

APPFA: THE INSIDERS WHO AUDIT PUBLIC PENSION FUNDS

While they quietly work behind the scenes at many of America's largest public pension operations, the funds they monitor have a loud impact on the financial marketplace. Members of the Association of Public Pension Fund Auditors (APPFA), though small in number, are collectively responsible for internal auditing more than \$1,927 billion (**\$1.9 Trillion**) of public pension funds.

"It's a lot of responsibility," acknowledges Linda Walker, who is the association's current president. "In many cases, our members are auditing the largest financial institutions in their state, and among us, we may represent the single largest pool of money in the country." Walker is an Audit Manager and Information System auditor for the Virginia Retirement System.

"Most of the training available isn't adequate for the special needs of pension fund internal auditors," adds Vice President Marci Sundbeck, Director of Internal Auditing with the Employees Retirement System of Texas. "That's why APPFA is so important. It helps make sure the people auditing these huge funds are constantly sharpening their skills."

As their roles continue to evolve, internal auditors of public funds describe themselves as everything from watchdogs to teachers. Yet, despite this breadth of perspective on what they do, most share a common view of their unique position.

"We achieve a level of detail in examining pension funds that external auditors are not concerned with," says Walker, "this is no slight against external auditors, mind you, it's just that they have different responsibilities and thresholds of involvement." Sundbeck likens the difference to two people examining a large ship. "The external auditors take the ship out for a cruise, walk the decks, and knock on the hull to be sure it won't sink. We, the internal auditors, go down below and take apart the engine to make sure all the pistons are firing correctly. They look at the big picture, we look at the details."

Expanding on Ms. Sundbeck's analogy, Larry Jensen, Chief, Office of Audit Services for the California Public Employees' Retirement System (CALPERS) says, "We have to be creative about what we do. If we looked at the engine last year and it seems to be running fine, then we take apart the rudder this year. The single most important skill for an internal auditor is being able to identify which part of a fund to spend your time and energy examining."

CALPERS is the largest single public pension fund in the country, including management of supplemental fringe benefit programs such as annuitant health care. With an audit universe that includes over 1,200 contributing employers, in addition to managing the investment and payment activities, Jensen says, "... allocating limited audit resources is a full time activity, especially when new audit and accounting issues surface. To do this, we must be creative in our audit planning and in how we work with audit clientele. One of our former initiatives was to train and work with audit clientele to do Control Self Assessment. We believe this initiative was successful, and this program accented our audit coverage in a very positive way."

Another major difference between internal and external auditors is their relationship to the organization being audited.

"By definition, external auditors come in from the outside to look at the pension fund whereas we audit from within the organization we work for," says Bob Schaefer, former APPFA President, and Director of Internal Audit for the State of Wisconsin Department of Employee Trust Funds. "External auditors report to legislators and, indirectly, the members of the fund. We generally report to management and the trustees."

By directly reporting to upper-level management and fund trustees, internal auditors advise decision-makers about potential problems and the ways to correct them.

"This is where APPFA can be so valuable," points out Richard Bendall, the current APPFA Treasurer and the Internal Audit Chief for the Los Angeles County Employees Retirement Association, "through the exchange of ideas, all of us can share in the most up-to-date auditing programs and techniques. When I have a question about the best way to accomplish something, I send a message to the membership using the e-mail list server program. I always get several replies from members that experienced something very similar."

Schaefer agrees, noting that he recently downloaded an audit program and various audit checklists from the library which is available to members on the APPFA website. In the instance noted, Mr. Schaefer used documents developed by the Virginia Retirement System for a new system they had installed. "Virginia was one the country's leaders in use of the technology at that time, having installed it several years prior, whereas Wisconsin's system was being implemented a number of years later. The Virginia experience was invaluable to us. To have an audit program already prepared saved us a tremendous amount of time and effort."

Steve Hayward, Internal Auditor for State Universities Retirement System of Illinois and a former APPFA Secretary, states that sharing audit programs is one of the best benefits of belonging to the organization, citing the sharing of ideas on member verification and "death matches," a process whereby people who have died are purged from the benefit system. "It may sound kind of morbid," he says, "but it doesn't reflect well on the management of our fund if we're paying retirement benefits to people who are no longer alive. Knowing how other APPFA members in the various large public retirement systems address these risks is extremely valuable."

"The highly specialized nature of the group is what makes it so worthwhile," says Stuart Cagle, Audit Director of the Teachers' Retirement System of Louisiana. "Internal auditing is in itself, a unique form of accountancy, internal auditing of public pension funds is even more specialized, and internal auditing of public pension funds with assets in excess of \$1 billion makes it about as specialized an organization as you might ever find." Concerns over risk management in the investment community prompted Mr. Cagle and several other APPFA members to join a group of pension system chief investment officers to develop a document that identified common risks faced by public pension systems and the practices being utilized to address those risks. In July 2000, the "Public Pension Systems: Statements of Key Investment Risks and Common Practices to Address Those Risks" document was released. This comprehensive document is used by many organizations in evaluating, managing, and auditing key investment risks of public pension funds.

