State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
AUDIT COMMITTEE MEETING

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

December 6, 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)
Shane Carson (state investment officer)
Mike Barnhill (state investment officer)
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)
Kathy Lea (chief pension officer, Division of Retirement & Benefits)

Others Present:
Daniel Mitchell (KPMG)
Melissa Beedle (KPMG)

CALL TO ORDER
CHAIR ROB JOHNSON called the meeting to order at 9:05 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 – October 4, 2017
MS. HARBO moved to approve the minutes of the October 4, 2017 meeting. MS. ERCHINGER seconded. The minutes were approved as presented.

PUBLIC/MEMBER PARTICIPATION, COMMUNICATIONS AND APPEARANCES
There was no public comment by telephone, and no one in attendance at the meeting indicated they wanted to address the committee.

REPORTS

A. Review of Financial Statements / Letter to Audit Committee GASB Update
[A copy of the KPMG slide presentation is on file at the ARMB office.]
DANIEL MITCHELL, KPMG Lead Engagement Managing Director, and MELISSA BEEDLE, KPMG Lead Engagement Manager, appeared before the committee to present the results of the June 30, 2017 audit of the Department of Administration Division of Retirement & Benefits.

MR. MITCHELL stated that KPMG had substantially completed with all the audits, and the final reports on the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) were issued yesterday. The Defined Contribution Plan and the Supplemental Benefit System (SBS) were issued a couple of weeks ago. They expected to issue the Judicial Retirement System (JRS) today. The schedule was a bit behind what they originally anticipated for issuing PERS and TRS, largely because of the additional effort that was required around implementing GASB 74. However, KPMG is sitting where they have issued historically and two weeks prior to when they issued last year.

MR. MITCHELL said there were no changes to the audit plan, except for the National Guard Naval Militia Retirement System (NGNMRS) with respect to the scrubbing that is required on the census data, in order for KPMG to be able to audit it and render an opinion.

Looking at the audit findings, MR. MITCHELL said the significant risks that were identified during the audit plan were the potential for management to override controls, and valuation of alternative investments. During KPMG's substantive test work, journal entries are subject to sampling where they can look at the underlying reasons for those journal entries. They also look at all post-closing entries to make sure there is no manipulation during the post-closing process. They did not find any issues to indicate that. The valuation of alternative investments is considered a significant risk for the benefit plans, and it flows in from the Treasury report with each plan's respective holdings of the alternative investments. For those reports, KPMG spends a significant amount of time challenging management's fair value assumptions and also involves their own specialists to look at that. They did not identify any significant issues relating to valuation of alternative investments. The only thing with respect to alternative investments is that some of the funds are reported on a quarter lag: that unadjusted audit difference flows through as it relates to specific plans.

MR. MITCHELL stated that the pension and post-retirement obligations is where most of the heavy lifting is done on the defined benefit plans. KPMG spends a significant amount of time testing the census data that goes through to the actuary, understanding the actuarial assumptions that are being used, not only for the pension liability but also for OPEB (other post-employment benefits), challenging those assumptions and using KPMG's own actuaries to challenge those assumptions. Nothing came out of that review process that made them think that those assumptions were biased in any way. There was some neutrality to the judgments around those estimates, meaning that management has not gone any less sensitive or more sensitive in the assumptions that were picked this year. Hopefully, that follows through all the meetings that the committee has been involved in looking at assumptions, when it comes to actuarial reports.

MS. ERCHINGER asked why Mr. Mitchell used the terms "less sensitive" and "more sensitive" instead of "less conservative" and "more conservative."

MR. MITCHELL replied that in the world of financial reporting, auditing and accounting, conservative is often blessed as being okay, when really the best estimate is what is okay. Being conservative could be an issue, especially if you move from being more conservative one year to being less conservative or middle ground the next year, which could produce very different results as the scale changes. For example, changing the investment return assumption from 8.0% to 7.5% has a significant impact on the pension liability and OPEB.

