COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION

ADMINISTRATIVE EXPENSES PERFORMANCE AUDIT

August 2005

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TRANSMITTAL LETTER

Clifton Gunderson LLP
Certified Public Accountants & Consultants

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of certain administrative expenses of the Colorado Public Employees' Retirement Association (PERA). The audit was conducted pursuant to Section 24-51-204(6), C.R.S., which authorizes the State Auditor to conduct or cause to be conducted financial and performance audits of PERA. The State Auditor contracted with Clifton Gunderson LLP to conduct this performance audit in accordance with *Government Auditing Standards*. This report presents our findings, conclusions, and recommendations, and the responses of PERA.

Clifton Gunderson LLP

Denver, Colorado
August 8, 2005

SECTION 2
RECOMMENDATION SUMMARY

Rec. No.	Page No.	Recommendation	PERA Response	Implementation Date
1	3-7	Enforce gift reporting policy	Agree	August 2005/Ongoing
2	3-7	Reevaluate gift reporting policy	Agree	September 2005
3	3-8	Vendor discounts	Agree	Third Quarter 2005
4	3-8	Disclosure of vendor conflicts of interest	Agree	Fourth Quarter 2005/Ongoing
5	3-10	Evaluate Board education costs	Agree	Continuing
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7	3-15	Improve controls over travel expenses	Agree	Immediately
8	3-16	Revise chart of accounts	Agree	January 1, 2006
9	3-18	Reevaluate budgets and expenses of Board and staff functions	Agree	Ongoing
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14	3-26	Convert car allowance to compensation increase	Agree	September 2005
15	3-27	Provide support and approvals for credit card purchases	Agree	Fourth Quarter 2005
16	3-28	Evaluate criteria for permanently assigning cellular phones	Agree	Fourth Quarter 2005/Ongoing

SECTION 3
PERFORMANCE AUDIT PROCEDURES AND RECOMMENDATIONS

Authority, Purpose, and Scope

This report presents the results of our performance audit of selected administrative areas of the Colorado Public Employees' Retirement Association ("PERA"). We reviewed and compared PERA's practices and policies related to gifts, Board education, travel and related expenses, Board and staff functions, credit cards, automobiles, merit increases and performance-based incentives, employee leave, and cellular phones for the years ended December 31, 2002, 2003, and 2004. The purpose of our performance audit was to review PERA's policies and procedures and related internal controls over these activities and identify areas for improvement. PERA incurs a variety of other administrative expenses that were not included in the scope of this audit such as professional services including actuarial, investment management, and computer system consulting services; equipment rental and services; building rental and utilities; and office supplies. The audit was conducted on behalf of the Office of the State Auditor under the authority of Section 24-51-204(6), C.R.S., which requires the State Auditor to conduct or cause to be conducted financial and performance audits of PERA. The audit was performed in accordance with generally accepted government auditing standards.

A performance audit includes gaining an understanding of the internal controls sufficient to plan the audit and to determine the nature, timing, and extent of the audit procedures to be performed to meet the audit objectives. A performance audit is not designed to provide assurance on internal control or to identify reportable conditions. The engagement was not specifically designed, and should not be relied upon, to identify and disclose all instances of fraud, abuse, defalcations, other illegal acts, or error or similar irregularities, if any, that may exist. However, instances of noncompliance with policies and procedures identified during the audit are presented in our report, along with recommendations where improvements may be beneficial.

In addition, the samples tested during the audit were not selected randomly; therefore, conclusions cannot be drawn related to any areas of expenses based on the error rate of the sample tested.

Overview

The Colorado Public Employees' Retirement Association was established in 1931 and operates under Title 24, Article 51 of the Colorado Revised Statutes. The primary purpose of PERA is to pay retirement benefits to members of the plan. PERA administers cost-sharing multiple-employer defined benefit plans for the State and School Division Trust Fund, Municipal Division Trust Fund and Judicial Division Trust Fund ("Division Trust Funds"). The purpose of the Division Trust Funds is to provide benefits to plan members at retirement or disability, or to their beneficiaries in the event of death. PERA also administers a cost-sharing multiple-employer defined benefit health care plan ("Health Care Trust Fund"), the Life Insurance Reserve, and a multiple-employer Internal Revenue Code Section 401(k) defined contribution plan ("Voluntary Investment Program"). PERA's membership includes approximately 360,000 employees and former employees of affiliated public employers; currently there are approximately 400 employers located throughout the State of Colorado that participate in PERA. As of December 31, 2004, PERA had total net assets of approximately $33.7 billion, of which $32.3

billion, or 96 percent, represents net assets of the Division Trust Funds. Total administrative expenses across all funds were approximately $28.6 million, $31.3 million, and $33.5 million for the years ending December 31, 2002, 2003, and 2004, respectively. In 2004, total administrative expenses represented approximately 0.1 percent of PERA's total net assets as of year end. PERA reports that PERA's administrative costs are comparable with other public pension funds. During 2004, PERA paid benefits of approximately $1.9 billion, of which $1.8 billion represented benefits paid from the Division Trust Funds.

As of December 31, 2004, PERA employed approximately 230 individuals. Responsibility for the organization and administration of the Division Trust Funds, Health Care Trust Fund, Voluntary Investment Program and Insurance Dividend Reserve is placed with the Board of Trustees of PERA, which is composed of 16 Trustees as provided under Section 24-51-203, C.R.S.

Financial Activity

Investments for the Division Trust Funds, the Health Care Trust Fund, and the Life Insurance Reserve are pooled and managed as one portfolio. Investment returns on employee and employer contributions are critical to the financial health of a defined benefit plan. For example, over 70 percent of revenue in 2003 and 2004 came from returns on investments. The table below shows the change in total net assets from 2000 through 2004, as well as the rate of return that PERA received on its investments for each year. This illustrates the relationship between investment performance and the value of the plan's net assets.

	2000	2001	2002	2003	2004
Total Net Assets at Year End (in billions)	$30.9	$28.0	$24.5	$30.2	$33.7
Rate of Return on Investments	0.2%	-7.7%	-11.8%	24.1%	14.1%

In order to determine a plan's ability to meet its obligations to pay benefits in the future, a funding ratio is calculated based on actuarial projections. The funding ratio represents the ratio of the actuarial value of plan assets divided by the plan's actuarial accrued liabilities. Similar to many other pension plans, PERA uses a four-year moving average of market value fluctuations in its actuarial calculation, which results in a "smoothing" effect on the variances of market returns. Thus, the actuarial calculations and the funding ratio for 2004 reflect the poor performance of the market during 2001 and 2002, as well as the good performance in 2003 and 2004.

In recent years, PERA's funding ratio has decreased significantly primarily due to poor returns on investments from 2000 to 2002 and increases in early retirements and purchase of noncovered service. The table below illustrates the decline in the funding ratio of the Division Trust Funds over the past five years.

Trust Fund	2000	2001	2002	2003	2004
State and School Division	104.7%	98.2%	87.9%	75.2%	70.1%
Municipal Division	111.4%	104.3%	93.6%	80.2%	77.2%
Judicial Division	120.2%	109.4%	98.3%	84.0%	81.0%

As of December 31, 2004, the Division Trust Funds had a combined funding ratio of 70.6 percent, indicating that PERA has approximately $.71 in estimated assets available to pay each $1.00 of estimated long-term liabilities. Under Section 24-51-211, C.R.S., a maximum amortization period of forty years is considered to be deemed actuarially sound. PERA's Comprehensive Annual Financial Report ("CAFR") for the year ended December 31, 2004 states that the amortization period for all the Division Trust Funds is "infinite", meaning that the current contribution rates are not sufficient to meet PERA's long term liabilities or the standard under state law to be considered actuarially sound.

While the return on investments is a very significant factor affecting PERA's funding ratio, changes to the contribution rates and the benefit package offered to members can also affect the ratio in the long term. If contribution rates are decreased and benefits are increased, this results in fewer dollars being contributed to fund higher obligations. During the years of strong market performance in the late 1990s and through 2000, the General Assembly enacted a series of changes to the plan that decreased the combined employer contribution rate from 11.4 percent in 1999 to 9.9 percent in 2001. As of December 31, 2004, the rate was 10.15 percent. Benefits were also increased in the years of strong performance. For example, in 1997 the benefit formula was changed to allow a participant with over 20 years of service to earn benefits of 2.5 percent of the individual's highest average monthly salary during the succeeding years, rather than the previous 1.5 percent. In addition, the MatchMaker program began in 2001 but was discontinued in May 2004. From 2000 to 2004, the number of benefit recipients increased from approximately 55,100 to 67,900, or by 23.2 percent.

