



OKLAHOMA TEACHERS RETIREMENT SYSTEM

AUDIT COMMITTEE MEETING

AUGUST 23, 2011

2:00 PM

MEETING MATERIALS

AUDIT COMMITTEE MEMBERS:

Chair: Bruce DeMuth

Members: Sherrie Barnes, Joe Ezzell, Richard Gorman, Galeard Roper, Jonathan Small

**ALL BOARD MEMBERS ARE ENCOURAGED TO ATTEND AUDIT COMMITTEE
MEETINGS**

TEACHERS' RETIREMENT SYSTEM OF OKLAHOMA
Audit Committee Meeting
Tuesday, August 23, 2011 – 2:00 PM
TRS Administration Board Room
2500 N. Lincoln Blvd., 5th Floor, Oklahoma City, OK

AGENDA

- 1. CALL TO ORDER**
- 2. DISCUSSION AND POSSIBLE ACTION ON FY-2012 AUDIT PLAN**
- 3. DISCUSSION AND POSSIBLE ACTION ON INTERNAL AUDIT DEPARTMENT STRUCTURE AND REPORTING**
- 4. QUESTIONS AND COMMENTS FROM TRUSTEES**
- 5. ADJOURNMENT**

***ALL BOARD MEMBERS ARE ENCOURAGED TO ATTEND
AUDIT COMMITTEE MEETINGS***

AUDIT COMMITTEE:

Chair: Bruce DeMuth

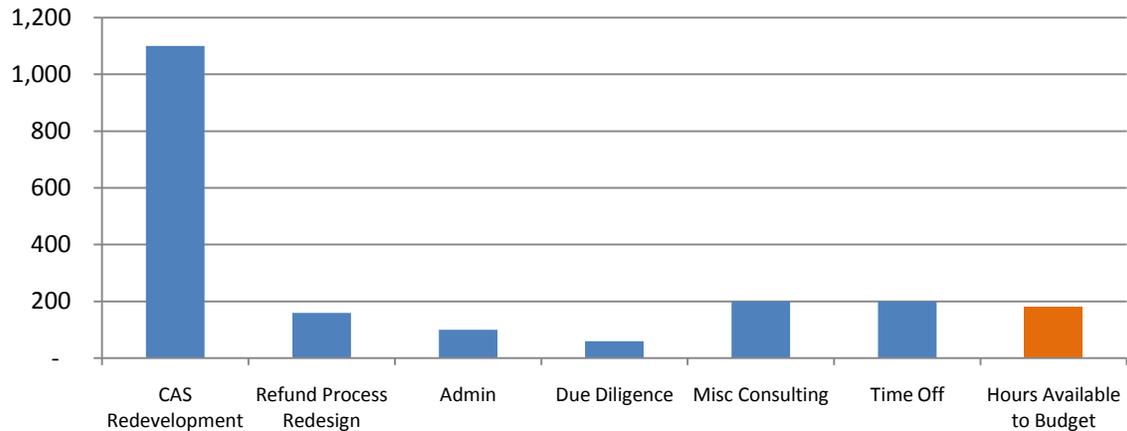
Members: Sherrie Barnes, Joe Ezzell, Richard Gorman, Galeard Roper, Jonathan Small

FY 2012 Proposed Budget/Plan

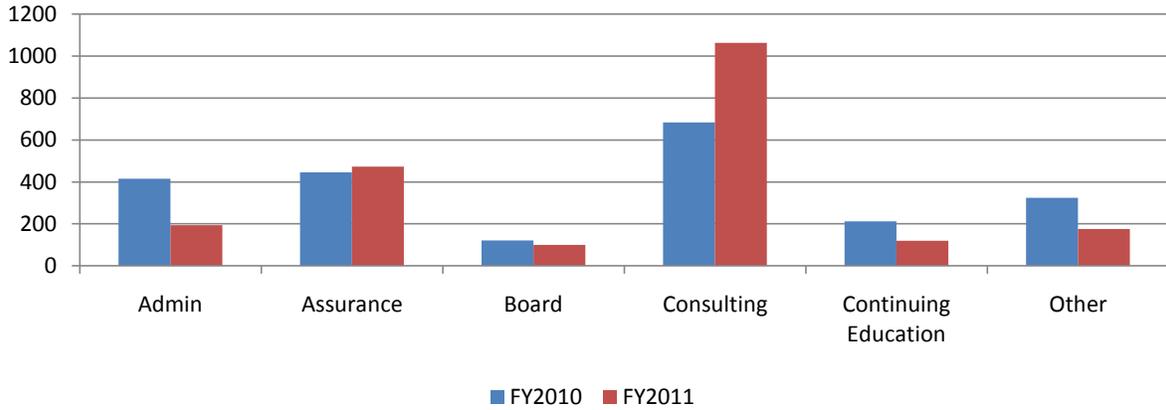
Cost Center	Project	%	Hours Used	Hours Budgeted	Hours Left
Consulting	CAS Redevelopment	55%	50	1,100	1,050
Consulting	Refund Process Redesign	8%	50	160	110
Admin	Admin	5%	23	100	77
Assurance	Due Diligence	3%	30	60	30
	Misc Consulting	10%	121	200	79
	Time Off	10%	16	200	184
	Hours Available to Budget	9%		180	180
Total Hours to Budget			2,000	290	2,000
				2,000	1,710

Queue	Other Possible Projects	Est Hours
Assurance	Federal Matching	160
Assurance	Deaths	80
Assurance	Financial Controls	
Assurance	Develop Exception Reporting	

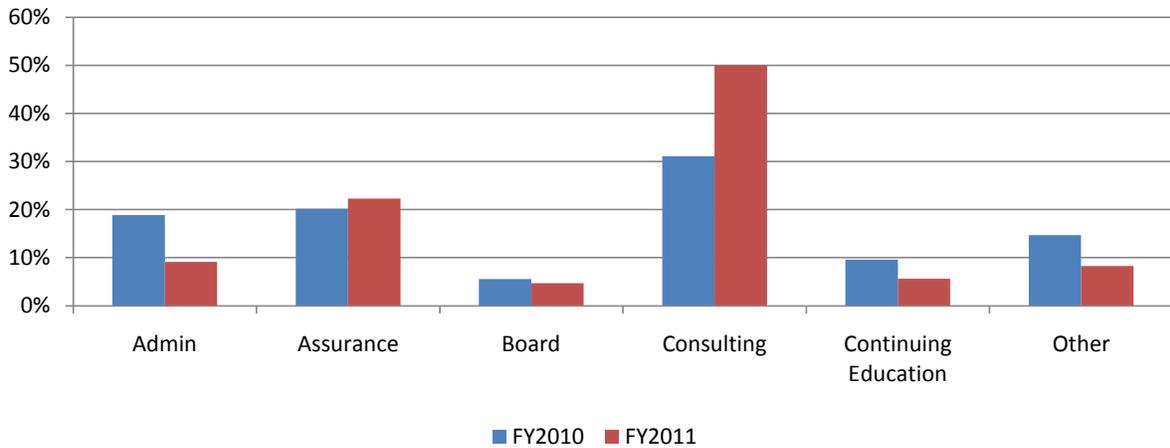
FY 2012 - Hours Budgeted



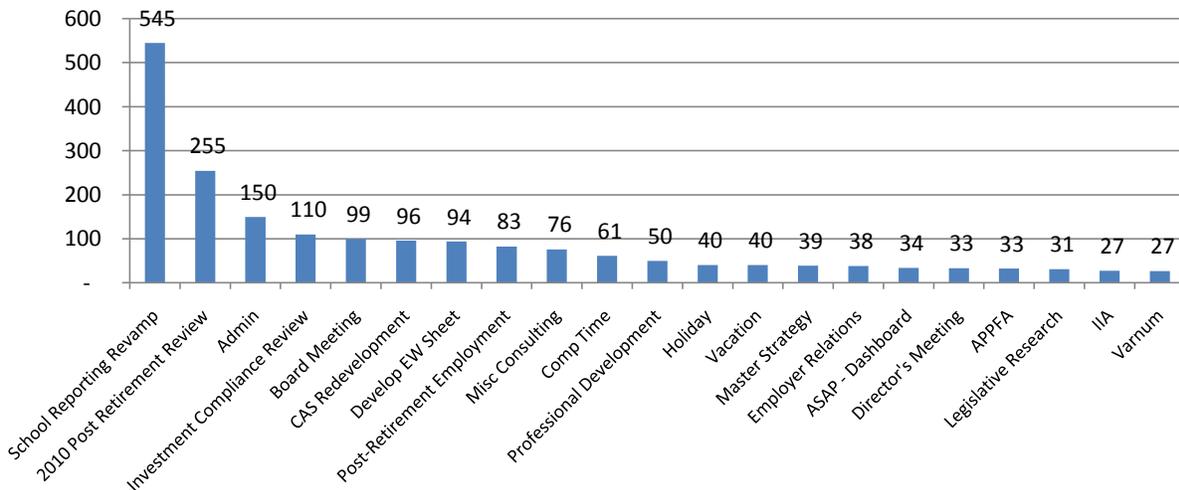
FY 2010 - 2011 Cost Center Comparison Hours



FY 2010 - 2011 Cost Center Comparison %



FY 2011 Top Projects by Hours





JAMES R. WILBANKS, Ph.D.
EXECUTIVE DIRECTOR

MARY FALLIN
GOVERNOR

STATE OF OKLAHOMA
OKLAHOMA TEACHERS RETIREMENT SYSTEM

Date: August 18, 2011

To: TRS Audit Committee Members and Trustees

From: James Wilbanks, TRS Executive Director

RE: KY Auditor of Public Accounts Report

Audit Committee Members and Trustees,

The following pages are excerpted from the final report of the Kentucky Auditor of Public Accounts (APA) review of the Kentucky Retirement System (KRS). The APA review was requested by the KRS Board after several recent issues came to light that ultimately led to the election of a new Board Chair, the termination of the Executive Director and the departure of the Chief Investment Officer. Many of the issues reviewed by the APA speak to the independence of the Internal Audit Department at KRS.

After reviewing the report, I thought it would be healthy and beneficial for the Audit Committee to review the information in the APA report and discuss these issues in regards to the Internal Audit Department at OTRS. Included in the pages that follow are the full Executive Summary of the APA report and the detailed pages discussing the findings related to Internal Audit findings. The findings that address the Internal Audit Department at KRS are highlighted for your convenience.

I look forward to discussing these issues with the Committee and the Committee reporting to the Board of Trustees.