While much of the emphasis in pension funds is on investment risks, the administrative and benefits side of pension systems also face an extraordinary number of risks as well. "APPFA decided that it would be beneficial to look at other (non-investment) risks that pension systems face," says Jeanette Eckert, an Internal Auditor at the Louisiana State Employees' Retirement System and a member of the APPFA committee, which worked on the benefit risk project. After several months of hard work, the committee released the "Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate those Risks" report in June of 2003. Ms. Eckert states, "The document is intended to be a reference guide to auditors and system administrators who are assigned the tasks of analyzing and addressing risks faced by public pension systems. Accordingly, the document identifies key administrative risks associated with all public pension systems and common practices to address, manage, and to the extent possible, control those risks."

Ken Kasper, Manager of Internal Audit for the New York State Teachers' Retirement System, says public pension funds are fairly unique because of their complexity. "Their size and diversity of benefit programs and investments makes it tremendously difficult to monitor all their parts. Thus, the process of allocating audit resources is an incredibly selective one. Through our collective experience, we are able to identify microcosms of risk on which internal audit teams should be focused."

In addition, with cash-strapped governments increasingly looking for "creative" ways to close budget gaps, fund managers and trustees are finding their work garnering more and more attention both from elected officials and the public at large. The APPFA network allows internal auditors to share new ways to help educate their fund managers and trustees.

Robert Kosky, Director of Internal Audit for Operations and Investments for the New York State Comptroller's Office (Common Retirement System), says that while management increasingly views the internal audit function as a highly effective management tool, some in the organization may view it as some sort of policing tactic. Changing this paradigm is a top priority for all audit managers. "This really has to do with communication and changing perceptions."

"The more people understand what we do, the more comfortable they'll feel about having us around. In fact, we have changed the way our reports are presented, not to be finger pointers, but to be advocates for change. What were formerly findings are now presented as *observations* and we work with our audit clientele in coming up with effective solutions." This can be very useful for a department that's been unsuccessfully petitioning management for a change, such as improved computer systems to enhance efficiency. Many times, this stamp of approval from the internal audit department will be helpful.

Mr. Kosky notes that while some fellow workers used to view auditors with suspicion, this has changed and our organization now views the internal audit function as an integral part of the management team. His experience in changing the audit paradigm is one Mr. Kosky has shared with fellow APPFA members.

John Spielman, Internal Audit Director at the Public Employees' Retirement Association of Colorado, has a similar perspective on educating those he is auditing. "In business, people don't like surprises," says Mr. Spielman, "so I let people know up front that it's my job to help eliminate those surprises, or at least identify them and correct them early. People from my fund appreciate this, to the point where they'll suggest areas for me to look at. This openness makes for great internal dynamics." In fact, as the former Audit Director at the fund, David Maurek showed this by

overseeing a major project to assist PERA in planning and refocusing major re-engineering efforts completed a few years ago. This is not a traditional audit role, but because of Internal Audit's experience in all aspects of the organization, Mr. Maurek was uniquely qualified to assist in the project. Mr. Spielman noted, "We must recognize that the audit role will not always follow traditional patterns and we must be prepared to assist our organizations to move forward in rapidly changing environments. Balancing the need for objectivity and independence is not easy, but if done with an eye for the good of the organization, it can be accomplished."

As well as serving as a clearinghouse for information, APPFA presents seminars at semi-annual meetings in May and November, allowing members to earn required continuing professional education credits at very low cost. Typical topics include audits of fixed income investments, auditing investment advisors, client-server audit approach, derivatives best practices, electronic funds transactions, equity real estate audits, analytical review techniques, audits of disability offsets, and topics on the changing role of auditors such as internal controls education for management using control self assessment techniques.

"There are a number of accounting associations I could belong to," says Brad Feaster, an internal auditor from the Public Employees' Retirement System of Mississippi and former APPFA Treasurer, "what makes this one so special is that we all face such similar challenges and problems. It's sort of like running into someone from your hometown when you're visiting another country; the connection goes much deeper than just meeting someone who speaks the same language. If we weren't so specific about the makeup of APPFA, I think we'd lose that unique connection."

The Association of Public Pension Fund Auditors was formed in Chicago in 1991 by four internal auditors from pension funds in Colorado, Illinois, New York, and Wisconsin. David Maurek, Steve Hayward, Steve Harding, and Bob Schaefer met May 6, 1991, at the Marriott Residence Inn in downtown Chicago as fellow steering committee members and formed the organizational structure of APPFA. The Constitution and By-Laws and the statement of purpose were adopted at this meeting. They established four major purposes for the new professional association:

- To unify and encourage cooperation among public pension fund auditors,
- To provide comprehensive professional development opportunities on pension related topics,
- To promote and maintain high professional standards for internal auditors of public retirement systems, and
- To encourage and facilitate research, publication, and dissemination of information among the membership.

Since then, APPFA has grown to 72 members from the United States and Canada, and many of the systems are listed among the top 50 funds in the U.S. Its members are comprised predominately of public employee retirement systems, including state, municipal and teacher plans. Although a majority of members favor steady growth of the organization, most are unwilling to give up the highly specialized requirements of admission.