MS. ERCHINGER then asked how KPMG defined the term "sensitive."

MR. MITCHELL said it was probably very close to "conservative" in that respect. In regard to this year's audit, if there had been an assumption change in just that one estimate, that has more sensitivity and more conservatism to it. Year over year, the assumptions that management has used are very consistent, and the same kind of thought process and methodology has been used to get to those assumptions. He added that KPMG has moved toward more of a dashboard in its presentation.

Moving on to outstanding matters, MR. MITCHELL said the only thing was the representation letter for the Judicial Retirement System that Mr. Worley spoke to this morning. KPMG received the actuary sign-offs last Friday, and they are waiting to finalize the JRS today.

CHAIR JOHNSON had a question on what the percentage figure for the unfunded liability or the funded status represented. The actuary, Conduent, presents a figure of something like 77% for the funded status of _______. In the CAFR, though, with the application of GASB 67, the net fiduciary liability percentage is about 66%. He asked what the difference was between the two numbers.

MR. WORLEY stated that in discussions of GASB 67 and GASB 74 in relation to the actuarial valuations, at conferences he has attended, it was presented that valuations have an actuary number for the funded status, and GASB 67 and 74 have a new number. The unfunded liability numbers are not going to be the same because a different mathematical model is used.

MR. MITCHELL added that one calculation is driven by the actuarial science, and the other by the accounting standard.

CHAIR JOHNSON said he was surprised, given the difference, that there is no footnote or reconciliation in the CAFR or the financial reports, because it raises questions.

MR. MITCHELL said he would talk to the GASB team to see if anything is being done industry wide, by means of a reconciliation in the footnotes or an education. KPMG's resource partner Jeff Markert, in his review of the financial statements, did not indicate that a footnote was missing.

MS. HARBO remarked that from the public perspective many people use a retirement system's funded status as a quick comparison for how the pension funds are doing compared to other states.

MR. MITCHELL pointed out that in the financial statements there should be consistency because of the GASB 67 reporting. If all the bonding agencies are looking at the same data that is calculated exactly the same way, then he would not be concerned over that. However, any reasonable person looking at the difference might think there is an error, if they do not understand the science behind the two calculations, and if it is not explained in a meaningful way.

MR. MITCHELL next talked about the pension and post-employment benefit obligations. He said KPMG spent a lot of time this year, especially on the GASB 74 side, understanding management's process, the use of the assumptions, and the identification of significant assumptions. They had many calls with their own team in Anchorage, with Conduent, with Mr. Worley in the Division of Retirement & Benefits, with KPMG's own actuary, and with the GASB 74 specialists in KPMG's professional practice team in New York City, to make sure they were comfortable with all the significant assumptions. KPMG tested 20 PERS employers (just shy of 500 employees in the census data), and 15 TRS employers (360 employees in the census data). KPMG also tested a sample of retired participants on the pension side, and both active and retired in the OPEB plans. Similar to prior years, there were a few census data items that were not correct, but they were off by very immaterial amounts. In discussions with KPMG's team and with Conduent, there were no indications that those exceptions would create a materially different result in the calculation of the overall liabilities. There were actually fewer exceptions in the census data than KPMG has encountered in the past, which is a good indication that the data is being cleansed over time with the State's internal audits and other practices.

MR. MITCHELL reported that no indications of management bias were identified. KPMG challenged the investment rate of return to see if it was still reasonable because, of all the actuarial assumptions, that one could significantly impact the liabilities. They received several reports from investment managers to ensure that the investment return rate made sense, and they were definitely comfortable with it at the end of the audit. Going forward, that is something they are going to watch. KPMG is seeing some lower percentages for the investment return assumption across the country, but that does not necessarily indicate the Alaska plans should be lower. The ARMB's investment return assumption is based on its performance, asset mix, and investment strategy, which supports the 8.0% assumption.