Please let me know if you have any questions.

**Examination of Certain Policies, Procedures, Controls,
and Financial Activities of Kentucky Retirement Systems**



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The Auditor Of Public Accounts Ensures That Public Resources Are Protected, Accurately Valued, Properly Accounted For, And Effectively Employed To Raise The Quality Of Life Of Kentuckians.

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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

June 28, 2011

Jennifer Elliott, Chairman
Board of Trustees
Kentucky Retirement Systems
Perimeter Park West
1260 Louisville Road
Frankfort, Kentucky 40601

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

Dear Ms. Elliott:

We have completed our examination of certain controls and management practices of the Kentucky Retirement Systems (KRS). The enclosed report presents, in total, 21 findings and offers 92 recommendations to strengthen KRS' controls and management oversight procedures.

Examination procedures included interviews of current and former KRS Board members, current and former KRS staff members, KRS consultants, and others. In conjunction with a review of applicable KRS policies and procedures, a sample of travel voucher reimbursements and procurement card purchases was examined to determine whether expenditures were appropriate and made in compliance with KRS policies. Our examination also included a review of the KRS Internal Auditor's draft report relating to placement agents. Our examination included records and information for the period July 1, 2007 through June 30, 2010, unless otherwise specified. The objectives developed by the Auditor of Public Accounts for this examination include:

- Evaluate various KRS policies, internal controls, and other aspects of the KRS operation;
- Ensure the transparent, efficient use of financial resources; and
- Make recommendations to strengthen and improve internal controls, as well as the oversight and operations of KRS.

Specific items scrutinized in the examination include: policies governing the internal audit process, staff reporting to the KRS Board, business conduct, conflict of interest, ethics policies, the use of placement agents at KRS, certain procurement policies, and the adequacy of current audits and financial reports.



Ms. Elliott
June 28, 2011
Page 2

The purpose of this examination was not to provide an opinion on financial statements or investment decisions, but to ensure that processes are in place to provide strong oversight of financial activity through a review of KRS organization's policies, Board governance, certain internal controls, and other financial transactions.

Due to the nature of certain matters discussed within this report and the ongoing U.S. Securities and Exchange Commission (SEC) "informal inquiry" into KRS, we will refer this report to the SEC's Municipal Securities and Public Pension Unit.

The Auditor of Public Accounts requests a report from KRS on the implementation of audit recommendations within (60) days of the completion of the final report. If you wish to discuss this report further, please contact Brian Lykins, Executive Director of the Office of Technology and Special Audits, or me.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Crit Luallen
Auditor of Public Accounts



Examination of Certain Policies, Procedures, Controls, and Financial Activities of Kentucky Retirement Systems

Examination Objectives

In August 2010, KRS internal auditors presented a draft audit report on the use of placement agents in KRS investments. This report was not approved by the KRS Board of Trustees and was sent back to the KRS Audit Committee for further review. During the September 2010 meeting of the Audit Committee, committee members voted to ask the APA to examine the use of placement agents at KRS rather than having KRS internal audit staff perform additional audit procedures. In an October 5, 2010 letter to the KRS Board Chair, the APA committed to perform a review of certain aspects of KRS. The purpose of this review was to address the following objectives:

- Evaluate various KRS policies, internal controls, and other aspects of the KRS operation;
- Ensure the transparent, efficient use of financial resources; and,
- Make recommendations to strengthen and improve internal controls, as well as the oversight and operations of KRS.

The scope of this review includes records, activities, and information for the period July 2007 through June 2010, unless otherwise specified; however, the time period of certain documents reviewed and various issues discussed with those interviewed may have varied.

Background

KRS administers three retirement systems which are qualified defined benefit plans under Section 401(a) of the Internal Revenue Code. As of June 30, 2010, these three systems served a combined total of 318,981 active, inactive, and retired members. The composition of the members participating in each system is as follows:

- Kentucky Employees Retirement System (KERS) – 123,138;
- County Employees Retirement System (CERS) – 193,690; and,
- State Police Retirement System (SPRS) – 2,153.

Each system offers a defined benefit pension, as well as health insurance benefits, to its participating members. Upon retirement, a defined benefit plan pays lifetime monthly benefits based on a formula established by statute that takes into account an employee's years of service and the highest average compensation of a three or five year period. Under a defined benefit pension plan, public employees are "promised" certain benefits based on years of service and salary amounts. This promise is considered an inviolable contract of the Commonwealth, which cannot be reduced for any current employee or retiree and as such it is protected by state law and also the Kentucky and U.S. Constitutions.

While the retirement contract is inviolable, specific details and calculations have been altered in recent years by the Kentucky General Assembly. Many of these significant changes were included in the Pension Reform Bill from a 2008 Special Session of the legislature, which mostly affected new employees, created: a new benefit tier for employees who began participating in the KRS after September 1, 2008; a one percent health insurance contribution by employees who began participation in the KRS after September 1, 2008; an increase in the number of years required for full retirement for new employees to 30; and new vesting requirements for health care coverage to 10 years. It also instituted a one and one-half percent limit on the annual Cost of Living Adjustment (COLA) for all retirees.

Funding for plan benefits is provided through three sources: the contributions paid by employees, the contributions paid by employers, and the return on investments. Beginning in FY 1993, the General Assembly has not fully funded KERS and SPRS for 12 out of 17 years. The enacted employer contribution rates beginning in FY 2003 for these systems have been consistently and significantly less than the recommended rates, contributing to a decrease in net assets for each plan within the two systems. This situation has resulted in an unfunded liability to meet future retirement costs based on actuarial projection.

In order to help reduce the unfunded liability KRS entered into a contract with the Centers for Medicare and Medicaid Services (CMS) to establish an Employee Group Waiver Plan for pharmacy benefits for Medicare-eligible retirees that led to an immediate reduction of over \$1.7 billion to the unfunded insurance liability for the fiscal year ended June 30, 2009. The General Assembly also passed the Pension Reform Bill during a 2008 Special Session that included a schedule to increase employer contributions each year starting in FY 2011, until reaching the full annual required contribution (ARC) in 2025 for KERS non-hazardous, in 2019 for KERS hazardous, and in 2020 for the SPRS plans.

The KRS Board consists of nine trustees including: three appointed by the Governor, two elected by KERS members and retirees, two elected by CERS members and retirees, one elected by SPRS members and retirees, and the Secretary of the Personnel Cabinet. KRS Board trustees serve a term of four years and cannot serve more than three consecutive terms. The standing committees of the KRS Board include the Administrative Appeals Committee, Disability Appeals Committee, Audit Committee, Investment Committee, Legislative and Budget Committee, Human Resources Committee, and the Retiree Health Plan Committee.

The KRS Board trustees select and hire an Executive Director to administer all KRS programs and oversee approximately 250 KRS employees. KRS Board trustees also select a Chief Investment Officer, who reports directly to the Investment Committee; and a Director of Internal Audit, who reports directly to the Audit Committee.

The assets of KRS are considered trust funds. The trust funds include investment earnings, employee contributions, and employer contributions from agencies that are supported by the General Fund, the Road Fund, Federal Funds, and Restricted Funds. All expenses incurred by KRS, including administrative expenses, are paid from these trust funds. Essentially, the General Assembly transfers the restricted funds budgeted for the operations of KRS in the *Budget of the Commonwealth* from the trust funds held by KRS solely for the benefit of members, retirees, and their beneficiaries. Even though the administrative expenses are included in the *Budget of the Commonwealth*, no General Fund dollars are appropriated to KRS. In fiscal year 2010, KRS had total administrative expenses of \$34,551,000.

APA Board Recommendation Review at KRS

As part of our examination of KRS, we performed a comparison of certain KRS policies, procedures and practices to the APA's "Recommendations for Public and Nonprofit Boards." Through this comparison to the APA's 32 recommendations, we found KRS policies, procedures, and practices generally provide effective structure for the financial oversight of KRS. However, we make recommendations in Chapter 3, Findings and Recommendations, to further strengthen KRS controls and provide for greater Board oversight.

Findings and Recommendations

Placement Agent Findings

The APA found that the use of placement agents was not transparent at KRS. One placement agent worked closely with the former CIO and was involved in numerous KRS investments without the knowledge of other KRS investment staff, KRS management, or the Board. Transparency is needed to ensure that investment decisions are made in the best interests of KRS and not the interests of placement agents or other parties. It was also determined that the payment of placement agent fees by investment managers did not correlate to an increase in the management fees paid by KRS or reduce the funds available to pay benefits to retirees.

Questions have been raised whether it is necessary for placement agents to be involved in KRS investments. SEC allows placement agents to operate in compliance with established SEC rules. Each public pension system must determine whether the involvement of placement agents is acceptable or should be prohibited. Certain investments may be unavailable to organizations that decide to ban investment managers that use placement agents. Therefore, the effect on KRS investment opportunities must be weighed against the risk of involving placement agents and whether this risk can be sufficiently mitigated through policy and monitoring.

Based on the information available to the APA, auditors found no evidence that a "pay-to-play" situation similar to those in other states has occurred at KRS. However, the APA's report will be referred to the SEC, which has the authority to determine if further investigation is warranted.

Finding 1: Former CIO violated KRS Placement Agent Statement of Disclosure Policy.

Related to a KRS investment approved at the September 29, 2009 Investment Committee meeting, the recommendation memo presented by the former CIO did not disclose that a placement agent was involved. The placement agent attended the Investment Committee meeting; however, the former CIO did not introduce him or inform the committee members of the placement agent's role in the investment. KRS approved a commitment to invest up to \$200 million, in \$50 million increments, without the knowledge that a placement agent was used and would be paid a fee by the investment manager. This is a direct violation of the Placement Agent Statement of Disclosure Policy that was adopted by the KRS Investment Committee on August 6, 2009, and ratified by the full Board on August 20, 2009.

Recommendations: We recommend that KRS ensure that all information required by the Placement Agent Statement of Disclosure Policy is presented to the Board of Trustees or a designated committee in a clear and transparent manner. We also recommend that KRS Trustees ensure full compliance with Placement Agent Statement of Disclosure Policy and inquire as to whether there is a placement agent involved in an investment decision. We further recommend that the KRS Internal Audit Division ensure that the criteria used in their findings are based on the actual and complete policy requirement when comparing what should be happening to what is happening and report noncompliance with the policy.

Finding 2: Full disclosure of placement agent information was not obtained by KRS staff as required by the Placement Agent Statement of Disclosure Policy.

