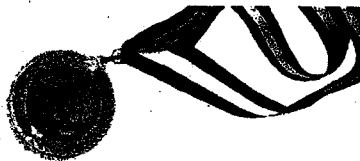


# *Florida State Board of Administration*



Report on the SBA Office of Compliance  
March 12, 2002

Prepared by  
*Medallion Consulting*



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## Report on the SBA Office of Compliance

### I. Introduction & Executive Summary

Medallion Consulting was asked by the Florida State Board of Administration ("SBA") to perform an evaluation of the role of the Office of Compliance ("OC") at the SBA and to make recommendations on the best structure and future role for the office. (As used herein, the term 'SBA' refers to the organization as a whole while the term 'Board' refers collectively to Florida's Governor, Treasurer, and Comptroller). The OC's mission statement, operations manual, and generally, its written responsibilities and role closely resemble those of an internal audit function. Thus, in this analysis, Medallion Consulting treats the OC as an internal auditing function.

The IAC and members of the SBA management team are in the process of determining whether and when, and to what extent, to engage an outside consulting firm to perform an "Operational Review" of the organization. The operational review is the equivalent of a diagnostic examination of the entire organization that can cover a range of topics across a wide array of policy and procedural issues. The review can have a wide focus or it can be narrowed to focus on specific subjects.

Our review of the compliance office, our observations and findings, and the subsequent implementation of our recommendations are a logical step in the orderly development of an economic and efficient scope for the operational review. For example, our recommendation regarding the risk assessment, if implemented, should help the IAC to focus on the areas that the operational review should explore. This effort will be accomplished well by the work of the Chief of Internal Audit working to develop the risk assessment and coordinate the operational review.

Our evaluation included a review of related documents, interviews by telephone and correspondence with key members of management and staff, a draft report and discussion,

and final written report and presentation. This Executive Summary includes only the more significant recommendations that are contained in the detailed narrative section of the report. Therefore, the reader is encouraged to consider the entire report. A summary of all recommendations is provided at Appendix E.

### **Responsibility for Compliance Within the SBA**

SBA executive management is responsible for compliance with laws, regulations, policies, and guidelines. Executive management delegates this responsibility to key members of the senior staff (e.g., Asset Class Chiefs). The senior staff is then responsible for the development, implementation, and maintenance of processes that are designed to ensure continuous compliance. The senior staff may accomplish continuous compliance through systems that include manual and automated procedures, and prevention and detection techniques.

Executive management is also responsible for monitoring control processes. It typically delegates the responsibility to the senior staff and often to an internal audit department. Part of the role of a properly functioning internal auditing department is to perform periodic compliance audits that are designed to test management's compliance processes, among other types of compliance auditing (e.g., contract compliance). Thus, compliance auditing should be included in internal audit's overall role. This description of internal auditing and its role in compliance monitoring is consistent with professional guidance on the operations of internal auditing.<sup>1</sup>

Although the office is called the "Office of Compliance," its written administrative procedures are descriptive of a typical internal auditing department. However, the office has not yet functioned in an internal audit capacity as fully described in its administrative

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<sup>1</sup> Standards for the Professional Practice of Internal Auditing, Performance Standard 2120. The Institute of Internal Auditors.

documents. For example, we note with no intent to impugn their work that much of their focus since inception has been on investigative matters and special projects.

In our mind (and we believe in the minds of SBA staff) this past focus raises the question, "What are we...compliance or audit?" We believe that there is a level of identity confusion outside and inside the OC. Its identity could be clarified. Changing the identity of the OC will help to avoid the confusion that is associated with the current use of compliance in the title of the office and its director, and with the dichotomy between the written role of the office and what it has done thus far.