As noted above, PERA's administrative expenses are relatively small in comparison to the assets under management ($33.5 million in administrative expenses in comparison to $33.7 billion in net assets under management at December 31, 2004). PERA has a fiduciary responsibility to ensure that the funds are spent efficiently and effectively and used prudently in all areas of operations.

Findings and Recommendations

As mentioned earlier, we reviewed PERA's policies and procedures in place over specific administrative areas—gifts, Board education, travel and related expenses, Board and staff functions, credit cards, automobiles, merit increases and performance-based incentives, employee leave, and cellular phones. We determined whether policies and procedures are operating effectively and that expenses are reasonable and necessary. In addition, we assessed whether PERA should consider improvements to policies and procedures.

During the audit, PERA management reported that it performed a comprehensive review of administrative operations beginning in the fall of 2002 and concluding in early 2004. As a result of the review, several new policies were established beginning in 2002 that were intended to improve controls and decrease administrative expenses. We noted decreases in expenses during 2003 and 2004 in a number of areas. However, we identified several areas where PERA could further strengthen controls and contain administrative costs, as discussed below.

Gifts

In recent years, gifts in the investment industry have become a source of concern because of the potential creation of conflicts of interest, excessive influence and inflated fees to the consumer. For example, an investment manager's purchase of gifts, meals, entertainment, and golf games for an investment advisor or consultant can result in undue influence in appearance or fact. The Securities and Exchange Commission ("SEC") and other regulatory bodies indicate that they are beginning to investigate these areas more closely than in the past, including gifts, travel, lodging, and entertainment provided by brokerages related to the institutional trading business. Pension consultants have also received scrutiny. The US Department of Labor recently began enforcing the Labor-Management Reporting and Disclosure Act, originally enacted in 1959, which requires disclosures of any gifts, gratuities, and entertainment used by employers, service providers, union officials and plan trustees that would influence the recipient. A May 2005 SEC staff report examined a selection of pension consultants who advise pension plans and trustees on matters such as identifying investment objectives and restrictions; allocating plan assets; selecting money managers and mutual funds to be offered to plan participants; monitoring money manager performance; and selecting service providers including custodians. The report raised concerns about relationships between pension consultants and money managers, broker dealers, or others that may result in conflicts of interest. The report recommended that pension consultants improve policies and procedures to address these possible conflicts and improve the fulfillment of the pension consultant's fiduciary duty to the pension plan.

PERA has established procedures to inform Trustees of their responsibilities and duties as fiduciaries of the plan and has established policies related to gifts, meals, entertainment, and conflict of interest concerns. The PERA Board of Trustees has a detailed Governance Manual that defines (1) the Board's charter and charters for all Board committees and the Executive Director and (2) Board policies in various areas such as general operations, planning, monitoring and evaluation, education, and member benefits. In addition, the Board has established Standards of Professional and Ethical Conduct for PERA Board Trustees which states, in part, that no Trustee shall "directly or indirectly seek or accept gifts, money, property, bonuses, fees, commissions, gratuities, excessive entertainment or hospitality, expense-paid trips, use of vacation facilities, personal or professional services or any other similar form of consideration from any person, agent, firm, corporation or association with which PERA does or seeks to do business that would influence or appear to influence the conduct of his or her duties." PERA has established similar standards for employees.

PERA requires employees and Trustees to read, complete and sign a conflict of interest and compliance questionnaire on an annual basis. The questionnaire includes specific questions requiring employees to identify gifts or benefits received (i.e. entertainment, meals, etc.) in excess of $100 during the year from a single source unless specifically excluded from reporting. PERA has indicated that this amount was derived in earlier years from thresholds established at the federal level. Exclusions from reporting requirements include attendance at conferences where part of the cost may be underwritten by a conference sponsor and meals are made available to conference attendees.

PERA's investment staff members serve on a variety of limited partnership advisory committees. These limited partnerships are the investment vehicle for the majority of PERA's $6 billion in real estate and alternative investments. Membership on the advisory committee ensures that PERA has input into partnership decisions and is aware of all partnership activities and developments. PERA considers attendance at these meetings or conferences to be directly related to the individual's position within PERA and part of PERA's investment management process. In general, PERA does not consider the costs of such meetings or conferences as individual gifts, but rather as business expenses incurred by the respective limited partnership.

In order to determine if PERA staff and Trustees were in compliance with PERA's Standards of Professional and Ethical Conduct and were appropriately completing the annual Conflict of Interest and Compliance Questionnaire, we obtained a listing of PERA's investment advisors and broker dealers. In mid-May 2005, we requested that the investment advisor or broker dealer provide a detailed list of any and all expenses incurred on behalf of PERA Trustees or staff that would include monetary and non-monetary remuneration (e.g. travel, official functions/meals/events, use of equipment, promotional items, event tickets, clothing and equipment, including indirect expenses for items such as golf and other outings, and any leased vehicles) during the years ended December 31, 2002, 2003, and 2004. We reviewed the responses provided by these vendors to determine whether PERA staff or Trustees had received items described above in excess of $100 from a single source during one year. For Trustees and employees with amounts in excess of this limit, we reviewed the Trustee or staff's Conflict of Interest and Compliance Questionnaire to ensure that the amounts were properly disclosed.

As of the date of our report, we were unable to obtain confirmations from all investment advisors and broker dealers. Of the 48 advisors and broker dealers included on the listing, we obtained responses from 18 advisors or broker dealers, or approximately 38 percent. Of the 18 responses received, instances of monetary and non-monetary remuneration were reported in the amounts of $8,683 in 2002; $11,097 in 2003; and $9,976 in 2004 of which, meals were $2,047, $4,399, and $5,530 in 2002, 2003, and 2004, respectively; entertainment was $3,112, $2,055, and $1,268 in 2002, 2003, and 2004, respectively, and conferences were $3,524, $4,643, and $3,178 in 2002, 2003, and 2004, respectively. PERA does not require that these advisors or broker dealers provide this information as part of their contract. The advisors and broker dealers have indicated that these requests are not customary and expressed difficulty in providing the information requested.

We reviewed the responses received from vendors for amounts in excess of $100 for a single staff member or Trustee. In cases where amounts exceeded $100, we requested that PERA provide a copy of the staff member's or Trustee's Conflict of Interest and Compliance Questionnaire to determine if such amounts were properly reported. During our testing, we noted no deficiencies in the reporting of Trustees; however, nine staff members failed to disclose monetary and non-monetary remuneration in excess of $100 annually from a single source. We noted the following gifts in excess of $100 annually for each employee: 1) sporting event ticket with a value of $116; 2) sporting event tickets with a value of $300; 3) fishing trip, meals and drinks with an estimated value of $240 and $300 (two years); 4) fishing trip, sporting event ticket, meals and drinks with an estimated value of $150 and $300 (two years); 5) ice show, dinner and gifts with an estimated value of $210; 6) ice show, dinner and gifts with an estimated value of $150; 7) ice show, dinner and gifts with an estimated value of $150; 8) sporting event ticket with an estimated value of $200; and 9) dinner and drinks with an estimated value of $250. Each instance is a clear violation of PERA's disclosure policy and accordingly, PERA should take immediate corrective action relative to these employees and ensure that all Trustees and employees understand the importance of complying with this policy. In other cases, investment advisors or broker dealers confirmed that PERA staff or Trustees attended lunches or dinners, obtained gift baskets, greens fees, event tickets, or other similar items; however, none were in excess of the $100 limitation and therefore were not subject to PERA reporting policies. We also noted certain instances in which the investment advisor or broker dealer reported amounts paid on behalf of PERA staff or Trustees for conference fees and related meals.

With respect to overall policies in this area, we reviewed the policies of certain Colorado employers and two retirement systems in other states, noting that generally, the responding entities prohibit the acceptance of monetary and non-monetary remuneration with substantial value, which is similar to PERA's $100 threshold disclosure requirement. However, due to recent concerns over the receipt of monetary or non-monetary remuneration, PERA should immediately reassess its policy. PERA should consider either reducing the threshold for reporting, or it should eliminate the acceptance of all monetary and non-monetary remuneration to avoid the perception of any impropriety

PERA policies allow staff and Trustees to attend conferences, particularly client conferences, where all or a portion of conference fees, meals, and hotel costs are underwritten by vendors. PERA should reevaluate the current policy which allows vendors including custodians, consultants, and limited partnerships to underwrite the cost of conferences and/or related expenses. Non-education travel and related costs paid directly by PERA for Trustees, including attendance at Board meetings, client conferences, and vendor conferences and meetings, were approximately $79,100, $68,600, and $35,600 for the years ended December 31, 2002, 2003, and 2004, respectively. PERA reports that there are generally no conference fees for client conferences and that lodging is often also provided as well. Although we were unable to determine the actual costs incurred by the client conference sponsor, we noted certain instances in which the actual cost was less than our estimated cost of attendance. For example, two Trustees attended a 2003 client conference meeting in Ireland sponsored by the Bank of Ireland, a PERA investment manager. PERA expenses were limited to the cost of transportation, approximately $1,600 for both attendees.