Significant disclosure of placement agent information is required by the Placement Agent Statement of Disclosure Policy (Disclosure Policy), adopted by the KRS Board in August 2009. This information was not obtained by KRS staff for an investment approved in September 2009. The Disclosure Policy requires that KRS staff are to obtain a written statement from the investment manager disclosing the use of a placement agent. If a placement agent was used by the investment manager, KRS staff are required to obtain ten specific items of information in writing from the investment manager prior to any investment being made. None of this information was obtained from the investment manager prior to the September 2009 investment being approved by the Investment Committee. After the approval of the investment, the final contract only included four of the required items.

Recommendations: We recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to include a specific party responsible for obtaining the disclosure information from investment managers. This may be specific to the CIO or include other related KRS investment staff. We also recommend that the KRS Legal Office work in conjunction with the KRS investment staff to develop a questionnaire to be distributed to potential investment managers to collect the required placement agent information. We further recommend that the KRS Board revise the Placement Agent Statement of Disclosure Policy to ensure that all items disclosed by an investment manager are presented to the Investment Committee for review and consideration. Investment Committee members should be aware of all requirements in the investment policies to ensure they are enforced and used to guide the work of investment staff as committee members intended. Finally, we recommend that the KRS Board amend the Placement Agent Statement of Disclosure Policy to require the investment manager include political contributions made by the placement agents to any Kentucky official within the prior two years.

Finding 3: Placement agent appears to have acted as a representative of KRS without disclosure to the Investment Committee.

The former KRS CIO worked in conjunction with one placement agent in a manner that lacked transparency and may not have been in the best interests of KRS. This working relationship appears to be different than that of other placement agents that had been in contact with the former CIO and resulted in the placement agent appearing to act as a representative of KRS rather than for the investment managers. This could conflict with the interests of KRS, as the placement agent may encourage an investment based on the placement agent fee received from the investment manager and not whether it was a good investment for KRS. Further concerning, it appears the former CIO did not fully disclose the extent of the placement agent's involvement to the Investment Committee, investment staff, investment consultants, and executive staff. This placement agent was involved in more investments during the former CIO's tenure than any of the other placement agents combined, indicating the possibility of preferential treatment.

Recommendations: We recommend that KRS Investment Committee members ensure that all adopted investment policies are carried out by staff as intended. This can be accomplished by requiring reports and disclosures concerning the activities of investment staff

and KRS contractors as discussed in Findings 2 and 4. Investment Committee members should ensure they are familiar with the adopted policies so that they are able to ask the mandatory questions related to these policies. We also recommend that the KRS Investment Committee and Board strengthen the Placement Agent Statement of Disclosure Policy by establishing guidelines for how the information provided is evaluated. This includes what action to take if a conflict is revealed between the placement agent and KRS staff members or officials. Finally, we recommend to further enhance transparency the General Assembly consider requiring the registration of placement agents as executive agency lobbyists with the Executive Branch Ethics Commission. This action may require expanding the definition of “Executive agency” in KRS 11A.201(6) to include Kentucky Retirement Systems.

Finding 4: A standardized investment recommendation process did not exist under the former CIO.

Prior to adopting additional investment policies in February 2011, KRS investment policies did not include specific guidelines for the type of information that must be presented to Investment Committee members when KRS investment staff submits recommendations for investments. The lack of standardization allowed the former CIO to determine what information would be provided to committee members as part of their review and approval process. This resulted in the Investment Committee not being informed of placement agents, KRS contracted investment consultants not providing recommendations for certain investments, and investment staff concerns not being considered.

Recommendations: We recommend that KRS investment staff and Investment Committee members ensure consistent compliance with all established investment policies. In addition to the information currently required to be presented to the Investment Committee under the addendum to the Transaction Policy for Limited Partnerships, investment staff should include the following information:

- The specific KRS investment policy and strategy associated with the investment and how that investment meets the requirements;
- Which firms were considered as the primary options;
- What steps were undertaken to locate the firms considered and all individuals or firms involved in identifying investment options and their services;

- Any risks associated with the recommended investment and the mitigating factors that allowed the investment to be recommended; and,
- A recommendation from at least one investment consultant on contract with KRS or explanation of why no consultant recommendation could be given.

We also recommend that KRS establish a formal method for investment staff to convey concerns about a potential investment to Investment Committee members when their concerns are not addressed by the recommendation memo. This method should alleviate the concern of reprisal. Investment staff should also be informed to bring concerns to the KRS Division of Internal Audit if possible fraud is suspected.

Internal Audit Findings

A final report draft of the KRS internal audit concerning placement agent involvement in KRS investments was submitted to the KRS Board for approval in August 2010. The draft report contained six findings and provided seven recommendations to KRS. The draft report also included an appendix that listed the placement agents involved in KRS investments over a five year period and their fees paid by investment managers. While the report draft had been approved previously by the Audit Committee, the full KRS Board did not approve the report due to concerns about the internal audit process and the resulting draft report. These concerns included that the report was purposefully delayed or information was withheld and that the audit may have been influenced by outside sources.

To address the concerns, the APA conducted interviews and reviewed extensive documentation and found no evidence to demonstrate that information from the internal audit was withheld, delayed, or otherwise covered up with the purpose of hiding fraud or other wrongdoing. The APA findings related to KRS internal audit involve the procedures used to monitor the internal audit function and ensure that this process maintains its independence from KRS management. Exhibit 3 provides a timeline of events and correspondence affecting the internal audit of placement agents.

Finding 5: Procedures for conducting a special audit that would document the requirements of the Division of Internal Audit or the Audit Committee did not exist.

The current Division of Internal Audit Procedures Manual (Procedures Manual) dictates that the Audit Committee must annually approve the schedule of audits contained in the Annual Audit Plan in May, but it does not contain any procedures on how special audits should be initiated, approved, or conducted. Specifically, the Procedures Manual does not require that the Division of Internal Audit request preapproval or guidance from the KRS Audit Committee on special audits not included in the Annual Audit Plan. The Director of Internal Audit did not inquire as to what procedures to follow in the absence of a documented process, but relied on professional judgment when the former KRS Executive Director requested a review on the use of placement agents. The lack of procedures limited the involvement of the Audit Committee and caused confusion regarding the audit process among Audit Committee members and the Division of the Internal Audit.

Recommendations: We recommend that the KRS Audit Committee develop and approve procedures that document the requirements related to special audits requested by management or external sources. Because the Audit Committee is only required to meet on a quarterly basis, procedures must be developed to guide the day-to-day activities of the Division of Internal Audit. The adopted procedures should state the Audit Committee's process to request and approve special audits, whether preliminary research should be conducted prior to approval, the amount of the Audit Committee's involvement in the audit scope and methodology, the type and method of communicating information to the Audit Committee prior to the completion of the audit, the distribution of the draft audit report, and when a special meeting should be conducted to discuss a special audit. We recommend that the Fraud Management Policy be integrated into the Internal Audit Procedures Manual. See Finding 9 for further discussion.

Finding 6: The involvement of executive staff in the internal audit process diminished the perception of independence within the internal audit function.

The KRS Internal Auditors included the former Executive Director and former General Counsel in the performance of the Placement Agent Audit, potentially compromising the integrity of the audit and creating a perception of a lack of independence in the internal audit function. Internal auditors requested that the

former General Counsel attend three interviews conducted as part of the internal audit process and allowed the former Executive Director to also attend. The former General Counsel also conducted research on a particular placement agent on behalf of the internal auditors. Further, the former Executive Director and former General Counsel were consistently updated on the potential concerns revealed during the fieldwork phase of the Placement Agent Audit, while the Audit Committee was not informed of the specific findings until the final draft report was released. While there is no evidence to demonstrate that either the former General Counsel or the former Executive Director unduly influenced the internal auditors or the audit process, their direct involvement diminished the perception of independence and thus the integrity of the final audit product.

Recommendations: We recommend that the KRS Division of Internal Audit conduct all audit fieldwork in an independent manner separate from the influence of KRS management. Managements' role is to provide the requested documents but it does not include performing audit procedures or evaluating documents, audit findings, or audit conclusions. We also recommend that the Director of Internal Audit retain outside counsel if there is any perceived conflict in the use of the KRS General Counsel for legal assistance, as allowed for under the Audit Committee Charter. Outside counsel also includes the assistance of the Attorney General's Office as allowed for under KRS 61.645(11). We recommend that the Division of Internal Audit operate with the understanding that audit working papers are not subject to the open records law, KRS 61.872, as allowed for in KRS 61.878(1)(i) and (j) and as stated in various Kentucky Attorney General opinions. However, it should be clearly understood that a document already subject to open records that is placed in audit working papers retains its identity as an open record.

Finding 7: KRS does not have a specific budget for the Division of Internal Audit.

The KRS budget does not include a separate line item for the Division of Internal Audit. The lack of a specific budget for internal audit potentially limits the Audit Committee's oversight of the internal audit function and the independence of the internal audit function. The budget for the internal audit function is instead developed by the COO based on discussions with the Director of Internal Audit and then submitted to the Board of Trustees for approval as part of the overall KRS budget. There is no documentation of the amount of funds allocated to the Division of Internal Audit because the KRS budget is compiled by expense category and not by office grouping. In the event that

the Director of Internal Audit assesses a need to expend funds beyond staff and regular supplies, a request must be submitted to the COO. It is then at the discretion of the COO to determine availability of funds under the budget. This reduces the independence of the internal audit function because the executive staff can control Internal Audit's funding.

Recommendations: We recommend that the Audit Committee approve an annual budget of the Division of Internal Audit based on the approved internal audit plan. The Director of Internal Audit should request the amount of funds estimated to conduct the internal audits approved by the Audit Committee. Any additional funding should also be requested by the Director of Internal Audit to the Audit Committee for approval. In addition, budgeted funds should be related to completing or expanding the internal audit plan, such as expenses for external audit assistance, independent counsel, technology upgrades, or other expenditures necessary for the internal audit function to operate as approved by the Audit Committee. Once approved by the Audit Committee, the annual budget for the Division of Internal Audit should be ratified by the full Board of Trustees to be included in the KRS budget by the COO. We also recommend that the budget for the Division of Internal Audit be well documented as a specific item in the KRS budget. The amounts available should be clearly budgeted and used by the KRS Audit Committee as a planning tool to monitor the resources that are available for the internal audit function.

Finding 8: The former Executive Director was involved in performing the evaluation of the Director of Internal Audit and did not include the full Audit Committee as required by the Internal Audit Procedures Manual.