MS. ERCHINGER mentioned that the ARMB's investment return assumption includes a real return of 4.88% plus an inflation assumption of 3.12% (which many believe is too high). The actuary (Conduent), in an upcoming report, will be presenting scenarios with alternative return assumptions. It appeared to her that the actuary was saying to consider a higher real return assumption and also consider lowering the inflation rate. Ultimately, the real return assumption in every one of the actuary's scenarios is higher than the ARMB's current real return assumption of 4.88%. So, the return that the ARMB needs is going to be higher than what it is shooting for now. To her, the actuary's scenarios are less conservative, but she was trying to understand how everybody looks at the numbers. Traditionally, everyone wants to focus on 8.0%, but she thought the important number to focus on was the real return target. So, while it would make many people happy to see the 8.0% return assumption go down, essentially it would be increasing the target that the ARMB has to hit. She asked for the auditor's take on that.

MR. MITCHELL stressed that he is not an actuary, and it is KPMG's actuarial team that looks at the investment return assumption. He thought the 8.0% is derived from the real rate of return, which is very important. The audit team did take a very close look at that. They can take a look at what is happening in other retirement plans, but that is not necessarily relevant, to the extent that other plans have different asset mixes. KPMG knows that the ARMB's asset mix has quite a bit more equity in it than some of the other systems, which leads to an expected higher return than some of the other systems. Then, KPMG looks at the scenarios that the actuary has not presented yet, and they need to get the data and understand what is driving that number and if it makes sense. If the outcome is the same, and the return assumption is still 8.0%, one could argue that it is okay in the overall aggregate basis. But one could challenge if the two pieces that make up that 8.0% are correct. KPMG got comfortable with the return last year because they looked at all the underlying data, and things have not changed that much in this last year.

MR. MITCHELL stated that if there are assumption changes, what he would like to do going into the coming year audit is make sure that this becomes a topic of discussion earlier on so that the KPMG team can at least be closely following behind to understand why an assumption change makes sense. If questions come up and the committee wants to explore that space, he would at least be able to provide some assistance in that regard.

Responding to CHAIR JOHNSON, MR. MITCHELL said that KPMG's analysis is in the audit opinion itself. It is the reasonableness of all these things that drive, ultimately, a set of financial statements. KPMG is saying that the financial statements are materially stated, taking all of those things into account. There is nothing on the face of the financial statements that presents the pension liability or the OPEB liability – that is in the notes. But it is a very important note number.

MR. MITCHELL stated that one of the challenges KPMG finds is the census data that the actuaries get. This year that was the census data on the NGNMRS. The concern is always how complete and accurate the census data is. It is always worth asking what has been done to reconcile that data set, because the actuary's output is only as good as the input that they get.

MS. ERCHINGER commented that, relatedly, the Alaska Department of Administration has worked closely with the actuary to get much better healthcare claims data, and good progress has been made in that area.

MR. MITCHELL reported that there were no changes in the accounting policies and practices, other than GASB 74 was implemented this year.

Regarding uncorrected audit statements, MR. MITCHELL said slide #7 showed the break-out of the misstatement related to the lag reporting on certain alternative investments, as it related to each of the retirement plans. He said it is not that the amount of change in fair value investments never gets booked: it gets booked in the following period. It breaches KPMG's reporting threshold to the ARMB by plan, but there is nothing there to indicate there is any material misstatement in the financial statements. This situation has been consistent for a number of years.

MR. MITCHELL next addressed significant deficiencies and material weaknesses in internal controls. The two defined contribution plans and the three defined benefit plans had no material weaknesses identified and no significant deficiencies related to internal controls that KPMG would be required to report to the committee. They will report on the audit of the NGNMRS once they are able to do the test work on the scrubbed census data.

Regarding audit fees, MR. MITCHELL noted that this year, at the request of the State, KPMG did not take the cost-of-living adjustment allowed for in the proposal. He added that there were no independence issues with respect to KPMG's ability to render an opinion on the reports being presented at this meeting.