PERA indicates that Trustee attendance at client conferences and due diligence will continue its downward trend, as staff is now responsible for the hire/fire decision for investment managers. If PERA assumes the full cost of staff and Trustee participation in client conferences, expenses in this area would increase as a result. Given current business practices, PERA should ensure that the expenses associated with attendance at such conferences is equal to that charged to other similarly-situated attendees.

PERA has taken steps to ensure that it is aware of potential conflicts of interest that may exist for consultants providing investment advice to the plan. In late 2003, as part of the request for proposal (RFP) process for investment consultants, PERA began requiring that firms responding to the RFP complete a questionnaire designed to identify potential conflicts such as relationships with PERA's investment managers; disclosure of conferences sponsored that PERA Trustees or staff attended; and disclosure of gifts, travel or entertainment provided to any PERA Trustee or staff member. PERA reviews this information when assessing proposals prior to awarding a contract. PERA reports that it keeps updated on potential conflicts that might arise from subsequent events by monitoring the investment industry and gathering information from a variety of sources throughout the course of business. Additionally, PERA now requires investment service providers to formally notify PERA of any significant changes in the nature of their business operations and personnel. The California Public Employees Retirement System has recently enhanced this process by adopting a board policy on consultant conflict of interest disclosures. In addition to requesting and assessing disclosures during the RFP process, the policy requires that staff contact the consultant once a year to obtain updated information on conflict of interests and establishes an annual reporting mechanism to the board investment committee on the disclosures by consultants and actions taken by staff in response. PERA could benefit from formalizing its process related to consultant disclosures and follow up, and by extending the process to include annual reports to the Board of Trustees.

Recommendation No. 1:

PERA should enforce its existing policy that requires staff and Trustees to report monetary and non-monetary remuneration above the $100 annual threshold from a single source and take immediate corrective action in cases where individuals violate this policy.

PERA Response:

Agree. Implementation date: August 2005/Ongoing. Colorado PERA enforces existing policy and those staff members who failed to report have filed amended disclosures. Training for Trustees and staff will be conducted to ensure they understand and comply with the monetary and non-monetary remuneration disclosure policy.

Recommendation No. 2:

PERA should reevaluate its existing policy related to monetary and non-monetary remuneration and lower the reporting threshold or prohibit staff and Trustees from accepting any remuneration regardless of amount. In addition, PERA should select a sample of vendors annually and require them to report such remuneration provided to PERA staff and Trustees.

PERA Response:

Agree. Implementation date: September 2005. In the fall of 2004, the Colorado PERA Board of Trustees reviewed the $100 limit policy for accepting monetary and non-monetary remuneration from external vendors. The Board determined at that time that the $100 limit was appropriate and that it should remain in place.

This recommendation will be referred to the Audit Committee for review. Staff will recommend policy to the Audit Committee requiring annual vendor reports on a sample basis.

Recommendation No. 3:

PERA should ensure that vendors' client conferences and other conferences have not provided PERA a discount on such expenses over and above that provided to similarly-situated entities.

PERA Response:

Agree. Implementation date: Third Quarter 2005. Colorado PERA will begin documenting cost differences between regular attendance and similarly-situated entity attendance at vendor client conferences and meetings when information related to costs is available.

Recommendation No. 4:

PERA should recommend that the Board of Trustees adopt a policy requiring investment consultant conflict of interest disclosures to include disclosing conflicts during the request for proposal process, and report to the Board annually any changes in the conflict of interest disclosures. PERA should assess whether other vendors, such as money managers, should be included in such a policy.

PERA Response:

Agree. Implementation date: Fourth Quarter 2005/Ongoing. Colorado PERA will research the feasibility of recommending a policy to the Board of Trustees that would require conflict of interest disclosures during the RFP and money manager selection processes. It should be noted that the process used for selecting the current investment consultant incorporated an extensive review of the potential for conflict of interest. The current investment consultant has no monetary relationships with any investment service providers.

Regarding the audit finding of Trustee travel to a client conference in Ireland in 2003, it should be noted that this investment manager has since been terminated.

Board Trustee Education

PERA requires that each PERA Board Trustee obtain a general understanding of the role of a Trustee and related governance principles, fiduciary responsibilities, the nature of PERA's business and the associated risks, the legal and legislative environment in which PERA operates, and actuarial and investment principles as well as pension plan design and other benefit programs. The Board establishes educational standards for Trustees, which currently require that new Trustees complete specific courses related to public pensions such as the International Foundation of Employee Benefit Plan's ("IFEBP") New Trustee Institute during the first year of service and the Pension Fund and Investment Management program presented by the Wharton School of Business at the University of Pennsylvania during the second year. The Board's Audit Committee is charged with overseeing any requests for waivers. Subsequent to the first two years, the policy states that Trustees are responsible for "self-evaluating their additional educational needs and obtaining knowledge in specific-needs areas in a controlled manner." PERA provides an assessment form to assist in this process. After the first two years, Trustees are required during each succeeding two-year period to receive at least 20 hours of educational programming at an educational session and report annually on this requirement. Formal written evaluations must be completed for all educational sessions. PERA provides Trustees with access to secured Web-based pages where Trustees can monitor the hours acquired and actual expenses in comparison to individual education budgets.

For the period tested, PERA reported Board education expenses as follows:

	2001/2002	**2003/2004**
Board Education[1]	$ 128,194	$ 102,168

[1] Represents two-year periods of 2001/2002 and 2003/2004.

The Board policy also states that Trustees may attend non-educational functions, which could include legislative hearings, meetings with other state pension funds or review of the activities of PERA's investment managers and custodian bank. These non-education functions are specifically excluded from the education policy, and Board policy requires that attendance must be requested or approved by the Board. Expenses reported above do not include non-education functions. Expenses related to non-educational conferences and travel are recorded in a separate account and included as part of PERA's travel and related expenses.

With respect to the education requirement, each Trustee receives a budget for a two-year period to use for educational purposes including related travel and lodging. For the 2001/2002 period, the Board established a two-year budget of $15,000 for each Trustee. Effective July 1, 2004, the Board changed the reporting period from a calendar year to a July 1/June 30 year. Accordingly, the 2003/2004 education budget period was extended to cover January 1, 2003, through June 30, 2005, or two and a half years. Trustee budgets were adjusted to $15,250, representing $12,000 for two years for continuing Trustees plus an additional $3,250 for the additional six-month period. In 2004, effective for the July 1, 2005/June 30, 2007, budget period, the Board reduced the Trustee education budgets to $12,000 for continuing Trustees, while leaving budgets for new Trustees at $15,000.

We compared actual Board educational expenses incurred on behalf of individual Board Trustees to the two-year budgets. We noted that costs incurred by individual Board Trustees varied significantly during the period under review. For example, while none of the Board Trustees exceeded their individual two-year educational expense budgets, during the 2001/2002 budget period, amounts incurred ranged from $15,000 (100 percent of budget) to $0. During the 2003/2004 budget period, amounts ranged from $15,250 (100 percent of budget) to $0. Trustees who do not incur costs, or incur relatively low costs for education programs meet the 20-hour requirements by utilizing in-house sessions provided by PERA and/or may have occupations that enable them to meet requirements through that environment. The latter situation requires that the Trustee receive a waiver from the Audit Committee to make this substitution. For the periods tested, all Trustees met the 20-hour requirement.

Although we did not obtain sufficient detail on policies from other pension plans to compare to PERA policies, a number of PERA Board Trustees did not require the full amount of the educational budget suggesting that the budgets may be higher than necessary, even considering the reduction to $12,000 for ongoing Trustees. This reduced budget still allows for expenses of approximately $600 per credit hour, including travel and related costs, to meet the 20-hour minimum requirement. PERA may establish other means to lower the costs for Trustee education such as expanding the number of in-house trainings. In any case, the varying backgrounds and levels of experience that Trustees bring to the Board, as well as the length of time served on the Board, should be considered in establishing education budgets. As noted above, PERA has begun to address these issues by providing a larger budget for new Trustees and reducing the budgets for continuing Trustees.

In addition to the testing noted above, we selected 12 transactions in a total amount of $33,448 related to individual Board Trustee educational expenses such as conferences, travel, or other related expenses (2 from 2002, 7 from 2003, and 3 from 2004). For each transaction selected, we traced the check amount to the supporting invoice or receipts and noted whether proper approvals from a PERA official were obtained. We did not note any exceptions related to Board education for transactions selected from 2002 to 2004.