The Director of Internal Audit has not received a performance evaluation by the full Audit Committee as required by the Division of Internal Audit Procedures Manual. Instead, evaluations were conducted by the former Chair of the Audit Committee and the former KRS Executive Director. This current practice is not in keeping with the Procedures Manual and is counter to the intentions of the Audit Committee Charter and infringes upon the independence of the Internal Audit function at KRS.

Recommendations: We recommend that the full Audit Committee of the Board of Trustees participate in the evaluation of the Director of Internal Audit as required by the Internal Audit Procedures Manual. Members of the Audit Committee may seek input from the Executive Director or any other appropriate KRS staff,

but only Audit Committee members should be directly involved in the evaluation meeting with the Director of Internal Audit. The opinions of KRS management should be tempered by the fact that the Audit Committee and the Director of Internal Audit are responsible for evaluating KRS operations.

KRS Board Governance and Operational Policy Findings

Finding 9: KRS policy allows management to insert itself into the fraud investigation process.

KRS approved the Fraud Management Policy on May 21, 2009, that addresses allegations of fraud and illegal acts, but the required procedures mainly involve executive management and provide for only minimal input from the Audit Committee. While these procedures have never been used, inserting management into key steps of the fraud investigation process, such as determining who would participate in the investigation, management is aware of the potential fraud and the investigation findings prior to the presentation of the report to the Audit Committee. Management involvement potentially compromises the independence of the fraud investigation process. Similar to other internal audit investigations, independence from management is needed to protect the integrity of the fraud investigation process.

Recommendations: We recommend KRS revise its current Fraud Management Policy to remove the requirement of an investigative team and incorporate the Fraud Management Policy fully under the internal audit function. We recommend the Audit Committee determine whether to conduct a formal investigation based on the recommendations of the Director of Internal Audit and input from Audit Committee members. We further recommend the Audit Committee determine the process for distributing the draft investigative report. See Finding 5 recommendations.

Finding 10: KRS policies should be strengthened to achieve greater accountability.

Through our evaluation of KRS policies relating to a number of administrative issues, opportunities were identified for KRS to strengthen its policies and achieve greater accountability. KRS policies do not address the timing of when staff or trustees are required to reimburse KRS for any personal expenditure that may have been incurred. KRS also policies do not provide guidelines or maximum amounts for allowable entertainment expenses. KRS ProCard policies do not require supporting documentation of ProCard charges, a deadline for this submission, or a penalty for not

providing support in a timely manner. The 12-month period for conducting an orientation for new Board trustees is too long and it was only conducted by the former Executive Director and the former KRS Board Chair.

Recommendations: We recommend that the KRS Board revise its policies to address the timing of staff or trustee reimbursements to KRS for any personal expenditure that may have been paid by KRS. A stringent deadline should be established, as well as, the actions taken for those that do not comply with this policy. We recommend that the KRS Board revise its policies to establish guidelines and limits on spending for the purpose of entertainment. The policy should clearly define the circumstances when it is appropriate to incur such expenses, the purpose for the expenses, and the maximum purchase amount allowed. We also recommend that the KRS Board revise its ProCard policy to require ProCard holders to submit invoices and any other documentation necessary to support the charges made. The policy should also establish a specified amount of time allowed for this submission and the actions that will be taken for those that violate the policy. We finally recommend that the KRS Board revise its new trustee orientation policy to require that it is performed within the first months of the trustee's service on the Board. The policy should require that the orientation be facilitated by a knowledgeable, independent party, such as a Board attorney or consultant with an emphasis on the legal and fiduciary responsibilities of Board trustees. The Board should consider requiring presentations by the CIO and other director level personnel as part of the orientation as well.

Finding 11: KRS did not consistently comply with its travel policies

During this examination, we requested and reviewed a sample of KRS travel vouchers for the period July 1, 2007 through June 30, 2010. The samples included all travel of KRS Board trustees, Executive Directors, General Counsels, COO, former CIO, and all Investment Directors. The auditor's review of this sample did not find excessive levels of spending on travel; however, we determined that KRS did not consistently enforce its travel policies related to obtaining pre-approvals for travel and consideration of the most economical accommodations.

Recommendations: We recommend that KRS enforce its policy requiring pre-approval for travel and the reviewer consider whether lodging is the most economical for the location. Any travel expenditures incurred without proper pre-authorization should be

brought to the attention of the KRS Board for determination as to the appropriateness of the trip and related expenses. We recommend that the KRS Board revise its travel policies to require that Request for Travel forms be submitted along with the travel vouchers to ensure that employees only receive reimbursement for the business related expenses that were pre-approved. We recommend that KRS revise its Request for Travel forms to include a space for the Executive Director or his designee to document the date of approval.

Finding 12: KRS policies did not require all members of the executive staff, including the Chief Investments Officer, to complete a conflict of interest statement.

The KRS Conflict of Interest and Confidentiality Policy Section 4 (1) requires the Executive Director and KRS Board trustees to complete a written conflict of interest statement. While other KRS policies that apply to the KRS Board and Executive Director also apply to executive staff, including the CIO and General Counsel, the conflict of interest and confidentiality policy does not.

Recommendations: We recommend the KRS Board revise its conflict of interest policy to include, at a minimum, a requirement for the CIO, Investment Directors, and General Counsel to file an annual written conflict of interest statement. We further recommend the KRS Board expand upon its conflict of interest statement to allow for an actual listing of relationships or actions that may cause a potential conflict. The form should identify the types of relationships and actions that should be disclosed, such as investments, past work relationships, political contributions, speaking engagements, gifts, or other potential conflicts of interest that may be of possible interest to KRS. This form should allow the individuals to provide a brief description of the relationship or action listed and should be regularly updated by individuals as their circumstances change.

Finding 13: The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violating the policy.

In 2009, an active trustee inquired about jobs with KRS investment contractors and informed the media of a planned investment manager contract termination prior to the KRS Board meeting. To address these actions, the former KRS Board Chair removed this trustee from the Investment Committee and filed a formal complaint with the Executive Branch Ethics Commission (Commission); however, these actions are not

documented in the KRS Board minutes. The KRS Conflict of Interest and Confidentiality Policy does not specify a penalty for violations. Without a stated penalty for violating this policy, it is difficult for the KRS Board to openly discuss the issue and to determine the appropriate response to a violation of the policy.

Recommendations: We recommend that KRS Board trustees comply with all KRS Board policies and not use the trustee position to improve his or her professional interest. If the trustee's career is in the investment industry, extra caution is necessary to avoid the appearance of conflicts. We recommend trustees follow the KRS Board bylaws to refer all news media inquiries to the Executive Director and do not discuss matters that affect KRS or the Board generally with the news media. We also recommend that the KRS Board revise its Conflict of Interest and Confidentiality Policy to include specific penalties or a process to be followed when a trustee is found to have violated policy requirements or bylaws. We further recommend that trustee disciplinary actions taken as a result of policy violations be disclosed during a public KRS Board meeting and that the action be documented in the Board meeting minutes.

Finding 14: KRS Procurement Policy authorizes KRS to spend funds for employee prizes, gifts and service awards.

Testing a sample of KRS ProCard transactions for the period July 1, 2007 through December 31, 2010, revealed that KRS routinely purchased employee retirement gifts, prizes, and service awards for its staff. This practice is allowed by the KRS Procurement Policy and is exempted from competitive sealed bids. Regardless of whether KRS complied with its policy, these purchases are personal in nature and are not a necessary business expense that provides benefit to KRS members.

Recommendations: We recommend that the KRS Board revise its procurement policies to no longer allow pension funds to be spent on monthly prizes. In lieu of using pension funds for retirement gifts, receptions, or other service recognition awards, KRS employees should be limited to receiving a certificate or plaque. If KRS staff would like to continue providing these awards, prizes or gifts, the expense should be collected from personal funds rather than at the expense of KRS members.

Finding 15: KRS had no established method for employees and citizens to anonymously report concerns.

The KRS Fraud Management Policy established on May 21, 2009, did not include a process for individuals

outside of KRS, such as citizens and contractors, to anonymously report concerns pertaining to potential fraud, waste, or abuse within KRS. The process established through the Fraud Management Policy is very specific to employees and how they may report matters through the structural hierarchy of KRS, with certain exceptions if reporting to a specific individual would create a conflict of interest. While this policy does state, "[t]he identity of any reporting individual and/or suspected individual will be kept confidential to the extent possible," the policy does not outline a means by which an employee or other individuals may report concerns without having to share any personal information.

Recommendations: We recommend the KRS Board create a multifaceted process through which KRS and its Board can effectively receive anonymous reports from individuals within and outside of its organization. While this may be accomplished through revising its current Fraud Management Policy, the expanded policy should ensure that the process is sufficiently independent to offset any risk of internal influence over the fraud investigation process. See Finding 9. We further recommend the KRS Board ensure that the process for anonymously reporting concerns is formally documented in KRS policies and properly disseminated to its employees and made available the public. The information should be easily accessible through the KRS internet website. We also recommend KRS consider including this information when issuing newsletters to its members. We finally recommend that the KRS Board include additional language in its policy to clearly document the employee protections that are available under the Kentucky Whistleblower Act.

Finding 16: Routine reporting to the Board is not sufficient.

While the KRS Board receives information from individuals and groups both inside and outside of its organization, certain operational information was not routinely reported, or in some cases was not reported at all. KRS staff does not routinely report budget-to-actual information to the KRS Board. The KRS Board is also not presented with any information related to investment expenditures, which includes the travel expenses incurred by KRS Investment staff. The KRS Board was also not aware of the actual salaries being paid to staff until recently and only approved the KRS salary structure, annual pay raises, and incremental increases for KRS staff at the organizational level. In addition, it was found that healthcare administrative expenses are not included in the budget provided to the KRS Board or the General Assembly.

Recommendations: We recommend that KRS include the administrative costs to operate the health insurance portion of the retirement system in the KRS budget that is approved by the Board and General Assembly. We recommend that the KRS Board require staff to provide to the Board quarterly budget-to-actual expenditure reports. This report should be detailed by budget line item and should include an explanation for significant variances. We also recommend that the KRS Board require staff to provide to the Board quarterly investment expenditure reports. This report should present investment costs by expense category so that specific investment activities can be monitored by the KRS Board. Expenses paid from the pension and insurance fund should be monitored by the KRS Board. We further recommend that the KRS Board require staff to provide to the Board an annual report of executive staff salaries. The report should provide their salaries for a three-year period to allow for comparative data and fully disclose salary data. The KRS Board should request additional salary data on all KRS staff as needed in their review of the KRS salary structure.