In moving forward, the Executive Director should clarify the identity and role of the OC by renaming it to the Office of Internal Audit ("OIA") and changing the title of its director from Compliance Officer, which is limiting, to Chief of Internal Audit. [Professional standards refer to the head of the internal auditing function as the Chief Audit Executive ("CAE")]. Additionally, the ED should 're-communicate' the OIA's responsibilities through issuance of a formal Charter, and through the ED's regular communications with management and staff.<sup>2</sup>

### **Limited Audit Planning Processes**

One of the most significant challenges confronting internal audit management is how to maximize auditing effectiveness with limited resources. In meeting this challenge, thorough planning is essential to facilitate the efficient use of staff time and to schedule worthwhile audit activities. Audit planning should be based on a careful assessment of the key risks facing the SBA, and culminate in a prioritized audit schedule.

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<sup>2</sup> The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board. (Standards for the Professional Practice of Internal Auditing, Attribute Standard 1000. The Institute of Internal Auditors.)

The OC lacks a written and systematic risk assessment. This may have several negative implications for the SBA including:

- Lack of long-term direction for the department
- Poor perception of the office in the eyes of the rest of the SBA
- Inefficient use of resources on areas of low or moderate risk
- Inadequate support/justification for adding resources
- Poor quality of information supplied to ED, IAC, and Board on risks addressed and risks not addressed (residual risk)

The OC should move as soon as possible to develop a written and systematic risk assessment that forms the basis for its audit planning process.

### **Organizational Reporting Structure**

A survey of 41 public retirement trusts having internal auditing functions indicates that fully 34% of Chief Audit Executives report only to the Board of Trustees or Audit Committee of the Board, 24% report only to the Executive Director, and 41% have a reporting relationship with both the Board of Trustees and Executive Director (typically, one is direct and the other is administrative). In other words, fully 75% of the internal audit departments have some level of reporting to the Board.

In the present structure at the SBA the CO reports only to the Executive Director. This structure is in keeping with only 24% of the PERS surveyed. It does not provide presently for three key processes involving the Board that are generally conducive to *maximum* independence of an internal audit office. These are:

1. Presentation of the annual audit plan to the Board for review and approval;
2. Periodic update of progress towards completion of the annual audit plan;
3. Responsibility of the Board to review and approve the hiring and firing of the Chief of Internal Audit.

A structure that allows these three processes to take place should also naturally allow for the Board to meet privately with the Chief of Internal Audit if necessary.

Although SBA is not alone in its current organizational structure, the best practice would be for the Board to adopt an organizational structure that is conducive to providing a reporting relationship with the Chief of Internal Audit. One possible reporting option would establish an Audit Committee of the Board as a standing committee. The Board could appoint an audit committee composed of individuals who are independent of the day-to day management of the SBA and who have the necessary combination of (audit, accounting, financial, investment) expertise to perform their review function effectively. (Refer to the diagram below: Recommended Reporting Option 1.) There are several possible ways to implement a modified reporting structure but the Board alone can determine which is most practical.

#### **Adequacy of Staffing Level**

A survey of the 41 public retirement trusts indicates the average size of the internal auditing professional staff is 2% of total staff size. In addition the survey indicates that fully 87% of all internal audit staff across all of the respondents have one or more professional designations (Certified Public Accountant, Certified Internal Auditor, Certified Information Systems Auditor, Certified Fraud Examiner). At its present level (2 professional staff) the OC does not have the resources to fulfill its responsibilities.

The new OIA staff size should increase to a total of four professionals in order to be at the *average* size for public retirement trust funds. In addition, when at its full complement, the four professionals should collectively hold from 4 to 6 professional certifications.

#### **Adequacy of Staff Experience**

The SBA is in need of a professional audit team that is not only the right size and appropriately accredited, but it also needs a team that has experience in its industry---namely, investments. The current vacancy of the Compliance Officer position is an opportunity for the SBA to hire someone at the head of the new OIA that is experienced in the business of an institutional investor. A qualified investment auditor should then be able to train new staff to effectively audit investments. Further, the complexity of the SBA's Information Technology necessitates periodic internal control audits. However, current staff in the office is not qualified to perform these audits.

The SBA should hire a person with experience in the investment field as its Chief of Internal Audit. The Chief should then hire an internal auditor who is qualified to audit the complexities of the SBA's information technology services. A person with the CISA (Certified Information Systems Auditor) may be a candidate for this task.