Recommendation No. 5:

PERA should continue to evaluate the reasonable cost of compliance with the Board educational policies, particularly with respect to Trustees that have served for two or more years, and make reductions as appropriate.

PERA Response:

Agree. Implementation date: Continuing. Trustee educational budgets have been, and will continue to be, reviewed biannually by the Board's Compensation and Budget Committee. As part of this process, a comprehensive review of the educational budget requirements, especially for Trustees with more than two years of tenure on the Board, will be performed.

Travel and Related Expenses

PERA incurs travel expenses across all areas of operations. For the past three years, PERA had travel and related expenses as follows:

Category	2002	2003	2004
Auto Mileage Allowance	$ 17,666	$ 15,048	$ 17,224
Airfare	135,291	127,883	102,936
Lodging, Meals and Incidentals	362,373	271,563	269,658
Rental Car	3,217	4,133	3,327
Conference & Meetings	181,902	179,945	146,364
Total Travel & Related Expenses[1]	**$ 700,449**	**$ 598,572**	**$ 539,509**

[1] PERA's Comprehensive Annual Financial Report combines travel with other expenses such as parking, in-house catering, and employee awards under "Travel and local expense" in the Schedule of Administrative Expenses. In 2002 and 2003 PERA-required education was shown as a separate line item; however, as of 2004 this expense was combined with "Travel and local expense."

During the period from 2002 through 2004, travel and related expenses declined from approximately $700,400 to $539,500, or by approximately 23 percent over the three-year period.

Over the three-year period of 2002, 2003, and 2004, the average annual amount and percent of total travel costs incurred by each department within PERA was as follows:

Department/Division	Average Annual Travel Expenses 2002-2004	Average Annual Percent of Total Travel Expenses 2002-2004
Investment Department	$ 238,489	38.92%
Support Services Department	93,865	15.31%
Benefits Department	93,483	15.25%
Board Travel—education	60,938	9.94%
Board Travel—other	45,516	7.43%
Legal Department	25,527	4.17%
Executive Director's Office	21,627	3.53%
Internal Audit Division	13,816	2.25%
Strategy and Innovation	10,151	1.66%
Government Relations	9,430	1.54%
Total Travel	**$ 612,842**	**100.00%**

As shown in the table above, investment activities incurred the largest percentage of travel at 38.92 percent. According to PERA, because approximately 57 percent of the portfolio is managed in-house, travel costs are higher than if the entire portfolio was managed externally. PERA estimates that there are significant savings in overall costs as a result of managing a portion of the portfolio internally. Support Services (accounting, information systems, human resources, property management and fleet services, etc.) represents the second largest percentage at 15.31 percent, and the Benefits Department (services to members including individual benefit counseling, seminars on retirement issues conducted throughout the State, etc.) represents the third largest percentage at 15.25 percent. However, if Board travel-related expenses for educational and other purposes are combined, Board travel would represent 17.37 percent of total travel. Board travel-other consists of costs to attend Board meetings, meetings with firms managing PERA funds, client conferences, and other events that do not meet the education criteria established by the Board. Board education policies and related expenses are discussed earlier in the report.

PERA's policy states that "all expenses incurred . . . [should be] authorized, reasonable, and necessary" for PERA business. Policies permit the reimbursement of staff and Board Trustees for travel-related expenses incurred in connection with PERA business. Such expenses may include lodging, meals, airfare, etc. Policies specifically exclude reimbursement for expenses such as alcohol, traffic violations, companion expenses, entertainment or health club expenses, and others. Mileage is reimbursed at the current rate allowed by the IRS. In advance of the travel, both PERA staff and Trustees are required to complete a travel authorization form estimating travel expenses and obtain the appropriate approvals as specified under PERA's policies. With respect to reimbursement for travel, Trustees are subject to the Board Expense Reimbursement Policy, which is part of the Board's Governance Manual. Except for the approval process, the Board policy follows the same travel policies and guidelines as employee reimbursement policies.

At the beginning of 2004, PERA established a travel booking engine through a corporate account with Expedia. Travel policies and guidelines issued in January 2004 require that air transportation be arranged through the engine for domestic travel or through the PERA travel coordinator for international travel. The policy states that the employee is responsible for selecting the lowest cost option for the business purchase, which generally requires 21 to 14 days advance notice. Staff may also book hotel reservations and car rentals through Expedia; however, staff is not required to use Expedia for these reservations since a lower rate may be obtained as a participant in a conference or meeting. PERA has indicated that under the arrangement with Expedia, certain policy rules have been built into the travel engine such as the lowest airfare requirement, use of economy cars when renting vehicles, and reporting of hotel rates. PERA management receives and reviews quarterly reports that detail exceptions to airfare and car policies and that report hotel rates charged. PERA management discusses the exceptions with staff as necessary.

Upon return from travel, PERA staff and Trustees must submit an expense report, including the travel authorization form, within four weeks of travel and provide receipts for all individual expenses in excess of $25. PERA's policy states that the expense report should include amounts personally paid by the staff member or Trustee, amounts prepaid by PERA such as airfare, and amounts purchased using a PERA credit card.

As indicated previously, PERA has reduced travel and related expenses by approximately 23 percent during the period from 2002 through 2004. During our review of the policies and procedures of certain Colorado employers and retirement systems in two other states, we noted areas for further improving PERA's policies and internal controls.

First, PERA's policies state that the cost of meals should be reasonable and necessary. However, policies do not establish a daily per diem that specifically limits the cost of meals. The employer policies that we reviewed for other pension plans had established some type of limit on these costs. In addition, although statutes specifically state that PERA is not subject to Colorado State Fiscal Rules, the Fiscal Rules provide a model for limiting the cost of meals incurred during travel and apply to all state agencies and institutions of higher education. The Rules limit meal costs to $31 to $51 per day depending upon the metropolitan area visited. During the audit, we reviewed a travel expense summary report prepared during 2004 by PERA's Internal Audit staff. The report compared the cost of meals incurred during travel for the period January through June of 2004 to the State Fiscal Rules meal limitations. The report includes approximately 340 employee travel days in which meals were reimbursed PERA. For approximately 30 of these days, or 9 percent, the meal charges exceeded the State Fiscal Rule's limitations by amounts ranging from $2 to $36 per day. Although we did not evaluate the costs of administering such limitations, the excess amounts indicate that there may be opportunities to contain some of these costs by limiting reimbursements to the lesser of actual costs incurred or a specified amount.

Second, PERA's policies do not address when a meal may be reimbursed if the staff member does not travel a complete day. For example, State Fiscal Rules require that the business travel must begin before 5:00 a.m. for breakfast to be considered a reimbursable expense. Because PERA does not address this issue, we were unable to determine instances in which meals would not have been reimbursable under a policy similar to that of the State.

Third, PERA policies for providing supporting documentation for travel should be more explicit. For example, PERA's policies do not require a detailed receipt. During our testing we noted several instances in which a staff member provided a credit card receipt as supporting documentation for a meal expense, but no detailed receipt. Because the credit card receipt does not include the specific items charged, we were unable to verify that no prohibited items, such as alcohol, were included in the amount reimbursed by PERA. We noted instances in which the staff member deducted amounts for alcohol, but these amounts also were not supported by an itemized bill. Further, PERA's policies do not require that, when reimbursing for a business meal involving two or more people, the staff member should provide a list of the names of those attending and the business purpose for the meal. As a result, in some instances, we noted that individuals were listed, and in other cases only the number of individuals was provided. We did not find a business purpose listed on the meal receipts in cases where reimbursement was provided for more than one individual.

Fourth, PERA does not specify a limit for lodging expenses other than limiting the cost to amounts considered reasonable and necessary. Based on our review of other entity policies, we noted that thresholds for lodging expenses were generally not established; however, one pension plan did establish limits. In instances when lodging could not be obtained within the lodging allowance rate established by the plan, the employee was required to provide written justification and obtain prior approval.

In order to determine the range of hotel rates paid by PERA, we selected a sample of 37 lodging charges incurred by PERA staff and Trustees during the first six months of 2004. We noted 12 charges representing 32 percent in which the charges exceeded $250 per night, with the highest rate being $435 per night. Because in some instances PERA's staff and Trustees travel to high cost areas and facilities, establishing a lodging expense limit that requires further review if amounts exceed an established limit would be beneficial in ensuring that such costs are reasonable and necessary.

To determine if PERA's existing controls were operating as intended, we obtained the total population of travel transactions for 2002, 2003, and 2004 and selected 60 transactions in the total amount of approximately $148,000 (20 transactions from each year). The total tested includes three in-house catering transactions addressed later in the report. For each transaction, we traced the check amount to the invoice and noted whether the transaction was properly approved and recorded. Out of the 60 transactions tested, we noted 6 transactions with an exception, or an exception rate of approximately 10 percent.