Finding 17: KRS does not budget for investment administrative expenditures such as travel, education, and conferences.

KRS budgets for general administrative expenses; however, direct investment expenses are not included in the KRS budget approved by the KRS Board. By not including the investment expenses in the budget process, these expenses are not presented within specific activity categories. In addition, KRS does not maintain a comprehensive list of investment travel and meetings that could document the necessity and effectiveness of the costs incurred. Investment costs are allocated as expenditures from both the pension and insurance funds but only limited monitoring can be conducted by the KRS Board and its Investment Committee.

Recommendations: We recommend the KRS Board adopt a budget that includes certain investment related expenses such as travel, education, and conferences that are not already included in the KRS budget. This budget should be monitored by the KRS Board to document their awareness of the funds used for investment purposes. We also recommend KRS staff provide regular quarterly reports to the KRS Investment Committee and full Board of budget to actual investment expenditures. The reports should be formatted in a clear and concise manner to facilitate the committee members' review of these expenditures made from various pension and insurance funds. We also recommend that KRS ensure that personal trips

taken in association with business travel be clearly identified and that leave balances be reduced as appropriate. The purpose of the daily travel, as stated on the travel voucher, should be an accurate and concise representation of the traveler's activity on that day. In addition, we recommend that KRS create a consolidated database to formally document meetings and costs incurred by KRS investment personnel. Staff should be appointed to record this information and maintain the database. Information on meetings, either local or out-of-state, should be provided in advance to ensure that all meetings are known and documented. The actual costs incurred for a meeting should be recorded in the database so that a complete record is maintained for monitoring and budget purposes. We further recommend that KRS provide regular reporting to its Investment Committee members detailing the investment meetings conducted and the costs incurred by KRS investment staff, including the CIO. This report should contain the date of the meeting, the purpose, the location, and the associated costs. This report should be presented for informational purposes to allow for discussion of the effectiveness of the meeting and to ensure additional accountability and transparency.

Finding 18: KRS Board meeting minutes were not completed in accordance with the Board bylaws.

In reviewing KRS Board meeting minutes for the period July 1, 2007 through December 30, 2010, we found several instances of meeting minutes not presented or amended in a timely manner as required under the Board's bylaws. The KRS Board of Trustees Statement of Bylaws and Committee Organization states, "[t]he Executive Director shall cause the minutes to be transcribed and presented for approval or amendment at the next regular meeting." During the time period under review, approximately nine out of 28 full KRS Board meetings and seven out of 22 Investment Committee meetings did not have the minutes transcribed, presented, or amended by the next regular meeting of those bodies.

Recommendations: We recommend that KRS staff ensure that KRS Board meetings and its committee meetings are transcribed in a timely manner as prescribed and required by the KRS Board bylaws. The appropriate number of KRS staff should be assigned the responsibility of transcribing the meeting minutes to ensure that there is adequate coverage based on the number and length of full KRS Board and committee meetings. The internal review process of the draft meeting minutes should also be evaluated to ensure that an effective and timely process is in place.

Finding 19: The KRS Board election and appointment process is inconsistent.

A review of KRS Board trustee requirements identified opportunities to make the KRS Board trustee election and appointment processes stronger and more consistent. Processes that could be strengthened include the application process, assurance of trustee qualifications, and disclosure of relevant information to members.

Recommendations: We recommend the same disclosure requirements and application process be followed for both appointed and elected KRS Board trustees. At a minimum, these requirements should include a current and detailed resume, a cover letter detailing the applicant’s specific qualifications to be an effective KRS Board trustee, authorization for a background check, acknowledgement of any felonies, and a formal application. We recommend this information be provided by potential appointees and election candidates at the initiation of the application process or election process. To ensure a consistent process, we recommend KRS perform a background check of candidates for elected trustee. This check should be performed and the results distributed to the KRS trustees prior to considering candidates that will be placed on the election ballot. We recommend that the KRS Board document background, experience, and qualifications for each trustee on the website’s “Meet the Board” page.

Finding 20: KRS bylaws do not limit the number of terms an individual may serve as Board Chair or Vice Chair.

The KRS Board bylaws state that the Chair and Vice Chair “may be elected to successive terms in office.” This policy does not specify the number of successive terms that a Board Chair or Vice Chair can serve. The former KRS Board Chair served fourteen consecutive terms as Chair.

Recommendations: We recommend a maximum number of terms be established for an individual to successively serve as Board Chair or Vice Chair. If legislation is not passed, we recommend that the KRS Board vote to limit the terms of the Board Chair and Vice Chair. In selecting the term limit for the Board Chair, a balance is needed to ensure stability but to also rotate the concentration of power held by one individual.

Finding 21: Additional external audit services would assist the KRS Board in strengthening oversight of its operations.

The only type of audits conducted at the request of the KRS Board was a financial statement audit and no

additional audits have been requested. During our review of audits performed of other state’s pension plans, we noted various types of audits conducted that would be beneficial for KRS. Given the current economic condition and the tenuous financial positions of many public pension plans, including KRS, further examinations or reviews could be used to ensure the effectiveness of internal controls, compliance with investment policies, soundness of the internal audit function, and adherence to industry best practices.

Recommendations: We recommend that the KRS Board Audit Committee seek, at least periodically, more than just an external financial statement audit of the retirement system. With additional external audit services, the Board could obtain a more in-depth analysis of any function or aspect of the retirement system (administrative, investment, or benefit delivery), comparison of policies to practice, and gain valuable insight into how operations might be improved as well the best practices identified in other states.

Chapter 3

Findings and Recommendations

Introduction to Internal Audit Findings

The KRS Division of Internal Audit was established in 2007 with the task of providing an “independent appraisal of the various operations and systems of control within Kentucky Retirement Systems.” The Audit Committee of the KRS Board oversees the actions of this division. An annual audit plan is developed and submitted to the Audit Committee that includes regular audits of the administrative functions within KRS. According to the Division of Internal Audit Charter, auditors may also undertake other types of special audits at the request of the Audit Committee or KRS management.

In October 2009, the former KRS Executive Director met with the Director of Internal Audit to request an internal audit related to the involvement of placement agents within the KRS investment process. According to a memorandum from the Division of Internal Audit to the KRS Board dated January 15, 2010, the goal of the internal audit was to “look back at the relationships we have had with placement agents in order to have a better understanding of the role placement agents’ play, the level of their involvement in KRS and the degree they were involved within our asset classes.”

A final report draft with the response from KRS management was submitted to the Audit Committee on August 17, 2010. The draft report contained six findings and provided seven recommendations to KRS. The draft report also included an appendix that listed the placement agents involved in KRS investments over a five year period and their fees paid by investment managers. See Exhibit 1 for a copy of this draft report, including the KRS management response. However, many of the placement agent fees included in the draft report have since been updated by KRS staff.

Upon submission of the draft audit report, the Audit Committee approved the document and sent it to the full KRS Board for further approval. The Board did not approve the draft report and sent the audit back to the Audit Committee due to concerns regarding the internal audit process and the resulting draft report. The concerns expressed at the full KRS Board meeting and the subsequent Audit Committee meeting included the following:

- The audit process was conducted without full disclosure to the Board and the Audit Committee;
- The audit process may have been influenced by outside sources;
- Information found during the audit was withheld from some trustees;
- The release of the audit may have been purposefully delayed; and,
- The internal audit did not fully explore certain issues.

To address these concerns, the APA responded to requests to review certain issues at KRS and initiated an examination. During our examination, we interviewed the KRS internal auditors, reviewed the internal audit documentation, and conducted interviews with current and past KRS Board trustees, executive management, an extensive list of other KRS staff, and outside sources. We also reviewed internal audit email correspondence concerning the placement agent audit and conducted further research related to placement agents. The APA review found no evidence to demonstrate that information from the internal audit was withheld, delayed, or otherwise covered up with the purpose of hiding fraud or other wrongdoing.

The APA findings related to KRS internal audit involve the procedures used to monitor the internal audit function and ensure that this process maintains its independence from KRS management. Specifically, the Audit Committee had not established any specific procedures for conducting a special audit, which resulted in the internal auditors having flexibility in the process. This flexibility resulted in the involvement of executive staff in some audit procedures, which gave the executive staff greater access to preliminary audit information than the members of the Audit Committee. While there is no evidence that executive staff involvement hindered the audit procedures or conclusions, their involvement negatively affects the perception of independence that should be maintained by the internal auditors. The accompanying recommendations are designed to ensure that the Audit Committee adequately monitors the KRS internal audit function so that its independence from KRS management can be maintained.

Exhibit 3 provides a timeline of events and correspondence affecting the internal audit of placement agents. This timeline identifies when the internal auditors received any preliminary information, what information was provided to the KRS Board, and when audit work was completed. It also contains the instances in which the executive staff members were involved in the audit process and when the internal auditors provided information to KRS Board trustees.

**Finding 5:
Procedures for
conducting a
special audit that
would document
the requirements
of the Division of
Internal Audit or
the Audit
Committee did not
exist.**

The current Division of Internal Audit Procedures Manual (Procedures Manual) dictates that the Audit Committee must annually approve the schedule of audits contained in the Annual Audit Plan in May, but it does not contain any procedures on how special audits should be initiated, approved, or conducted. Specifically, the Procedures Manual does not require that the Division of Internal Audit request preapproval or guidance from the KRS Audit Committee on special audits not included in the Annual Audit Plan. The Director of Internal Audit did not inquire as to what procedures to follow in the absence of a documented process, but relied on professional judgment when the former KRS Executive Director requested a review on the use of placement agents. The lack of procedures limited the involvement of the Audit Committee and caused confusion regarding the audit process among Audit Committee members and the Division of the Internal Audit.

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The Procedures Manual defines a variety of special audits that may be carried out by the Division of Internal Audit. These include information technology audits, investigative audits, management audits, and performance audits. While there is a definition as to why these audits would be performed and their purpose, there are no procedures associated with the actual conduct of these audits. There are no procedures that discuss the level of Audit Committee involvement in the approval process or the development of audit scope.

According to the KRS Audit Committee's Charter, the Audit Committee has the responsibility "to institute and oversee special investigations." However, this responsibility is not reflected in the Procedures Manual so there were no procedures that required the Audit Committee to approve the Placement Agent Audit prior to its initiation.

