

October 13, 2010

To: Members of the Board of Retirement

From: Donald White, Chairman of the Audit Committee

Subject: Summary of the October 13, 2010 Audit Committee Meeting

The Audit Committee Meeting commenced at 1:17 p.m. on Wednesday, October 13, 2010. The Committee members in attendance were Chair Donald White, Dale Amaral, Liz Koppenhaver, other Board members present were Annette Cain-Darnes, Elizabeth Rogers, Darryl Walker and David Safer. Members of the Staff present were Catherine Walker, Assistant Chief Executive Officer; J.P. Singh, Chief Financial Officer; Kathy Foster Assistant Chief Executive Officer; Robert Gaumer, Chief Counsel; Rose Kwong, Benefits Manager; Victoria Arruda, Human Resources Officer, Betty Tse, Chief Investment Officer; Latrena Walker, Project and Information Services Manager; and Harsh Jadhav, Internal Audit Director.

ACTION ITEMS

None.

INFORMATION ITEMS:

External Audit

None

Internal Audit

1. Progress Report on Internal Audit Plan

Staff presented the Internal Audit Department Report giving a status update on the Annual Internal Audit Plan, Internal Audit Initiatives, results of the Actuarial Process Audit, and results of the Service Provider Contract Audit.

In reviewing the progress on the Internal Audit Plan, it was noted that the Actuarial Process Audit and the Service Provider Audit were completed in September 2010 and October 2010, respectively; the General Contracts Audit is expected to be completed in late November or early December of 2010; the SAS 70 – Type II Review of Funds Managers was cancelled based on feedback from other pension fund auditors on lack of legal requirement for Fund Managers to comply; Audits related to Accounting Calculations and Benefit Process were postponed to next year.

In addition, the status of the key audit initiatives was given as follows:

- ACL (Analytical Audit Tool) to compare data from different systems and various file formats was implemented.
- Annual Data Integrity review to focus on testing of major repository data was performed. This year the focus was on Pension Gold through the Actuarial Process Audit.
- The implementation of the Ethics Hotline was placed on hold pending the implementation of the Website Redesign Project and a legal department review on the use of the hotline.
- The Public Pension fund Policy Review will commence by the end of 2010, results will be available during the first quarter of 2011.

2. Results of the Actuarial Process Audit

The objective of this audit was to determine if ACERA's process for providing data to the Actuary for the actuarial valuation is accurate and complete.

The audit involved the testing of 15 controls: 5 low risk, 5 medium risk, and 5 high risk. The results showed that 60% of them were effective or remediated, 80% of the high risk controls were effective or remediated, and 87% of the Controls were at least partially effective. The audit findings resulted with no ineffective controls.

Some of the key issues discovered in the audit related to the coordination across departments in providing accurate and complete information, and review of active and retired member counts in the census data prior to sending the information to the Actuary. Remediation of these issues will involve setting up a cross-functional team to perform reconciliations between current year and prior year data and comparing the initial member count with the final actuarial valuation. Another issue mentioned was that ACERA does not have an adequate review process to validate changes made in the actuarial assumptions. The proposed remediation included having ACERA Management conduct annual meetings with the Actuary to discuss and review significant events affecting the plan and key changes made in the actuarial assumptions from the previous year.

Positive findings were also noted as follows:

- ACERA has good process in place for managing and protecting private member information from unauthorized access.
- Senior Executive leadership and ethics driven culture.
- Strong risk management through proper use of outside legal consultants.

At this point Audit Committee member Elizabeth Rogers requested explanation on whether the Internal Auditor can place a value judgment on the ethics culture at ACERA, since this would be a more subjective opinion. Staff responded that both subjective and objective valuation is necessary in order to understand the control environment, since audit scope and testing effort are adjusted based on both types of valuations. Audit Committee Chairman, Don White agreed with Staff and provided additional insight on the necessity for both types of valuations. In addition, Ms. Rogers asked for more clarification on the proper use of legal consultants, to which staff

explained that whenever ACERA's lack of technical expertise represented a risk factor, Management would not hesitate to outsource it to legal counsel with subject matter expertise.

Audit Committee member Dale Amaral raised the question about the independence of the Internal Auditor and made it clear that he reports directly to the Board and that this should be stated in writing. On this matter a reference was made to the Audit Committee Charter. Mr. Amaral recommended that the reporting relationship between the Internal Audit Department and the Board of Retirement be reviewed in the future, to provide clear direction on how the Internal Auditor will escalate issues related to fraud or misappropriation of funds to the Board.

3. Results of the Service Provider Audit

The objective of this audit is to determine if Service Provider Contracts were approved by Staff without proper approval from the Board of Retirement.

This audit involved the testing of 4 controls: 1 low risk, 1 medium risk, 2 high risk. The results showed that only 50% of the controls were either effective or remediated, 100% of the high risk controls required remediation, and a major part of the remediation will occur by revising the Service Provider Policy to clarify the ambiguity in the policy language.

The key issues that were found were:

- Some contracts were reviewed by Legal after work had started.
- There is no clear policy governing temporary employment service providers. Average combined spent per year has been \$753,519 since 2002. (Note: 2010 spend was calculated through June 30, 2010)
- The audit reported a 68% exception rate, where Staff failed to obtain approval for Service Provider Contracts requiring "Formal Board Approval", when the annual estimated contract amount exceeded \$50,000, making the control clearly ineffective.

In addition to proper Board approval, the Audit Department recommends that the control be modified to ensure that contracts are managed and tracked by both provider and project. Staff should estimate the budget on time and material contracts prior to contract approval, and any overspending should be reported back to the Board of Retirement.

In addition, the following high level revisions to the Service Provider Policy were recommended:

- A more comprehensive section on monitoring contracts is required.
- Definition of when a legal department review is required.
- Policy is a high level document for overall guidance. A separate detailed procedure manual providing guidance for Staff on the process for approval of different contract types is required. Board Member Annette Cain-Darnes requested that this procedure be presented to the Audit Committee within 90 to 180 days.
- Definition of which types of vendors are considered service providers is necessary.

- An example of contract approval chart should be included as part of the documented procedures.

Positive findings were:

- No evidence of “Stacking”.
- Improved Annual Budget Process.
- Strong proactive Legal Department

Board Member, Liz Koppenhaver recommended that we consider the budget implications of hiring a Compliance Officer. In addition, there was discussion that if such a role was hired, whether it should report to the Legal Department.

Trustee/Public Input

None

Future Discussion Items

1. 2010 External Audit Kick Off Meeting
2. Results of the General Contracts Audit.

Establishment of Next Meeting Date

Next meeting is scheduled for Wednesday, February 9, 2011 at 1:30 p.m.

Meeting adjourned

The meeting adjourned at 2:19 p.m.