CHAIR JOHNSON suggested changing the wording about independence to make it with respect to the Division of Retirement and Benefits, the Department of Revenue, and the Alaska Retirement Management Board. MR. MITCHELL indicated he would make that change.

MR. MITCHELL briefly went through the required communications for related party issues, that there were no illegal acts of fraud during the audit, and no indication of non-compliance with laws and regulations. There were no modifications to the audit report. KPMG did add an emphasis-of-matter paragraph with respect to GASB 74 to point out to readers that it had been implemented during the year. There were no subsequent events identified or other matters. Regarding material written communications, KPMG will be issuing its letter to the Audit Committee that has the representation letter, engagement letter, and the summary of uncorrected misstatements. The audit team will be looking at the State CAFRs for PERS and TRS when they are issued next week, because their report is in there. They will look through it for consistency and to make sure there are no changes to the financial statements.

MR. MITCHELL next reported on significant difficulties in the audit, saying that the audit team decided to call out that they identified several discrepancies in census data of the National Guard Naval Militia Retirement System. Before the actuary can put together good pension liability and OPEB liability numbers, that data needs to be scrubbed. He understood that would begin happening at the first of the new year, and KPMG will be following closely behind that process to complete their audit. Staff dealing with the audit team through this data issue have been very professional.

MS. ERCHINGER mentioned that while the NGNMRS census data was identified in this audit as a specific problem, the Division of Retirement & Benefits has informed the committee for a number of years about significant challenges with the census data that the Division receives from the employer. It is important to note that the employers are responsible to give the State good information. The auditors and the actuaries are relying on the data that comes from employers. The employer in this case needs to help get better information to the State.

MR. MITCHELL agreed, saying that the control definitely has to start with the employer understanding the responsibilities of maintaining complete and accurate records and transmitting that data when required. Now is the time to get the data corrected and pushed out to the actuary so that the results are accurate and meaningful.

MS. ERCHINGER asked if there was a State contribution to the NGNMRS.

MR. WORLEY said no, but it is an appropriated amount from the general fund.

MS. ERCHINGER mused that, if deficiencies in the census data come to light such that contributions were not made for unreported people, the State is actually going to foot the bill.

MR. MITCHELL stated that as KPMG was embarking on this process, the initial indications of the data were not an underfunding. He stressed that his comment was not based on having done any audit work though.

Wrapping up his report, MR. MITCHELL said there had been no disagreement with management, KPMG was not aware of management's need to consult with other accountants, no other significant issues were discussed with management, and there were no difficult or contentious matters. He felt that this year the overall communication improved over the prior year. One of the headlines coming out of the audit last year was about trying to get the Aetna health claims data. It was still a struggle this year, in the sense that there is a lot of work that goes on with the service provider, but Aetna was very cooperative with KPMG going onsite. Mr. Worley and his team did an exceptional job of assisting in the coordination of that. KPMG is sitting here today largely because of the processes that were put in place and the teams' ability to work together to get through a significant amount of test work on the medical claims in an efficient manner. There was no additional cost to the plans this year. Last year, there was some additional billing associated with getting the Aetna data, when the auditor claims testing extended into January and beyond.

MS. ERCHINGER inquired about KPMG's additional audit work that is necessitated by auditing the underlying employer census data.

MELISSA BEEDLE stated that KPMG assigns one staff person to the census data test work. This year the person visited the employers from mid-August to early October. It encompasses about 500 hours of the person's time. Mr. Worley was helpful in explaining the purpose of the test work to employers who were reluctant to cooperate with the KPMG staff person at first.

MR. WORLEY said that the Division is updating and improving its communication to the employers about the census audit in relation to the DRB internal audit versus the employer's own audit versus somebody else coming out and doing audits of an employer.