- One transaction during 2002 in which PERA paid $6,398 related to an annual meeting attended by a staff member. These expenses were reimbursable to PERA by the Coalition to Preserve Retirement Security; however, PERA did not request reimbursement from the organization until during the time of our audit in June 2005 and was subsequently reimbursed during July 2005.

- Five transactions totaling $6,340 were posted to the incorrect general ledger travel account. This affects PERA's ability to accurately track and report travel expenses.

In addition, we noted that the expense reports were not consistently used in the manner intended under PERA policy. As noted above, the policy requires that all travel expenses, including those that were prepaid, be included on the expense report. Further, as of 2004, the travel authorization form was required to be included with the submission of the expense report. We noted some instances in which prepaid airfare was not included in the expense report and other instances in which the approved travel authorization was not attached to the related expense report. We identified these instances during 2004, after PERA had initiated the policy requiring staff to submit an authorization form. In addition, we noted that PERA accounting staff do not routinely request authorization forms with the expense reports or compare the authorization to the actual expenses incurred. We noted two instances in 2004 in which the actual expenses exceeded the travel authorization amounts by 23 percent and 31 percent. As a result, in some instances, the supervisor approving expense reports did not have the travel authorization to compare to actual expenses incurred.

Finally, we identified instances in which certain expenses appeared excessive. With respect to air transportation, we noted two instances in 2002 in which an employee obtained first class or business class air transportation for international travel rather than coach. For example, in one instance, a staff member traveled first class from Denver to Chicago and then business class from Chicago to London for a total cost of $7,352. However, after PERA updated the travel policies in 2004, we did not note instances in which PERA employees obtained first class or business class air transportation. With respect to hotel rates, we noted one instance during 2002 in which an employee incurred hotel expenses of $297 per night, and one instance during 2004 in which an employee attended a conference and incurred hotel expenses of $375 per night. With respect to meal expenses, we noted one instance during 2002 in which an employee charged $130 in meal expenses for one day, and one instance during 2004 in which a staff member incurred dinner charges of approximately $60 per meal.

While improvements in managing travel expenses have been made, PERA should continue to strengthen policies and procedures, ensure controls are operating as intended and evaluate costs to ensure amounts are reasonable and necessary. In addition, during our testing we noted inconsistencies in the accounts to which PERA recorded various travel-related expenses. For example, meal or lodging expenses for the Board Trustees and staff were coded to various general ledger travel accounts without a clear rationale for the differing treatment. These inconsistencies lead to errors in reporting expenses within a certain category. PERA should review its chart of accounts and determine if revisions can be made to improve the reporting accuracy of expenses within certain categories.

Recommendation No. 6:

PERA should reevaluate policies and procedures for travel and related costs to ensure that these costs are reasonable and necessary. PERA should consider establishing a limit for reimbursing meals as well as a reimbursement policy for meals when an employee does not travel the entire day. The actual amount of the meals reimbursement would be the lesser of the limit or actual costs incurred. PERA should require itemized receipts for reimbursable expenses and improve documentation for business meals by requiring documentation on the receipt for the names of attendees and the business purpose. PERA should also adopt policies that establish limits for lodging rates and require prior supervisory approval for amounts exceeding these limits and documentation to justify the excess amount.

PERA Response:

Agree. Implementation date: Fourth Quarter 2005/Ongoing. Colorado PERA will continue to review policies and procedures for travel and related costs to ensure that they are appropriate and necessary to carry out PERA's business operation. The recommendations to include itemized receipts and to improve documentation supporting business-related meal expenditures have been implemented. Limits for lodging will be established and in those few instances where the established limit may be exceeded, supporting documentation justifying the expense will be attached to the expense report and reviewed and approved by the traveler's supervisor.

PERA will continue to assess the costs and benefits of implementing a policy that would limit reimbursement to a pre-established maximum, as well as formalizing reimbursement requirements when the PERA staff member does not travel the entire day. This recommendation will be forwarded to both the Audit and the Compensation and Budget Committees of the Board.

As identified by the auditors, a significant portion of staff travel is conducted by the Investment Department. Because over half of PERA's investments are managed internally, travel is necessitated, typically to high cost areas. PERA has identified over $20 million in savings annually through the in-house management of trust fund assets.

Recommendation No. 7:

PERA should improve controls over travel and related expenses by:

a. Ensuring that Trustees and employees comply with existing policies for completion of expense reports. As part of these improvements, PERA should ensure that travel authorizations are attached to expense reports, and that all expenses related to travel are included on expense reports as required under PERA policies.
b. Comparing expense reports and the related travel authorizations and requiring supervisory review of variances in excess of a specified amount.
c. Requesting timely reimbursements from outside organizations.

PERA Response:

Agree. Implementation date: Immediately.

a. Colorado PERA will strengthen the review and approval process for expense reports, ensuring that travel authorizations are attached to expense reports, and that the expense reports reflect all expenses incurred related to travel.

b. Variances between the estimates identified on a travel authorization request and the final expense report will be reviewed by the traveler's supervisor before being submitted for payment. Significant variations from the travel authorization estimate will be discussed with the traveler.

c. Reimbursement requests for outside organizations will be made in a more timely manner.

Recommendation No. 8:

PERA should ensure that the chart of accounts allows the organization to sort expenses as necessary to accurately report amounts related to Trustee and staff travel and conference fees as well as other expenses such as Trustee and staff functions.

PERA Response:

Agree. Implementation date: January 1, 2006. Colorado PERA will modify the current chart of accounts, effective with the new budget year of January 1, 2006, so that expenses can be more easily sorted.

Board and Staff Functions

PERA incurs costs related to a variety of Board and staff activities and meetings which may also involve individuals from outside organizations. We tested Board and staff function expenses such as Board planning sessions, meetings and social events from the total expenses summarized below.

	2002	2003	2004
Board Planning Sessions	$ 24,740	$ 24,769	$ 11,053
Board Functions[1]	28,356	30,185	12,227
Staff Functions	25,291 [2]	11,860 [3]	12,200
Total Board and Staff Expenses	**$ 78,387**	**$ 66,814**	**$ 35,480**

[1] Includes Board retirement dinners.
[2] Includes staff planning sessions in the amount of $16,066.
[3] Includes $1,590 cancellation fee for the Director planning session.
Note: PERA provides reimbursement to Board Trustees for reasonable and necessary expenses to attend monthly Board meetings, such as mileage and lodging for out of town Trustees. Such expenses are not included above since these expenses are reported under Travel and Related Expenses.

We noted that total Board and staff expenses listed above declined from approximately $78,400 in 2002 to approximately $35,500 in 2004, or approximately 55 percent. We have discussed the testing for each area below.

Board planning sessions. Each summer, the PERA Board holds a planning session to provide an opportunity for the Board and management to discuss PERA's overall strategic plan, particularly with regard to the upcoming year and the Legislative Session. As of the beginning of 2004, PERA implemented policies designed to reduce costs related to Board planning sessions, and the Board determined that the budget and costs related to these sessions would be reevaluated annually to identify ways to obtain lower travel and lodging expenses, such as holding the event in Denver. As shown above, we noted a decline in expenses related to Board planning sessions from approximately $24,700 in 2002 to approximately $11,100 in 2004, or approximately 56 percent. Alcohol purchases represented approximately $1,500, $1,400 and $400 during 2002, 2003, and 2004, respectively. PERA has eliminated alcohol purchases.

Board functions. PERA also provides the Board with lunches or other meals when the Trustees meet in the course of conducting PERA business. For retiring Trustees, PERA provides a retirement dinner. Prior to October 2003, PERA had not established budgetary limits or a limit on the number of attendees for Board Trustee retirement functions. However, during October 2003, PERA established a policy limiting the cost of retirement dinners to $3,500 and 40 attendees per event. Additionally, in March 2004, PERA modified the policy to prohibit the purchase of alcohol. We noted a decline in expenses related to Board retirement dinners from approximately $3,600 per dinner in 2002 and $2,300 per dinner in 2003, to $1,200 per dinner in 2004, or approximately 67 percent over the three-year period. Alcohol purchases represented approximately 28 percent of the total cost of the one retirement dinner in 2002 (approximately $1,000 of the total cost of $3,600) and 28 percent of the three retirement dinners in 2003 (approximately $2,000 of the total cost of $7,000). We noted that no alcohol expenses were incurred for the 2004 retirement dinner.

Staff functions. PERA reports that funds are allocated annually for staff functions. These activities include a holiday lunch, annual departmental staff lunch, a summer barbeque, and periodic staff meetings to discuss the highlights of Board meetings and other events. PERA prohibits the payment of alcohol expenses related to staff functions. PERA held three, three, and four staff functions at a cost of $25,291, $11,860, and $12,200 during 2002, 2003, and 2004, respectively. During 2004, PERA also held an ice cream social conducted primarily for the benefit of the tenants of a PERA owned building at a cost of $5,128.