In the absence of an established policy or procedure to convey the expectations of the Audit Committee concerning special audits, the Division of Internal Audit developed a process for the Placement Agent Audit based solely on judgment. Regarding the communication of audit results, the internal auditors followed the standard process required for audits already approved within the Annual Audit Plan. However, additional steps were taken to notify the Audit Committee of actions taken and the preliminary data received. In addition, the former Chair of the Audit Committee was also provided with a summary of findings prior to the report draft.

The Placement Agent Audit was initiated by a request from the former Executive Director to the Director of Internal Audit at the end of October 2009. This request was not presented to the Audit Committee at their next regularly scheduled meeting on November 5, 2009, but there may not have been sufficient time to perform preliminary research for a presentation to the Audit Committee. By November 24, 2009, the scope and audit plan had been developed but the Audit Committee was not informed of the Placement Agent Audit until the next scheduled quarterly meeting on February 4, 2010.

The initial presentation of the Placement Agent Audit included a memorandum that disclosed the general scope of the audit and the work conducted up to that time. A spreadsheet was attached to the memorandum titled, Placement Agent Used During Engagement, that listed the names of placement agents that were associated with KRS investment managers. This information did not include the fees paid to the placement agents by the investment managers because not all of the information was available until February 26, 2010. During this initial presentation, the Director of Internal Audit did not request approval or further guidance for the audit, but the Audit Committee members asked few questions and provided no feedback.

When the placement agent information being collected was complete, the internal auditors noted that one placement agent appeared more than any other during the tenure of the former CIO. Based on the potential risk of any preferential treatment, additional audit steps were developed. This included interviews with pertinent KRS staff, KRS investment consultants, and the placement agent in question. During this process, the former KRS Executive Director and former General Counsel participated in some interviews and research. While this is not a violation of policy or procedure, the impact this had upon the independence of the internal audit function is discussed further in Finding 6.

On April 27, 2010, the additional audit work was completed and the Division of Internal Audit began formulating findings. After the May 4, 2010 Investment Committee meeting was adjourned, the former Chairs of the Investment and Audit Committees were privately informed of the audit findings. At the May 13, 2010 meeting of the Audit Committee, members were notified that work on the audit was still ongoing, but no specific findings or preliminary information was presented. While additional audit procedures could have been taken, such as requesting email information related to the former CIO, this was not discussed with the Audit Committee; however, committee members did not ask questions concerning the extent of the progress of the audit or the potential findings.

Per the Procedures Manual, the standard audit process is to draft the report and receive management's response prior to providing the report draft to the Audit Committee. After receiving management's response to the final draft of the audit on July 12, 2010, the report was sent to the Audit Committee as well as the Investment Committee. The Investment Committee received the draft because the Division of Internal Audit was requesting a management comment related to the committee's oversight of KRS investments. Due to scheduling, the Investment Committee meeting was held before the Audit Committee's meeting, which gave the Investment Committee members an opportunity to discuss the report before it was discussed with the Audit Committee.

At the August 17, 2010 Audit Committee meeting, the report draft was presented for discussion and approval. At this meeting, Audit Committee members raised a number of concerns about the process in which information from the audit was disseminated to trustees. While internal auditors could have taken certain steps to more fully discuss the audit with the Audit Committee during the audit process, by not establishing more specific procedures, it was the Audit Committee that allowed the Division of Internal Audit the flexibility to develop the audit scope and determine what process to follow.

The manner in which the audit process was performed was not a violation of the Division of Internal Audit Charter or the Procedures Manual. However, had the internal audit procedures required the Director of Internal Audit to bring information regarding potential conflicts of interest or unethical practices directly to the Audit Committee, the actions of the former CIO and a placement agent that should have been disclosed may have been more fully examined. These actions are identified in Findings 1 through 3 of our audit report. This could have resulted in changes to the investment policy and potential personnel actions in connection with the former CIO, who resigned on June 24, 2010, which was prior to the presentation of the final report draft.

Recommendations

We recommend that the KRS Audit Committee develop and approve procedures that document the requirements related to special audits requested by management or external sources. Because the Audit Committee is only required to meet on a quarterly basis, procedures must be developed to guide the day-to-day activities of the Division of Internal Audit. The adopted procedures should state the Audit Committee's process to request and approve special audits, whether preliminary research should be conducted prior to approval, the amount of the Audit Committee's involvement in the audit scope and methodology, the type and method of communicating information to the Audit Committee prior to the completion of the audit, the distribution of the draft audit report, and when a special meeting should be conducted to discuss a special audit.

We recommend that the Fraud Management Policy be integrated into the Internal Audit Procedures Manual. See Finding 9 for further discussion.

Finding 6: The involvement of executive staff in the internal audit process diminished the perception of independence within the internal audit function.

The KRS Internal Auditors included the former Executive Director and former General Counsel in the performance of the Placement Agent Audit, potentially compromising the integrity of the audit and creating a perception of a lack of independence in the internal audit function. Internal auditors requested that the former General Counsel attend three interviews conducted as part of the internal audit process and allowed the former Executive Director to also attend. The former General Counsel also conducted research on a particular placement agent on behalf of the internal auditors. Further, the former Executive Director and former General Counsel were consistently updated on the potential concerns revealed during the fieldwork phase of the Placement Agent Audit, while the Audit Committee was not informed of the specific findings until the final draft report was released. While there is no evidence to demonstrate that either the former General Counsel or the former Executive Director unduly influenced the internal auditors or the audit process, their direct involvement diminished the perception of independence and thus the integrity of the final audit product.

During the Placement Agent Audit conducted by the KRS Internal Audit, additional audit work was performed when it was found that one placement agent had been involved in more investments than any other placement agent during the tenure of the former CIO. The internal auditors determined that interviews were needed with the former CIO, the KRS Director of Alternative Investments, the identified placement agent, and two investment consultants retained by KRS on contract. While the former CIO and the Director of Alternative Investments were interviewed by an internal audit staff member only, the other three interviews included the former General Counsel and the former Executive Director. According to the Director of Internal Audit, executive staff were included to emphasize the importance of the interviews to KRS.

Based on a previous position with another agency, the Director of Internal Audit had the perception that internal audit working papers were subject to an open records request under KRS 61.872. It was then rationalized by the Director of Internal Audit that including the former General Counsel in the audit process would protect certain documents from open records requests due to attorney-client privilege. However, the Director's concern for protecting audit working papers is not necessary due to exemptions under KRS 61.878(1)(i) and (j), which has been interpreted by the Kentucky Attorney General in several opinions to apply to audit working papers.

According to both internal auditors that conducted the Placement Agent Audit, neither the former Executive Director nor the former General Counsel hindered their ability to ask questions during the three interviews. It was also conveyed by the internal auditors that the former Executive Director did not ask questions during the interview and was primarily there to listen. Based on a comparison of the questions prepared by the internal auditors prior to the interviews with the notes from the meetings, it does appear all of the planned questions were asked. However, the extent to which the presence of the executive staff affected the responses of those interviewed or the internal auditors' additional follow-up questions cannot be known.

The internal auditors also requested the former General Counsel conduct research on the placement agent in question to determine if there were any connections to potential "pay-to-play" arrangements. According to internal auditors, this was due to the former General Counsel having the only access to certain legal databases. However, the internal auditors should have worked in conjunction with him to direct his actions or requested access to the information to perform the work themselves. There was no written request from the internal auditors stating the scope of the research, nor was there a summary of the work completed. The audit documentation does include the results of searches conducted, but the former General Counsel stated that minimal documentation of these searches was available because most resulted in no returns. To confirm the conclusions of the former General Counsel, this work was re-performed by the APA.

While the internal auditors should have access to assistance from legal counsel, the General Counsel could not be considered independent from the investment process. The General Counsel develops the investment contracts between KRS and investment managers that pay the placement agents. In working with the former CIO to develop these agreements, the former General Counsel played an integral role in documenting and disclosing the final terms in the investment process.

In addition to assisting in the audit work process, the former Executive Director and former General Counsel were included in discussions with the internal auditors about potential findings throughout the Placement Agent Audit. Based on email correspondence, both executive staff members were notified of findings and concerns prior to the Audit Committee being notified. An April 30, 2010 email from the Director of Internal Audit to both the former Executive Director and the former General Counsel indicates that the internal auditor met with these executive staff to discuss the potential findings of the Placement Agent Audit. No records of this meeting are available. While preliminary findings were later reported to the former Chairs of the Audit Committee and Investment Committee on May 4, 2010, the full Audit Committee was not informed of the information known by the executive staff. Another email on June 8, 2010 from the in-charge internal auditor to the former General Counsel states that the draft report is completed and requests a meeting to discuss. As discussed in Finding 5, the Division of Internal Audit followed the standard audit process in which Audit Committee members are not informed of preliminary findings until a final report draft is completed.

Internal Audit did not indicate that including the former Executive Director and former General Counsel hindered or controlled the audit process in any way. However, the involvement of KRS executive staff caused mistrust among the Audit Committee members that rely on the Division of Internal Audit to review management activities.

Recommendations

We recommend that the KRS Division of Internal Audit conduct all audit fieldwork in an independent manner separate from the influence of KRS management. Managements' role is to provide the requested documents but it does not include performing audit procedures or evaluating documents, audit findings, or audit conclusions.

We also recommend that the Director of Internal Audit retain outside counsel if there is any perceived conflict in the use of the KRS General Counsel for legal assistance, as allowed for under the Audit Committee Charter. Outside counsel also includes the assistance of the Attorney General's Office as allowed for under KRS 61.645(11).

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We recommend that the Division of Internal Audit operate with the understanding that audit working papers are not subject to the open records law, KRS 61.872, as allowed for in KRS 61.878(1)(i) and (j) and as stated in various Kentucky Attorney General opinions. However, it should be clearly understood that a document already subject to open records that is placed in audit working papers retains its identity as an open record.

Finding 7: KRS does not have a specific budget for the Division of Internal Audit.

The KRS budget does not include a separate line item for the Division of Internal Audit. The lack of a specific budget for internal audit potentially limits the Audit Committee's oversight of the internal audit function and the independence of the internal audit function. The budget for the internal audit function is instead developed by the COO based on discussions with the Director of Internal Audit and then submitted to the Board of Trustees for approval as part of the overall KRS budget. There is no documentation of the amount of funds allocated to the Division of Internal Audit because the KRS budget is compiled by expense category and not by office grouping. In the event that the Director of Internal Audit assesses a need to expend funds beyond staff and regular supplies, a request must be submitted to the COO. It is then at the discretion of the COO to determine availability of funds under the budget. This reduces the independence of the internal audit function because the executive staff can control Internal Audit's funding.

