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INTERIM EXECUTIVE DIRECTOR

Internal Audit Memorandum No. 2008-01

June 13, 2008

General Bob Milligan *Bob B. Milligan*
Interim Executive Director
State Board of Administration
1801 Hermitage Boulevard
Tallahassee, Florida 32308

Dear General Milligan:

We have completed the second follow-up audit of the recommendations made to the State Board of Administration (SBA) contained in the OIA Report # 2007-01, Incentive Compensation Plan Audit.

We are pleased to report that the six recommendations accepted by the SBA have been implemented. The full list of the recommendations made, including the seventh recommendation not accepted by the SBA, is shown in Appendix A.

We thank the Chief Operating Officer and Senior Investment Policy Officer and Economist for the cooperation and courtesies extended to us during the audit.

Sincerely,

Florida D. Rivera-Alsing
Florida D. Rivera-Alsing
Chief of Internal Audit
Office of Internal Audit

cc: Gwenn Thomas, Chief Operating Officer *Rm 701 ST*
James Francis, Senior Investment Policy Officer and Economist *[Signature]*

Scope, Objectives, and Methodology

Scope and Objectives

This follow-up audit entailed the review of the status as of May 31, 2008 and the progress of management efforts in implementing the six recommendations accepted by the SBA contained in OIA Report # 2007-01 issued on March 8, 2007. In certain cases, we reviewed subsequent information to provide updated information regarding current processes.

The purpose of this follow-up audit was to evaluate whether the recommendations made and accepted were effectively implemented. Specifically, to determine whether:

- Each recommendation was implemented to address identified risks/conditions raised or that alternatives to the recommendations were used to address the risks/conditions.
- The changes implemented were effective in addressing risks/conditions raised.
- Other issues have developed that need management's attention.

Methodology

This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* published by The Institute of Internal Auditors, Inc., and accordingly included such tests of records and other auditing procedures deemed necessary.

Appendix A: List of the Seven Recommendations and Their Status

No.	<u>Recommendations</u>	<u>OIA Conclusion on the Status</u>
1a	<p><u>Policy 20-221, Incentive Compensation Plan (ICP) for Investment Professionals, does not include certain provisions that may affect the determination of the eligibility for ICP.</u></p> <p>We recommend that the SBA review and address the following provisions:</p> <p>i. Breach of risk budget by units that manage more than one asset class like FI that manages both FI and Cash or like Global and International Equity (GIE) that manages both International Equity and Global Equity.</p> <p>ii. Breach of risk budget at the total fund level but not at the asset class level.</p> <p>iii. Cap on number of investment professionals to whom the incentive compensation will apply. The ICP materials presented to the Trustees stated that ICP will apply to not more than 47 investment professionals.</p>	<p><i>Implemented.</i></p> <p>i. The updated ICP Policy includes a provision on SIO’s with multiple asset class responsibilities.</p> <p>ii. This is not covered in the updated ICP policy. However, the SBA’s Senior Investment Policy Officer & Economist advised us that breach of risk budget at the total fund level, for practical purposes, is not possible if the asset classes are within their active risk limits.</p> <p>iii. Updated ICP Policy does not cap the number of investment professionals. Rather, the policy states “<i>The funding for and number of initially eligible employees in the incentive compensation plan will be developed by the COO; approved by the Executive Director; and submitted as a line item in the annual budget approved by the Trustees.</i>” We reviewed the FY 2008-09 budget submitted to the Trustees and the breakdown of the \$374,241 proposed ICP budget. We found no exception.</p>
2a	<p><u>IPE Policy 20-511, General Performance Measurement Policies, took effect on July 1, 2005, but is still in draft form.</u></p> <p>We recommend that the finalization of the policy be done as soon as possible.</p>	<p><i>Implemented.</i></p> <p>We received a copy of the signed policy.</p>
2b	<p><u>IPE Policy 20-511, General Performance Measurement Policies, took effect on July 1, 2005, but is still in draft form.</u></p> <p>Moving forward, we recommend that IPE ensure that policies affecting the ICP are updated and finalized long before performance numbers are published and the ICP payment is made.</p>	<p><i>Ongoing.</i></p> <p>As of June 12, 2008, no changes have been made to the general performance measurement and, therefore, IPE Policy 20-511 that took effect on July 1, 2005, remains the same. The Investment Policy and</p>

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		Economics Unit continues to be mindful of the recommendation and understands that the policy should be updated and finalized before performance numbers are published and the ICP payment is made.
3a	<p><u>The SBA does not perform monthly reconciliation of the time-weighted return for the private asset classes.</u></p> <p>We recommend that the quality assurance process for performance measurement include all of the asset classes. This will ensure that all of the published investment returns both at the asset class level and fund level have been checked for reasonableness.</p>	<p>Implemented.</p> <p>The time weighted return of the private asset classes was included in the quality assurance process started in July 2007.</p>
3b	<p><u>The SBA does not perform monthly reconciliation of the time-weighted return for the private asset classes.</u></p> <p>All reports submitted to the SBA by consultants that contain investment returns should be reviewed by the Senior Investment Policy Officer and Economist (SIPOE). SIPOE, under Policy 10-062, Performance Measurement, is primary responsible for ensuring that a quality assurance process is in place to monitor and validate the data generated by the performance measurement provider.</p>	<p>Not Implemented – we agree to disagree.</p> <p><i>Management Response:</i> The reports addressed in this recommendation have no nexus to the incentive compensation program. As such, the recommendation is not germane to the audit.</p> <p><i>OIA Response to Management Response:</i> If the investment return calculated by the consultants is not going to be used to check the reasonableness of the year-end return calculated by the IPMP, we agree that 3b is not relevant to the ICP. However, implementing the recommendation helps ensure the consistency of investment returns reported on different documents within the SBA.</p>
4a	<p><u>The SBA does not require SAS 70 report from its IPMP.</u></p> <p>To obtain reasonable assurance that the independent performance measurement provider (IPMP) has adequate and effective internal controls in place to ensure that the investment returns have been computed in accordance with the agreed-upon procedures, we recommend that the SBA require its IPMP to submit Type II SAS 70 reports annually.</p>	<p>Implemented.</p> <p>We received a copy of the IPMP Type II SAS 70 report.</p>
5a	<p><u>Fixed Income (FI) Does not Use the Reconciled Accounting Data in the Calculation of its Preliminary Returns.</u></p> <p>We recommend that FI adhere to the established procedures of the SBA.</p>	<p>Implemented.</p> <p>We compared the June 2007 and July 2007 market values (MV) used in the performance reconciliation between SBA and Mellon Analytical Solutions, LLC with the MV from FI. We noted no exceptions.</p>