With respect to the amount of expenses incurred for Board planning sessions and Board and staff functions, although the overall level of expenses has decreased, PERA should continue to evaluate policies and monitor budgets to further reduce costs, ensure that the number of events is reasonable, and that policies concerning the prohibition of the purchase of alcohol are enforced.

To test selected transactions in these areas, we obtained the population of PERA Board and staff function expenses for 2002, 2003, and 2004, which included Board and staff planning sessions and Board and staff functions. From the population, we selected 20 events in the total amount of approximately $105,500 (6 from 2002, 5 from 2003, and 9 from 2004). For each event selected, we traced the check amount to the supporting invoice and noted whether the transaction was properly approved. We noted one exception related to one transaction in which PERA incurred $107 in alcohol expenses during the 2002 staff planning session, which is a violation of PERA's policies. PERA two-day staff planning sessions were eliminated subsequent to 2002 and replaced by four quarterly half-day planning sessions. We noted no exceptions related to the Board and staff functions during 2003 and 2004.

Finally, we noted that the Human Resources Division purchases gift cards which are issued to reward employees under three different programs. PERA considers these programs beneficial in recognizing and supporting employee performance and overall well-being. Under the first program, gift cards are provided to employees in appreciation for years of service, starting at 10 years ($50) and continuing in 5-year increments to 30 years ($150). PERA estimates that approximately $1,600 will be spent on these cards during 2005. Under the second program, employees are given a $25 gift card during the December holidays. In December 2004, PERA spent approximately $6,000 for these cards. Under the third program, PERA supports a wellness program in which staff members may earn gift cards. PERA estimates that expenses related to these types of cards approximate $4,000 annually. We estimated that in total, PERA spends approximately $12,000 on gift cards each year. PERA should review gift card policies to determine the necessity of this employee benefit, or if the programs can be reduced or redefined to more clearly enhance organizational and employee performance. Further, PERA has not determined which employees received in excess of the $25 IRS de minimis gift limit and therefore should have the amount reported as compensation on their W-2s issued for tax purposes.

In-house Catering. During our testing, we identified numerous instances in which PERA incurs catering expenses for functions such as Board meetings, staff meetings, or meetings involving individuals from outside organizations. PERA considers in-house catering to be beneficial in terms of cost and time savings. In-house catering expenses are as follows:

	2002	2003	2004
In-house Catering	$ 69,941	$ 68,685	$ 56,442

These expenses declined from approximately $69,900 in 2002 to approximately $56,400 in 2004, or approximately 19 percent. Currently, PERA has not established a specific policy related to in-house catering; however, such expenses should be reviewed to ensure that the costs in all instances are reasonable and necessary for conducting PERA's business. During our test of transactions in this area, we selected three in-house catering transactions in the total amount of $7,342. We identified one exception for a transaction in the amount of $1,240 for catering expenses in which the expense was both incurred by and approved for payment by the same individual. This represents a lack of segregation of duties as the same individual both initiated and approved the reimbursement.

Recommendation No. 9:

PERA should continue to reevaluate budgets and monitor expenses for Board planning sessions and Trustee and staff functions to ensure policies are appropriate, adhered to and that costs are reasonable and necessary.

PERA Response:

Agree. Implementation date: Ongoing. Colorado PERA will continue to reevaluate budgets and monitor expenses for Trustee planning sessions and staff functions through the annual budget process involving the Board's Compensation and Budget Committee and the Board itself.

Recommendation No. 10:

PERA should reevaluate gift card policies to determine if current programs meet their intended goal and are reasonable and necessary. Further, PERA should maintain a detail listing of gift cards purchased and issued to employees to ensure a proper accounting of all gift cards. The listing should be reconciled periodically to the number of unissued gift cards. In addition, amounts issued to employees in excess of $25 should be reported on the employee's W-2 as compensation.

PERA Response:

Agree. Implementation date: Immediate/Ongoing. Current practices related to providing employee incentives via gift cards have been modified to comply with IRS limits and awards are reported as compensation when the $25 threshold is exceeded. In addition, PERA will reevaluate gift card policies through the annual budget process involving the Board's Compensation and Budget Committee and the Board itself.

Recommendation No. 11:

PERA should develop and implement policies over in-house catering expenses to ensure that all costs incurred are reasonable and necessary for the purpose of conducting PERA's business. Also, such expenses should be approved by someone other than the person incurring the expense.

PERA Response:

Agree. Implementation date: Current/January 1, 2006. Colorado PERA now requires documentation of the business purpose and attendees for in-house meals. Additionally, PERA now requires such expenditures be formally approved by a supervisor before payment.

Merit Increases and Incentives

Over the years, PERA has contracted for a variety of studies related to the compensation provided to employees. In the 1990s, PERA contracted with firms to perform several external reviews of its compensation program, and in 2001, PERA engaged Watson Wyatt to conduct a market analysis study. The purpose of the 2001 study was to compare PERA's professional and management compensation to the market and establish new ranges as needed to ensure PERA's compensation program and practices were competitive. In 2003, the Board approved a Total Compensation Philosophy that encompasses all components of compensation such as base salary, variable pay (e.g. incentives), performance management programs, as well as a comprehensive range of benefits. PERA's Total Compensation Philosophy Statement states that:

> In order to achieve our vision to be the plan of choice for public employees, we must attract, retain, and motivate a highly qualified and competent workforce. In accordance with that objective, our base pay will target the market's average pay for similar jobs in our peer companies, which will be obtained from external and custom salary surveys…

In 2004, PERA requested that the Hay Group assist in the development of programs to support the Total Compensation Philosophy and review all compensation practices for the total employee population, excluding the Investment Department positions. McLagan Partners was engaged to review the compensation practices for the Investment Department. Phase I of the Hay study involved a comprehensive evaluation of PERA positions that resulted in a ranking of each job based on its comparative value to the organization. Phase II was a compensation analysis which compared current compensation levels for each position to the market, and resulted in recommendations for PERA's base salary ranges for 2005. PERA's compensation program in 2005 is based on the recommendations of the Hay study, as well as input from executive management and other studies such as the one performed for the Investment Department by McLagan Partners.

Our audit did not include a detailed review of PERA's compensation program and the related studies. We reviewed PERA's practices related to merit increases to base pay and incentives during 2002, 2003, and 2004. Personal leave policies are discussed in the next section of the report.

At year end, employees may receive merit increases to their base pay as well as incentives, which do not increase base pay. PERA reports that both merit and incentive payments are based on performance and approved by the employee's supervisor and executive management. There are three types of incentives: 1) individual incentives based on individual performance, 2) department-based incentives, which are awarded on the basis of the department achieving specific benchmarks, and 3) long-term incentives, which are available to the PERA executive management team and are awarded on the basis of consistent and sustained performance related to the objectives of PERA's strategic plan. Incentives are discussed in more detail below.

We obtained a listing of the 25 highest-paid positions based on annual base salary as of December 31, 2004. Of the $16.2 million in total PERA staff salaries in 2004, the 25 top positions were paid a total of approximately $4 million including incentives, or approximately 25 percent of total salaries. We noted that approximately half of these positions were investment professionals whose compensation includes a market-based index performance incentive. These 25 positions represented about 11 percent of PERA's total staff of approximately 230 at the end of 2004.

We reviewed the annual merit increases in base pay as well as incentives for the 25 highest-paid positions for 2002, 2003 and 2004. We noted the following relative to these positions:

- During 2002, base pay increases ranged from 0 to 15.4 percent with an average of 8.2 percent. Incentives ranged from 0 to 40 percent of base pay with an average of 15.4 percent.
- During 2003, base pay increases ranged from 0 to 16.7 percent with an average of 5.1 percent. Incentives ranged from 0 to 35.4 percent of base pay with an average of 10.8 percent.
- During 2004, base pay increases ranged from 0 to 8.1 percent with an average of 3.5 percent. Incentives ranged from 0 to 39 percent of base pay with an average of 13.9 percent.

With respect to merit increases, these declined from an average of 8.2 percent to 3.5 percent from 2002 to 2004. As of 2004, base salaries had increased from about $3.3 million to $3.5 million, or 7.7 percent over the period. PERA reports that it used the Hay Group study to compare different groups of employees within the organization to different employers when evaluating compensation. For its executive staff, this comparison includes public pensions as well as private companies. The Hay Group materials included a summary of a "key position salary survey" that compared executive level positions at PERA with 72 other statewide public pension systems. The value of the survey is limited because there is not sufficient comparative detail about the other systems, such as the value of assets under management or the system's scope of business activities. For example, PERA's total net assets ($33.7 billion) were well above the median and average assets of the systems reviewed ($12.1 billion and $22.3 billion, respectively). PERA has a relatively large scope of activities as it administers a defined benefit plan and voluntary defined contribution plan, as well as a health care plan, and manages over half of its investments in-house. PERA should continue to monitor salaries to ensure that base salaries are comparable to similar entities.