MS. BEEDLE commented that KPMG conducts census data auditing of the major employers in the retirement plans every year, and those employers are fairly receptive to KPMG being there. KPMG understands that these employers are often being audited by their own auditors at the same time that KPMG wants to be there, and it is extra effort on their part. KPMG tries to coordinate the right timing with the employer, in order not to disrupt too much.

B. Information Update: Employer Audit Report

AJAY DESAI, Director of the Division of Retirement & Benefits, referred to the memorandum report dated November 13, 2017, included in the meeting packet, that summarized the activities of the DRB Audit Unit during the second quarter of fiscal year 2018. He said nothing alarming was happening in the quarter. Of a total of 86 audits in hand, 32 are from fiscal year 2017 and 54 are from FY18. So far, they have completed slightly under 25% of the goal. The goal is to increase this number a bit every year to shorten the period between the employer audits. Currently, the auditors are getting back to an employer after three to four years. They are trying to get back to an employer in two to three years' time. They are standardizing procedures and reports to help with that.

MR. DESAI said the findings of the audits completed so far have been fairly standard. The common findings are temporary employees, rehired retirees from PERS and TRS, and SBS eligibility.

MR. WORLEY reported that the Alaska Association of School Business Officials had invited the Division to its meeting yesterday. Melanie Helmick, the Division auditor, spoke to about 30 people about the audit process the Division goes through and some of the common audit issues that come up in the school districts. Many good questions developed from her talk, including about termination studies. It highlighted that the Division has to look at each employer as independent and cannot compare one school district with another school district because they behave differently in terms of organization. Ms. Helmick's presentation was very well received.

MS. ERCHINGER stated that in the years she has been on the ARMB and on this committee some significant legislative changes have affected the Division. She thought that caused the employer audits to lag because of more pressing matters that needed to be done. One administration focused on automating the data and turning everything into electronic records instead of paper records. Again, in preparation for Kay Gouyton's retirement, another phase focused on getting all the policies in writing for transition purposes. She was impressed to see how far the Audit Unit has come in being able to get employer information electronically and begin making improvements and reaching out to employers. It has all been a great improvement to the retirement plans and to the accuracy of the information within the systems. She applauded Ms. Helmick and the leadership of the Division for now even being able to strive for 50 employer audits in a year.

MS. HARBO asked for the meaning of “Rehires with pre-existing arrangements for continued employment,” under common employer audit issues on page 3 of the report.

MR. WORLEY said it was about the bona fide terminations. With the change in regulation that is going into effect on January 1, 2018, the Division wants to let the employers know that there has to be a bona fide termination from PERS and TRS.

MS. ERCHINGER mentioned that she understood there were some built-in exceptions to the new regulation for the State, but there was no such provision for non-State employers. She found that troubling and unfair, if true, and wanted more information on that in the future.

MR. DESAI said he did not think there were any exceptions to the new regulation, regardless of the employer. The new rule was simply following the Internal Revenue Service regulations. However, he would check where the information that Ms. Erchinger read was coming from, because it has been a very confusing subject to begin with.

C. Future Audit Committee Topics

CHAIR JOHNSON mentioned the topic of rehires that Ms. Erchinger just raised, as well as a possible discussion of reconciliation of the GASB 67 unfunded liability numbers with the actuarial funded status calculations.

MS. ERCHINGER requested a future discussion of the methodology for estimating future employer salaries that is used to calculate the allocation of the pension liabilities. She indicated there was no rush on this, and she was looking for only a general overview.

D. Further Meeting Schedule

The 2018 committee meeting schedule was included in the packet.

OTHER MATTERS TO PROPERLY COME BEFORE THE COMMITTEE

There were no other matters.

PUBLIC / COMMITTEE MEMBER COMMENTS

There were no comments.

ADJOURNMENT

<u>MS. HARBO moved to adjourn</u>. <u>MS. ERCHINGER seconded</u>. The meeting adjourned at 10:00 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