Under the current budget process, the Audit Committee of the Board of Trustees is not involved in planning or developing a budget proposal specifically for the Division of Internal Audit. Budgetary discussions only occur at meetings of the full Board of Trustees for review and approval. While all members of the Board of Trustees have the opportunity to review the proposed overall budget for KRS, this budget does not specify the exact funding for the Division of Internal Audit.

Without a documented budget allowance based on anticipated workloads and other needs, it is possible for the COO to arbitrarily deny an expenditure request made by the Division of Internal Audit. While a funding request could be denied due to valid budgetary constraints, this ability allows the COO to impact the internal audit function through funding. Without a distinct budget process for the internal audit function that involves the Audit Committee, the COO is in the position to approve or deny additional funding for internal audit.

According to the Division of Internal Audit Charter,

Internal Auditing is an advisory function having independent status within Kentucky Retirement Systems. The Internal Auditor – shall be functionally responsible to the Audit Committee and administratively responsible to the Executive Director and be independent of any other section, branch or officer...

This statement establishes the independence of the internal audit function, as well as the Audit Committee’s responsibility to determine how the Director of Internal Audit functions. In addition, this statement also makes the Executive Director responsible for overseeing the day-to-day administrative tasks of the internal audit function. This responsibility is typically given to management to ensure the individual is complying with other operating policies such as the approval of timesheets and leave requests. These are actions that the Audit Committee members could not oversee at the regular quarterly meetings; however, the oversight of a specific budget for the Division of Internal Audit can be accomplished at quarterly meetings.

As the body established for overseeing the internal audit function on behalf of the Board of Trustees, the Audit Committee’s charter includes a responsibility to “ensure there are no unjustified restrictions or limitations” on Internal Audit. The current budget process restricts the independence of the Division of Internal Audit and diminishes the oversight role of the Audit Committee. There is a potential for restrictions or limitations if KRS executive staff control the funding levels of the Division of Internal Audit. Because the Division of Internal Audit is responsible for evaluating KRS operations, their funding decisions should not be made by staff that are responsible for KRS operations.

Recommendations

We recommend that the Audit Committee approve an annual budget of the Division of Internal Audit based on the approved internal audit plan. The Director of Internal Audit should request the amount of funds estimated to conduct the internal audits approved by the Audit Committee. Any additional funding should also be requested by the Director of Internal Audit to the Audit Committee for approval. In addition, budgeted funds should be related to completing or expanding the internal audit plan, such as expenses for external audit assistance, independent counsel, technology upgrades, or other expenditures necessary for the internal audit function to operate as approved by the Audit Committee. Once approved by the Audit Committee, the annual budget for the Division of Internal Audit should be ratified by the full Board of Trustees to be included in the KRS budget by the COO.

We also recommend that the budget for the Division of Internal Audit be well documented as a specific item in the KRS budget. The amounts available should be clearly budgeted and used by the KRS Audit Committee as a planning tool to monitor the resources that are available for the internal audit function.

Findings and Recommendations

Finding 8: The former Executive Director was involved in performing the evaluation of the Director of Internal Audit and did not include the full Audit Committee as required by the Internal Audit Procedures Manual.

The Director of Internal Audit has not received a performance evaluation by the full Audit Committee as required by the Division of Internal Audit Procedures Manual. Instead, evaluations were conducted by the former Chair of the Audit Committee and the former KRS Executive Director. This current practice is not in keeping with the Procedures Manual and is counter to the intentions of the Audit Committee Charter and infringes upon the independence of the Internal Audit function at KRS.

According to the Division of Internal Audit Procedures Manual, all internal audit staff are to receive the same performance evaluations as other KRS staff. The Director of Internal Audit is responsible for conducting these evaluations while the Audit Committee is to review the Director. The Procedures Manual specifically states that, “the Audit Committee reviews the performance of the Director of Internal Auditing, and the Director reviews staff’s performance.” The procedures do not include the Executive Director in this process. Both the former Executive Director and the Director of Internal Audit signed the Procedures Manual in February 2009 to acknowledge its adoption and should have been aware of this requirement.

The Audit Committee Charter also indicates that it is their responsibility to “review the effectiveness of the internal audit function.” The Executive Director is not included in that responsibility. The purpose of this relationship is to protect the independence of the internal auditing function at KRS.

Within both the Audit Committee Charter and the Charter of the Division of Internal Audit, internal auditing is conceived and intended to be an independent function to evaluate the KRS operations. The Executive Director, who is in charge of KRS operations, should not be involved in the evaluation of the Director of Internal Audit due to the inherent conflict impacting the independence of the internal audit function. Involving the Executive Director in the evaluation of the Internal Auditor can reduce the reliability of the internal audit function.

Recommendations

We recommend that the full Audit Committee of the Board of Trustees participate in the evaluation of the Director of Internal Audit as required by the Internal Audit Procedures Manual. Members of the Audit Committee may seek input from the Executive Director or any other appropriate KRS staff, but only Audit Committee members should be directly involved in the evaluation meeting with the Director of Internal Audit. The opinions of KRS management should be tempered by the fact that the Audit Committee and the Director of Internal Audit are responsible for evaluating KRS operations.

Findings and Recommendations

Introduction to Findings Related to KRS Board Governance and Operational Policies

Findings 9 through 21 relate to KRS Board governance and operational policies, practices, and procedures. These findings primarily resulted from the testing performed when evaluating KRS Board activities and comparing operational policies to the 32 process and control recommendations developed and presented by the APA in the document, “Recommendations for Public and Nonprofit Boards.” Chapter 2 of this report summarizes the results of this review. However, these findings also resulted from the examination of concerns raised during interviews with KRS staff and trustees. The accompanying recommendations are designed to strengthen KRS policies and thus improve the ability of the KRS Board to govern and monitor the organization.

Finding 9: KRS policy allows management to insert itself into the fraud investigation process.

KRS approved the Fraud Management Policy on May 21, 2009, that addresses allegations of fraud and illegal acts, but the required procedures mainly involve executive management and provide for only minimal input from the Audit Committee. While these procedures have never been used, inserting management into key steps of the fraud investigation process, such as determining who would participate in the investigation, management is aware of the potential fraud and the investigation findings prior to the presentation of the report to the Audit Committee. Management involvement potentially compromises the independence of the fraud investigation process. Similar to other internal audit investigations, independence from management is needed to protect the integrity of the fraud investigation process.

The purpose of the policy, according to its introduction, states, “KRS recognizes the need to maintain the public’s confidence and trust in the integrity of KRS and the Commonwealth of Kentucky,” and, individuals who encounter fraudulent or illegal activities “have a right to know that allegations or suspicions of impropriety will be fairly, objectively, and timely investigated.” However, it is questionable whether the policy’s procedures ensure that objectivity can be maintained with executive management involvement.

According to the Fraud Management Policy, the Director of Internal Audit and the General Counsel or designee will jointly review the allegations and make a preliminary determination as to how the investigation should proceed. If together they determine that a full investigation should be conducted, a team will be named to conduct the investigation. The team, referred to in KRS policy as the Fraud Investigation Team, consists of “the Director of Internal Audit or designee, the General Counsel or designee, the Ethics Officer, the Director of Information Security, Human Resources and/or other persons as designated by the Executive Director as appropriate for type of fraud alleged.”

Findings and Recommendations

These procedures allow the Executive Director to designate the members of the Fraud Investigation Team, which could lead to internal influence within the fraud investigation. The process would be strengthened by requiring the Audit Committee to determine the composition of the investigation team. The investigative process should be led by the Director of Internal Audit under the supervision of the Audit Committee, not management. The General Counsel should be consulted on the related legal issues but should not lead the investigation.

After the investigation, the Fraud Management policy states, “the Fraud Investigation Team will prepare a report of its findings for review by the Executive Director, which will then be presented to the Audit Committee at its next regularly scheduled meeting, unless the findings require a special meeting to be scheduled.” However, the policy does not clearly state the purpose of the Executive Director’s review. This policy could easily allow the Executive Director to have direct input into the findings or influence the direction of the findings. The team investigating the issue should report directly to the Audit Committee.

Recommendations We recommend KRS revise its current Fraud Management Policy to remove the requirement of an investigative team and incorporate the Fraud Management Policy fully under the internal audit function.

We recommend the Audit Committee determine whether to conduct a formal investigation based on the recommendations of the Director of Internal Audit and input from Audit Committee members.

We further recommend the Audit Committee determine the process for distributing the draft investigative report. See Finding 5 recommendations.

Finding 10: KRS policies should be strengthened to achieve greater accountability.

Through our evaluation of KRS policies relating to a number of administrative issues, opportunities were identified for KRS to strengthen its policies and achieve greater accountability. In addition to the recommendations related to specific audit findings, there were additional policy weaknesses that should be addressed by the KRS Board. A summary of our policy evaluation is provided in Chapter 2 of this report.

Reimbursements to KRS

KRS policies do not address the timing of when staff or trustees are required to reimburse KRS for any personal expenditure that may have been incurred. A time requirement for the reimbursement of personal expenses would assist KRS in administering a reimbursement policy. The time requirement should be applicable to reimbursements of any ProCard purchases and any charges that were discovered to be personal through the travel voucher review.

Findings and Recommendations

3. Nominal value prizes, such as t-shirts, mugs, writing portfolios, etc, may be awarded to KRS employees on a random basis each month.
4. Periodically, KRS may sponsor “parking lot picnics” or other nominal food gifts in appreciation for the service of KRS employees.
5. These gifts are excluded from the employee’s taxable federal and state income consistent with Internal Revenue Services Publications 525 and 535.

Expenditures for retirement gifts, monthly prizes, and service awards given to KRS employees were reviewed within our sample of ProCard transactions. While retirement gifts included larger ticket items such as a digital camera, a camcorder, and rocking chairs, monthly novelty prizes and service awards included t-shirts and \$25 restaurant gift certificates, respectively.

The expenditures tested complied with the guidelines established through KRS policy. For example, KRS did not exceed the \$200 maximum for two employees that retired with over 20 years of service. Based on our review of ProCard invoices, purchases that exceeded the above policy limits included documentation that the additional amount had been paid from the personal funds of KRS staff and not from KRS agency funds.