In terms of incentives, we noted that PERA paid almost $1.4 million to these top 25 positions over the three-year period, as detailed below:

	2002	**2003**	**2004**	**2002 through 2004**
Individual and Departmental Incentives	$ 430,045	$ 332,960	$ 447,534	$ 1,210,539
Long-term Incentives	75,002	38,400	40,973	154,375
Totals	**$ 505,047**	**$ 371,360**	**$ 488,507**	**$ 1,364,914**

Unlike the merit increases, which on average decreased as a percentage of base pay during 2002 through 2004, the incentive payments to these top positions remained substantial, averaging approximately 15.4 percent in 2002 compared to approximately 13.9 percent in 2004. While incentives do not increase an employees' base pay in subsequent years, these payments have been sizable each year. We also noted that during each year under audit, 20 to 24 of the 25 top positions received an incentive payment. Although approximately half of those receiving incentives represent investment professionals, PERA should continue to evaluate the criteria to obtain an individual and/or departmental incentive to determine if the standards and benchmarks are too low and therefore, easily attainable.

With respect to the long-term incentives, PERA's original policy allowed for members of the executive management team to receive up to 15 percent of their base pay as an incentive every third year, with the first three-year period beginning in 1990 and ending in 1992. In April 1995 the Board approved an increase of up to 20 percent of base pay. Currently, three of the five members of the PERA executive management team are eligible for the long-term incentive under the terms of their offer of employment letters. PERA management reports that it expects the long-term incentive program to end at the conclusion of the current three-year period on July 1, 2006. These long-term incentives, which are paid in addition to the individual incentives, were an important factor leading to an individual's total incentive compensation reaching as much as 40 percent of base pay in some instances during the period reviewed.

PERA reports that incentives for the Customer Service, Benefit Services, and Insurance Divisions have been eliminated as of December 31, 2004. These changes, together with the elimination of the long-term incentives, should decrease incentive payments in subsequent years.

For departmental incentive payments, we tested the incentives paid against the benchmarks that had been established to determine if these payments were consistent with policies. During the three-year period PERA staff members within the Investment Department, Customer Service Division, Benefit Services Division, and Insurance Division were eligible to receive incentive payments. These incentives were paid based upon each work group attaining specified performance-based benchmarks. The Board of Trustees defines benchmarks for the Investment Department based on input from outside consultants. For example, during 2003, the Fixed Income Division within the Investment Department attained a return of 6.16 percent, which exceeded the 6.09 percent industry benchmark approved by the Board. PERA's management approved the benchmarks for the remaining work groups. These benchmarks were primarily based on certain customer service or processing levels and were limited to 10 percent of compensation. For example, the Customer Service Division could obtain up to a 10 percent incentive if the average time to answer a call was within 20 seconds and the rate of abandoned phone calls was 5 percent or less for the period.

The table below shows the incentives, which are calculated as a percent of the individual's salary, earned during 2002, 2003, and 2004 in comparison to the incentive limits, or maximums, for the departments/divisions eligible for incentive pay.

	2002		**2003**		**2004**	
	Limit	**Actual**	**Limit**	**Actual**	**Limit**	**Actual**
Investment Department:						
Fixed Income Division	30%	0%	30%	15%	30%	0%
Equities Division	30%	30%	30%	15%	30%	18.75%
Real Estate Division	30%	30%	30%	30%	30%	30%
Alternative Investment Division	30%	0%	30%	0%	30%	0%
Customer Service Division	10%	5.6%	10%	8.3%	10%	8.7%
Benefit Services Division	10%	8.0%	10%	7.9%	10%	7.4%
Insurance Division	10%	10%	10%	10%	10%	10%

As noted earlier, incentive payments were eliminated for the Customer Service, Benefit Services, and Insurance Divisions as of December 31, 2004. Therefore, only the Investment Department will continue to be eligible for performance-based incentive payments.

In order to determine if incentive payments were paid in accordance with policies, we obtained the benchmarks for each department/division for the years ended December 31, 2002, 2003, and 2004 and the incentive payments made for each period. We confirmed that if division staffers received an incentive payment, the payment was based on performance exceeding the established benchmark. We then compared the incentive payments to the incentive limit noting that the employee selected for testing received the appropriate performance-based incentive payment.

In addition to these incentives, certain PERA executives were eligible for longevity incentives. During the period from 2002 through 2003, PERA paid individual employees amounts ranging from $32,000 to over $79,300 based upon established criteria. Longevity incentives phase out in July 2006.

Recommendation No. 12:

PERA should continue to refine the comparables when evaluating total staff compensation to ensure that base salaries are comparable to private entities as well as similar pension plans. PERA should also continue review the criteria for staff incentives to ensure these payments reflect outstanding contributions to the organization.

PERA Response:

Agree. Implementation date: Ongoing. Colorado PERA will continue to review and update compensation policies. This is a critical part of PERA's business operation since employees are PERA's primary asset.

The PERA Board adopted a Total Compensation Philosophy Statement in 2003 that guides PERA's human resource policies. PERA completed several compensation studies under the guidance provided in the statement in 2004 and implemented the findings in 2005. This effort will be ongoing through the Board's Compensation and Budget Committee's comprehensive annual budget process.

Employee Leave

In addition, we noted that PERA policies on employee leave can contribute substantially to the amount of compensation received by retiring long-term staffers. Under state law, PERA is not part of the Colorado State Personnel System, and PERA leave accrual policies are can result in significant pay-outs to long-term PERA employees upon retirement or termination. From 2002 through 2004, PERA paid $1.15 million in accrued personal leave to departing employees. Amounts paid to individuals ranged from $28 to $240,600. During the three-year period, an additional $248,500 was paid to current employees who had accrued personal leave in excess of the maximum allowed at year end.

Comparison of Leave Accrual Policies for Full-Time Employees
State of Colorado Personnel System (State Fiscal Years 2002 – 2004) and
Colorado Public Employees' Retirement Association (2002 -2004)

Years (Months) of Service	**Hours Per Month**	
Accrual rates are for annual and sick leave under State Personnel, personal leave under PERA	***State Personnel***	***PERA***
1st through 5th year (1st through 60th month)	14.66 hours	14 hours
6th through 10th year (61st through 120th month)	16.66 hours	17 hours
11th through 15th year (121st through 180th month)	18.66 hours	20 hours
16th year on (181st month on)	20.66 hours	24 hours

As the table indicates, under the State Personnel System, full-time employees accrue both annual leave and sick leave. The maximum amount of annual leave that may be carried over at the end of the fiscal year increases as the employee's years of employment increase up to a maximum of 336 hours. Sick leave accrues at 6.66 hours per year regardless of the amount of time employed with the State, and the maximum that may be carried over to the next fiscal year is 360 hours. Together, the maximum amount an employee under the State Personnel System can accrue in annual and sick leave is 696 hours, or 87 days, if the employee has worked for the State at least 16 years. Any excess annual or sick leave is forfeited at the end of the fiscal year.

Under PERA, full-time employees accrue only personal leave, which may be used for vacation, sick, or personal reasons, and this leave is recognized and expensed annually. During 2002 through 2004, long-term employees were able to accrue up to 2,080 hours, or 260 days, of personal leave. Accordingly, a PERA long-term staff member could receive as much as a year's salary in leave payouts upon termination or retirement from PERA. As of 2005, PERA changed its policy and reduced the maximum accrual to 1,040 hours, or 130 days. After this reduction, PERA's leave policy will still result in a long-term PERA staff member having the ability to accrue as much as 130 days of leave. Under the State Personnel System the maximum leave accrual is 87 days; thus, under PERA, an employee of 16 or more years may earn up to 33 percent more in allowable leave accruals than a state employee (130 days vs. 87 days). However, PERA does not provide a short-term disability policy to its employees, and there is a 90 calendar-day waiting period before becoming eligible for PERA's long-term disability program for employees with less than five years of service. Under the State Personnel System, qualifying employees are eligible for short-term disability after a 30 calendar-day waiting period or using up all accrued sick and annual leave, whichever is longer. This policy is available to state employees for up to 150 calendar days, or about five months, if the employee continues to meet certain disability or illness-related requirements. In terms of costs, one of the advantages of providing a short-term disability policy is that specific criteria must be met in order for an extended period of leave to be available to an employee, as opposed to providing higher rates of leave accumulation to all employees to be used for either vacation, sick, or personal reasons.