### **Working Smart**

The current economic and fiscal environment is such that the Office of Internal Audit also needs to "work smart."

The OIA should implement techniques that are designed to foster efficiency in internal auditing. When the staff size increases to the recommended number, efforts should be made to implement "process auditing" (replaces traditional audits of transactions and segmented activities) including integration of all significant aspects of the process (including IT audit work). Working smart could also include streamlining the audit process/practices, staff empowerment, use of technology (the OC has IDEA software and is trained in its use), self-assessments, team audits, and other opportunities to reduce audit cycle time and improve cost-effectiveness. Working smart also includes continuing its current policy of outsourcing (after the risk assessment is done).

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### **Role and Placement of Investment Compliance**

Presently, each Asset Class Chief has responsibility for investment compliance (to the extent that transactions are under their discretion) and for implementation of processes that are designed to monitor compliance. (The Asset Class Chiefs monitor external managers who are responsible for compliance with the guidelines for the portfolios under their discretion.) We believe that this approach places compliance responsibilities where they belong and where they should remain.

As the industry moves toward one-day settlement, systems will become such that, in the process of effecting settlement in such short time frames, they will simultaneously enable complex and efficient automated pre-trade compliance monitoring of publicly traded securities. Since publicly traded securities represent the most significant portion of the SBA's internally managed investments, the SBA may adopt such systems for compliance monitoring. However, the need for internal pre-trade compliance monitoring at SBA may not be that pressing since most assets are passive indexed investments and the guidelines for these assets are generally not trade specific, but rather more focused on aggregate statistics, e.g., percentages of total fund, etc. (refer to Appendix F for a diagram of the compliance system need.)

Any decision by the SBA to implement pre-trade compliance systems should give careful consideration to the cost-benefit relationship and the specific guidelines that warrant pre-trade monitoring. That said, if the SBA does adopt internal automated pre-trade compliance monitoring systems, ownership of those systems would no longer be appropriately vested with each asset class Chief. Rather, the compliance monitoring system then would be vested more appropriately with someone independent of actual transactions. (Note: We were not asked to review the investment compliance processes at the SBA. We include this discussion because it has implications for the Office of Compliance.)

As the SBA moves forward toward real-time trading, it may adopt a pre-trade automated compliance monitoring system. Ownership of such a system should reside with someone

within the investment department, but not with one of the Asset Class Chiefs. We believe that adoption of an automated centrally located compliance monitoring system would necessitate the establishment of a separate investment compliance position that should report to the Deputy Executive Director in his capacity as Chief Investment Officer ("CIO"). The continuing role of the Office of Internal Audit should include periodic evaluations of the manual and automated investment compliance monitoring systems and processes of the investment departments.

### **Summary Conclusion**

The SBA should consider the recommendations of our report as it moves forward to restructure and reorganize the Office of Compliance. Our comments in the above summary highlight several of the 19 recommendations included in the body of the report below. We encourage a complete reading of the document to gain our full perspective.

### **Report Limitations**

This report should be read and evaluated with several caveats in mind:

First, the subject addressed in this report is somewhat subjective and not susceptible to absolute or definitive conclusions. When we express a judgment or make a recommendation, we also generally set forth the factual observations and rationale that led us to that viewpoint. Many of our conclusions are less in the nature of definitive recommendations, than they are alternatives for the SBA to consider in light of its evolving management and practices now and over the coming years.

Second, in conducting this review we necessarily relied to some extent on oral and written representations of the people with whom we discussed the Office of Compliance and as reflected in documentary information we obtained. We were not hired to, and did not attempt to, conduct a formal audit of the office.

Third, we conducted our audit primarily from an administrative perspective. This report does not, and is not intended to, provide legal advice.

Fourth, our review considers and analyzes the overall administrative structure and operations of the Office of Compliance. Our report does not analyze the SBA taken as a whole and, although we reviewed some internal controls and have recommendations to improve them in certain areas, we do not opine on the SBA's overall internal control structure.

