investment Officer BOB MITCHELL explained that the high yield guidelines specify that the portfolios can hold up to 5% in securities that are not rated by rating agencies. Mackay Shields was compliant with the threshold until the ARMB took money out of their mandate. When that happened, it changed the percentages in the portfolio and tripped the compliance rule. Investment staff had a conversation with them, and they indicated that they expected to be able to sell those non-rated securities by the end of August. Market conditions were not such that they felt they could get good execution by liquidating the securities. When August came and went and the issue was not resolved, staff held two conversations with Mackay Shields and left it where they now believe they can be compliant within the next 60-90 days. He will be meeting with them next week in New York and talking to them more about that. He expected that the issue will take care of itself.

CHAIR JOHNSON asked if the Equifax data breach had any implications on the Division of Retirement & Benefits.

MR. DESAI responded that so far the Division has not received any significant inquiries that alarm them regarding this particular data breach.

PUBLIC / COMMITTEE MEMBER COMMENTS

There were no comments.

ADJOURNMENT

MS. HARBO moved to adjourn the meeting, and MS. ERCHINGER seconded. The meeting adjourned at 10:14 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.

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Karen Pearce Brown