Additionally, for current employees, PERA policy requires payment to the employee for any leave accrued over the maximum at year end, unlike the State Personnel System which requires that employees forfeit excess leave at year end. PERA's reduction in the maximum accrual should decrease the amounts paid out at termination or retirement; however, because PERA's policy still requires excess leave to be paid out to current employees, the change is likely to spread the cost over a longer period, rather than result in overall reductions in cost.

Leave policies are an important part of an employer's total compensation package. PERA should evaluate its leave policies to identify ways in which to reduce costs and remain competitive with other peer companies, including other pension plans.

Recommendation No. 13:

PERA should evaluate employee leave policies to identify ways to reduce costs while remaining competitive. This process should include assessing rates of accumulating leave and allowable maximum accruals, payments of excess leave to current employees, and the costs and benefits of incorporating a short-term disability policy into its leave policies.

PERA Response:

Agree. Implementation date: Fourth Quarter 2005/Ongoing. As part of the Board's Compensation Philosophy, PERA conducts regular evaluations of all compensation policies including employee leave policies. Comparisons are made to appropriate peer groups and policies are adjusted as needed. The evaluation of employee leave policies is currently underway as part of PERA's annual budget process and will be reported to the Board upon completion of the evaluation. Adjustments, if necessary, will be made to the employee leave policy to ensure compliance with the Total Compensation Philosophy.

This evaluation is a significant part of the Board's Compensation and Budget Committee's comprehensive annual budget process.

Automobiles

PERA maintains five automobiles for use by employees traveling throughout the State of Colorado and one for use by the Property Management Division. In addition, until 2005, six PERA executives were provided a choice of a car allowance in the monthly amount of $1,173 ($14,076 annually per person) or an assigned PERA-owned car.

For the period tested, PERA reported automobile expenses as follows:

	2002	2003	2004
Car Purchases – net of trade ins	$ 22,943	$ 72,440	$ 49,977
Car Allowances	26,979	31,671	45,790
Totals	**$ 49,922**	**$ 104,111**	**$ 95,767**

For vehicle purchases, we noted that PERA purchased two fleet vehicles during 2002, three company cars during 2003, and three fleet vehicles during 2004. The average cost per vehicle per year approximated $29,200, $38,500, and $27,400 for 2002, 2003, and 2004, respectively. The cost of the three assigned PERA-owned cars purchased during 2003 ranged from a gross cost of approximately $37,000 for a Jeep Cherokee to $39,000 for a Town and Country Van, not including trade-in value at purchase or resale proceeds at disposition. PERA should evaluate the purchase of vehicles to ensure all expenses incurred are cost effective.

In 2005, the car allowances and assigned PERA-owned cars were eliminated for four of the six executives, and in lieu of an allowance or vehicle, each received a one-time compensation adjustment increase of $9,000, or a total of $36,000 for the four executives. The compensation adjustment was based on the cost of the automobiles purchased in prior years and the residual value at trade-in as estimated by the Director of Property Management. These adjustments represent permanent increases to the base pay of these personnel and therefore should be considered when assessing executive compensation at PERA in comparison to other entities. For the remaining two executives with car allowances, one executive retired and the other executive continues to receive the car allowance. PERA did not eliminate this allowance because the allowance was a provision in the executive's employment contract. However, upon renewal, the

Board should consider converting this car allowance to a one-time compensation increase in the interest of increasing the transparency for reporting compensation to executives.

We reviewed the Car Purchases general ledger account activity to determine the propriety of the purchase of vehicles for the years ended December 31, 2002, 2003, and 2004. In addition, we reviewed the Car Allowances general ledger account activity to determine the propriety of the payments for the years ended December 31, 2002, 2003, and 2004. For vehicle purchases, we tested purchases in the total amount of $256,067 and noted no instances in which vehicles were not purchased in accordance with PERA's policies. For car allowances, we recalculated the monthly expense amounts for 2002, 2003, and 2004 in the total amount of $104,440 without exception to PERA policies.

Recommendation No. 14:

PERA should consider converting the remaining car allowance to a one-time compensation increase upon the renewal of the employee's employment contract.

PERA Response:

Agree. Implementation date: September 2005. This recommendation will be referred to the Board of Trustees.

Credit Cards

PERA issues certain types of credit cards to selected employees to conduct PERA business depending on the employee's business needs. PERA issues:

- Credit cards to employees that incur moderate levels of expenses such as those related to travel, meals, and other business related activities.
- Credit cards, referred to as purchase cards, to employees that incur frequent expenses such as Directors and Field Education Representatives that travel on a regular basis or employees who routinely purchase capital items or other goods and services, such as employees responsible for maintenance.

The credit and purchase card limits are based on the individual employee's spending requirements and approved by the Chief Administrative Officer. Similar to other expenses, employees must provide documentation to support the expense, such as a receipt or an invoice, prior to payment or reimbursement. As of December 31, 2004, PERA had issued 16 credit cards and 12 purchase cards.

For the period tested, PERA reported expenses as follows:

	2002	2003	2004
Credit and purchasing card expenses	$ 251,598	$ 240,264	$ 222,270

We selected a total of 12 monthly credit card statements, which included credit card and purchase card statements (4 from 2002, 2003, and 2004). The credit or purchase card statement reflects the credit purchases made by all PERA employees. We reviewed the statements and employee's expense reports to determine if split transactions had occurred (i.e., multiple amounts charged to the same vendor on the same day by the same or a combination of employees). In addition, we selected 25 transactions in the total amount of $21,351 from the monthly credit card statements for the three-year period (8 from 2002, 9 from 2003, and 8 from 2004). For each transaction selected, we traced the amount to the invoice or receipt and noted whether the transaction was properly approved.

Of the 12 monthly statements selected for testing, we noted no charges for multiple amounts charged to the same vendor on the same day by a single or by multiple employees.

Of the 25 transactions selected for testing, we noted 2 exceptions related to 2 transactions, or an exception rate of approximately 8 percent.

- One transaction invoice during 2002 in the amount of $456 for staff function decorations was not signed to indicate approval for payment.
- One transaction during 2003 in the amount of $179 for a publication was not supported by a receipt or invoice.

Recommendation No. 15:

PERA should ensure that employees provide the appropriate supporting documentation and approvals for credit and purchase card charges prior to issuing payments.

PERA Response:

Agree. Implementation date: Fourth Quarter 2005. Colorado PERA will strengthen the management review and approval process for credit and purchase card purchases prior to sending the documentation to Accounting for payment. The training for management authorized to approve credit and purchase card expenditures will be provided during the budget process this fall.

<u>Cellular Phones</u>

The PERA Information Systems Division ("ISD") determines the necessity of employee cellular phones based on the employee's responsibilities. ISD issues cellular phones to employees and maintains other cell phones for temporary use by employees. ISD selects the plan that is most appropriate for the employee's business needs and is responsible for tracking all cell phones issued to employees. ISD receives the cell phone monthly invoices, reviews them for propriety and approves the invoices for payment. Employees must reimburse PERA for personal phone usage that is in excess of the employee's allocated minutes. Employees are allocated minutes based on expected usage; therefore, if an employee exceeds the minutes allocated, ISD requires the employee to review the monthly statement and identify any personal usage. Employee-owned cell phone usage for PERA business purposes may be reimbursed upon approval from the IS Division Director.

For the period tested, PERA reported cell phone expenses as follows:

	2002	2003	2004
Cell phone expenses	$ 39,475	$ 38,380	$ 66,711

As of December 31, 2004, ISD reported that a total of 60 cell phones were issued to PERA employees, of which 54 were permanently issued and 6 were temporarily issued. ISD maintains a perpetual inventory of cell phones and conducts a monthly inventory. Therefore, based on the total number of PERA employees, approximately 20 percent are assigned permanent cell phones. During our testing, we noted an increase in cellular phone expenses from 2003 to 2004 which was primarily a result of the purchase of 27 SmartPhones at a cost of approximately $500 per phone and an increase in monthly charges for the use of these phones. The SmartPhones are cellular phones that allow access to the PERA e-mail system. Such phones are issued to executive management, employees within the Investment Department, ISD, and building management to increase productivity by readily allowing these employees access to e-mail.

We selected 10 transactions related to cell phone usage in the total amount of $37,657 (3 from 2002, 3 from 2003, and 4 from 2004). For each transaction selected, we traced the check amount to the invoice noting proper invoice approval. We did not note any exceptions.

Recommendation No. 16:

PERA should continue to evaluate the criteria for permanently assigning cell phones to PERA employees.

PERA Response:

Agree. Implementation date: Fourth Quarter 2005/Ongoing. Colorado PERA will continue to evaluate the costs and benefits related to the assignment and use of cell phones through the Board's Audit Committee and the Compensation and Budget Committee's comprehensive annual budget process.

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