Fifth, our observations are necessarily based only on the information we considered, including representations from staff, as of and during the compressed period within which we were asked to complete our review. At this phase of our review we have not had the opportunity to interview members of the Board or IAC. Therefore, our report lacks their perspective, individually and collectively. As the Board and IAC consider our report and whether to implement our recommendations, we would be pleased to incorporate their views in a later version of the report or in the implementation of our recommendations.

Our report cannot and does not attempt either to assess the manner in which any of our recommendations may be implemented or observed in the future, or predict whether the SBA's practices as represented to us will be observed in the future. Nor does our report supplant or reduce the Board's ongoing, independent fiduciary duties to structure and evaluate the SBA's administrative operations, practices and programs.

Finally, although we have discussed our findings with, and submitted draft versions of our report to representatives of the Board, the final form and content of the report reflect the independent judgment of Medallion Consulting.

## II. Detailed Narrative and Recommendations

### A. Background of Compliance and Internal Auditing at SBA

The Office of Compliance ("OC") at the SBA was established in the summer of 1999 as an independent appraisal function. It was then determined that the OC should be the central point for coordination of activities that promote accountability, integrity, efficiency and compliance in SBA programs and activities.<sup>3</sup> According to its Mission Statement, the OC is to increase assurances that:

- SBA assets are safeguarded
- Operating efficiencies promoted
- Compliance is maintained with prescribed laws, and Board of administration and management policies.

*add • reliability and integrity of financial & operating information*

Establishment of the OC came about at the initiative of the Executive Director with the Board's concurrence "to permit constructive oversight of the SBA's activities."<sup>4</sup> Operations of the OC began when the Compliance Officer ("CO") started work at the SBA on August 1st 1999. The CO reports directly to the Executive Director ("ED"). This level places the CO on the SBA executive management team. The SBA's ED reports directly to the Board, but there is no formal reporting relationship of the CO to the Board.

Soon after the CO began work at the SBA, a Compliance Manager and administrative assistant were hired. The OC functions today with the same complement of staff (3). However, the CO slot is vacant due to his departure as of December 31, 2001.

Prior to the formation and establishment of the OC, the SBA had no dedicated staff person functioning as internal auditor or compliance officer. However, the SBA through the

<sup>3</sup> FSBA Office of Compliance Mission Statement

<sup>4</sup> Memorandum July 22, 1999. ED to Board.

auspices of the Chief Financial Officer ("CFO") had outsourced internal audits on an ad hoc, as needed basis.

Since its inception the OC has functioned through a combination of internal projects and out-sourcing of the two major audits performed thus far (Real Estate Asset Class operations and Securities Lending).

Florida's Auditor General performs the SBA's annual financial audit. The CFO's office is the primary liaison with the AG's auditors. The AG's auditors have interacted with the OC to obtain information regarding SBA policies and procedures. The AG's auditors have also inquired whether the OC has previously reviewed an area prior to initiating their own review. However, the AG's auditors have not reviewed the work of the OC.

Other audits are performed by the Office of Program Policy Analysis and Government Accountability ("OPPAGA").

**B. Analysis of responsibilities included in the FSBA's current compliance function**

- 1. Identify and evaluate any written mission statement, charter, policies, procedures, and job descriptions related to the current compliance function. Identify and evaluate the extent of overlap or intrusion of the compliance function into what would otherwise be considered internal auditing's role.**

The office maintains a mission statement, charter, policies and procedures manual, and job descriptions. These documents are generally in good form except for a few minor observations noted in the table below. The Mission Statement represents a hybrid between the responsibilities of an agency Inspector General<sup>5</sup> and the description of Internal Auditing contained in Internal Auditing Standards.

Although the office is called the "Office of Compliance," its written administrative procedures are descriptive of a typical internal auditing department. However, the office has not yet functioned in an internal audit capacity as fully described in its administrative documents. For example, we note, with no intent to impugn their work that much of their focus since inception has been on investigative matters and special projects.