Recommendations

We recommend that the KRS Board revise its procurement policies to no longer allow pension funds to be spent on monthly prizes. In lieu of using pension funds for retirement gifts, receptions, or other service recognition awards, KRS employees should be limited to receiving a certificate or plaque. If KRS staff would like to continue providing these awards, prizes or gifts, the expense should be collected from personal funds rather than at the expense of KRS members.

Finding 15: KRS had no established method for employees and citizens to anonymously report concerns.

The KRS Fraud Management Policy established on May 21, 2009, did not include a process for individuals outside of KRS, such as citizens and contractors, to anonymously report concerns pertaining to potential fraud, waste, or abuse within KRS. The process established through the Fraud Management Policy is very specific to employees and how they may report matters through the structural hierarchy of KRS, with certain exceptions if reporting to a specific individual would create a conflict of interest. While this policy does state, “[t]he identity of any reporting individual and/or suspected individual will be kept confidential to the extent possible,” the policy does not outline a means by which an employee or other individuals may report concerns without having to share any personal information.

On May 21, 2009, KRS established a formal written policy documenting the process by which an employee concern of fraud or illegal acts can be reported and the internal process for evaluating and investigating such a concern. Per the KRS Fraud Management policy, if an individual has a concern relating to fraud or an illegal act they should resolve the concern by discussing it with a supervisor or director. If the concern relates to a supervisor or director, then the concern should be discussed with the Executive Director. If the concern relates to the Executive Director then the individual should report the matter to the Director of Internal Audit, and finally, if the matter involves the Director of Internal Audit then the individual should report the concern to the Chair of the Audit Committee.

According to the Director of Internal Audit, the KRS internet website had included, at one time, a means by which individuals could report concerns anonymously to KRS. The website, created in late 2008, provided individuals with the mailing address of the Internal Auditor through which anonymous concerns could be expressed. The KRS website was updated in August 2009, converted from a “dot (.) com” to a “dot (.) gov” website address designation. According to the Director of Internal Audit, the information included on the previous website has gradually been placed on the current website. However, the process to report an anonymous concern has not been included on the new KRS website.

Despite having a specific reference for reporting anonymous concerns on the previous website, employees we interviewed were not aware of an anonymous method for reporting concerns. Further, KRS policies do not include a documented process that would reflect the information that was temporarily made available on its website.

The Board and its organization would benefit from the creation of an anonymous reporting mechanism to allow for anonymity to individuals who wish to report a concern to KRS and its Board. The mechanism established to receive concerns should be multifaceted in that there should be more than one means available to individuals to voice a concern, such as, through a hotline number, an email address easily accessible through its website, and a postal address for receipt of letters or other documentation individuals want to share with KRS to support their concern. The Board would need to designate a person or persons to specifically receive these concerns.

While the current Fraud Management policy does include a statement indicating that individuals acting in good faith in reporting a concern will not be subject to retaliation or reprisal, additional language to clearly document employee protections available under the Kentucky Whistleblower Act would be beneficial. Without direct reference to this act, employees may not be sufficiently aware of their rights.

Findings and Recommendations

Recommendations We recommend the KRS Board create a multifaceted process through which KRS and its Board can effectively receive anonymous reports from individuals within and outside of its organization. While this may be accomplished through revising its current Fraud Management Policy, the expanded policy should ensure that the process is sufficiently independent to offset any risk of internal influence over the fraud investigation process. See Finding 9.

We further recommend the KRS Board ensure that the process for anonymously reporting concerns is formally documented in KRS policies and properly disseminated to its employees and made available the public. The information should be easily accessible through the KRS internet website. We also recommend KRS consider including this information when issuing newsletters to its members.

We finally recommend that the KRS Board include additional language in its policy to clearly document the employee protections that are available under the Kentucky Whistleblower Act.

**Finding 16:
Routine reporting
to the Board is not
sufficient.**

While the KRS Board receives information from individuals and groups both inside and outside of its organization, certain operational information was not routinely reported, or in some cases was not reported at all. From our interviews with KRS Board trustees, one of the consistent comments was that they receive a lot of information. However, the information provided could be more informative and valuable to the KRS Board in providing oversight to the organization.

In addition, it was found that healthcare administrative expenses are not included in the budget provided to the KRS Board or the General Assembly. However, the KRS Comprehensive Annual Financial Report does include healthcare administrative expenses as part of KRS' total administrative expenses. In addition, KRS 61.645(13) requires that all expenditures relating to the administrative operations of the system be contained in the biennial budget request adopted by the General Assembly. According to KRS, only the administrative expenses that are paid from the retirement system's pension funds are presented because contributions for the purpose of paying health benefits must be maintained in the insurance trust funds and not commingled to pay pension benefits. Without affecting the account used to pay expenses, healthcare administrative expenses can be disclosed to the KRS Board and General Assembly to ensure that they are aware of the amount budgeted for the cost of operating the health insurance portion of the retirement system.

*Budget to Actual
Reporting*

KRS staff does not routinely report budget-to-actual information to the KRS Board. According to the COO, who is responsible for the budgeting process, the KRS budget was approved by the Budget Committee and then ratified by the full KRS Board. The COO stated that while the KRS Board did not receive any formal reports of budget-to-actual expenditures, he stated "I routinely tell them where we stand vis-à-vis the approved budget as a whole."

Findings and Recommendations

A term for a Board Chair and Vice Chair is for one year, for the period beginning the first meeting in April until March 31 of the next year. The KRS Board Chair has typically made the committee assignments, selected the Committee Chair, and determined when special meetings are called. Being in the position of Board Chair or Vice Chair for an extended period of time can result in allegiances and familiarities with other trustees and KRS staff that may not be beneficial to KRS as a whole. If this control is not periodically rotated to other trustees, a board can become divisive if there are trustees that feel powerless to make changes.

Recommendations We recommend a maximum number of terms be established for an individual to successively serve as Board Chair or Vice Chair. If legislation is not passed, we recommend that the KRS Board vote to limit the terms of the Board Chair and Vice Chair. In selecting the term limit for the Board Chair, a balance is needed to ensure stability but to also rotate the concentration of power held by one individual.

**Finding 21:
Additional
external audit
services would
assist the KRS
Board in
strengthening
oversight of its
operations.**

The only type of audits conducted at the request of the KRS Board was a financial statement audit and no additional audits have been requested. Several procedures were performed by the APA to evaluate the adequacy of the audits conducted including a comparison to other public pension plan audits relative to audit cost and hours, a review of the KRS request for proposal (RFP) process, and a review of the independent auditor's workpapers. During our review of audits performed of other state's pension plans, we noted various types of audits conducted that would be beneficial for KRS. Given the current economic condition and the tenuous financial positions of many public pension plans, including KRS, further examinations or reviews could be used to ensure the effectiveness of internal controls, compliance with investment policies, soundness of the internal audit function, and adherence to industry best practices.

Our review found no significant differences in the cost and hours of the KRS financial statement audit to the financial statement audits of other state's public pension plans similar to KRS in asset and member levels. Because many retirement systems, including KRS, rely on a third party custodian to assist in the management of the plan's assets, complex investment transactions are booked by the third party. These transactions are included on the third party's financial statements and tested for proper compliance during that organization's financial statement audit, which contributes to a reduced price for the KRS audit.

After a review of the RFP process for a KRS external auditor, we found that the RFP was written adequately to receive and obtain the necessary financial audit services. In addition, the evaluation and scoring of the proposals was documented and complied with requirements.

The working papers of the independent external auditor conducting the FY 2010 financial statement audit were reviewed on location. The audit conclusions were supported by the working papers and the audit procedures performed appear appropriate for a retirement system.

While the KRS financial statement audit was comparable in costs and hours to other states' audits, the KRS Board has not requested any additional audit services. A financial statement audit does not address all management areas that benefit from an independent audit, unless the audit scope is adjusted by the KRS Audit Committee at the time the auditor is engaged. The various types of audits that can be requested by the KRS Board include the following:

Financial Statement Audit – A financial audit done in accordance with government audit standards looks at (1) whether the audited organization's financial statements are fairly presented in accordance with applicable accounting principles, (2) whether there are any significant problems with the organization's internal controls, and (3) whether the organization complied with applicable legal requirements. KRS received this type of audit annually.

Performance Audit - A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Compliance Audit – A compliance audit is undertaken to confirm whether an entity is following the rules and regulations applicable to an activity or practice prescribed by an external agency or authority.

Management Audit – A management audit is an assessment of methods and policies of an organization's management in the administration and the use of resources, tactical and strategic planning, and employee and organizational improvement. The objectives of a management audit are to (1) establish the current level of effectiveness, (2) suggest improvements, and (3) establish standards for future performance.

Special Examinations – Special examinations are performed in response to concerns expressed by interested parties about particular issues or to address specific allegations presented by whistleblowers and concerned citizens.

The audit inquiry sent to other states to facilitate a comparison of audit costs and hours also included a request for the most recent audits conducted of the state's retirement system. Our review of these audits found that certain states conducted more than just the basic financial statement audit for their retirement system. These states and the additional audits are listed in the following table.

Findings and Recommendations

Table 17: Additional Audits Conducted for Other State’s Retirement Systems

State	Additional Audits/Examinations
Illinois	In 2011, a Compliance attestation examination to determine whether the retirement system obligated, expended, received, and used public funds in compliance with the statutes.
Pennsylvania	In 2006, a Performance audit of the retirement system by the State Auditor’s Office and a Fiduciary review of the retirement system by a third party.
Utah	In 2009, a Performance audit comparing administrative and investment costs of the plan to other retirement plans. In 2003, a Performance audit of the investment practices of the retirement system was conducted.
Minnesota	In 2008, an Information Technology audit was conducted of the state retirement system.
Wisconsin	Statutes now require a biennial management audit of the retirement system board.
Oregon	In 2007, a Computer Application Controls review was conducted. In 2004, a Change of Director review was conducted.
Nebraska	In 2006, a Performance audit related to compliance, the PIONEER computer system, and management was conducted.
West Virginia	In 2007, a post audit examination was conducted of the retirement system’s expense fund covering a two-year period.

Source: Auditor of Public Accounts based on information provided from other states through an audit inquiry administered by National Association of State Auditors, Comptrollers and Treasurers.

Recommendations We recommend that the KRS Board Audit Committee seek, at least periodically, more than just an external financial statement audit of the retirement system. With additional external audit services, the Board could obtain a more in-depth analysis of any function or aspect of the retirement system (administrative, investment, or benefit delivery), comparison of policies to practice, and gain valuable insight into how operations might be improved as well the best practices identified in other states.