In our mind (and we believe in the minds of SBA staff) this past focus raises the question, "What are we...compliance or audit?" We believe that there is a level of identity confusion outside and inside the OC. Its identity could be clarified. Changing the identity of the OC will help to avoid the confusion that is associated with the current use of compliance in the title of the office and its director, and with the dichotomy between the written role of the office and what it has done thus far.

**Recommendation 1:** The Executive Director should clarify the identity and role of the OC by renaming it the Office of Internal Audit ("OIA") and changing the title

of its director from Compliance Officer, which is limiting, to Chief of Internal Audit. [Professional standards refer to the head of the internal auditing function as the Chief Audit Executive (“CAE”)]. Additionally, the ED should ‘re-communicate’ the OIA’s responsibilities through issuance of a formal Charter, and through the ED’s regular communications with management and staff.<sup>6</sup>

**Table – Observations on OC Governance Documents**

Document	Observation
Mission Statement – Bullet Points	<b>Recommendation 2:</b> The Mission should include reviewing the reliability and integrity of financial and operating information.
Mission Statement - Specific Responsibilities	These reviews include: Determining that all SBA operating units are complying with laws, regulations, and policies and procedures. <b>Recommendation 3:</b> This should be clarified as follows: Evaluating SBA processes and procedures used by operating units to ensure compliance with laws, regulations, policies, and procedures.
Mission Statement - Specific Responsibilities	Notably absent from this section is any responsibility for the detection of fraud or unethical acts. <b>Recommendation 4:</b> Specific responsibilities should include employing audit procedures capable of detecting indications of fraud or unethical acts.
Mission Statement - Specific Responsibilities	It is common for internal audit departments to coordinate the work of external auditors. This responsibility is not included in this document. <b>Recommendation 5:</b> The OC should act in such a role and in cooperation with the CFO.
Charter	According to the annual report of the compliance office for the year ended June 30, 2001, the Executive Director approved a charter for the compliance office. However the charter does not exist as a stand-alone document. <b>Recommendation 6:</b> The Mission Statement and General Objectives of the department as they appear in the Chapters 1 & 2 of the Manual should be incorporated into a formal charter and issued above the signature of the Executive Director.

<sup>5</sup> Florida Statutes Title IV. 20.055

<sup>6</sup> The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board. (Standards for the Professional Practice of Internal Auditing, Attribute Standard 1000. The Institute of Internal Auditors.

**2. Identify areas of compliance that are not included, or covered to a greater or lesser extent than they should be, in the current structure – this focus will include all areas of SBA reach including the Investment Plan (DC/PEORP) and all sources of compliance monitoring, e.g., investment consultant and other outsourcing.**

Presently, each Asset Class Chief has responsibility for investment compliance (to the extent that transactions are under their discretion) and for implementation of processes that are designed to monitor compliance. We believe that this is where compliance responsibilities belong and should remain. Effective systems to monitor investments compliance are essential for internally managed funds.

As the industry moves toward one-day settlement, systems will become such that in the process of effecting settlement in such short time frames they will simultaneously enable complex and efficient automated pre-trade compliance monitoring of publicly traded securities. Since this type of asset represents the most significant portion of the SBA's investments, we believe that the SBA will eventually adopt such systems for compliance monitoring. However, the need for internal pre-trade compliance monitoring at SBA may not be that pressing since most assets are passive indexed investments and the guidelines for these assets are generally not trade specific, but rather more focused on aggregate statistics, e.g., percentages of total fund, etc. (refer to Appendix F for a diagram of the compliance system need.)

Any decision by the SBA to implement pre-trade compliance systems should give careful consideration to the cost-benefit relationship and the specific guidelines that warrant pre-trade monitoring. That said, if the SBA does adopt internal automated pre-trade compliance monitoring systems, ownership of the systems will no longer be appropriately vested with each asset class Chief. Rather, the compliance monitoring system should be vested with someone independent of actual transactions.

**Recommendation 7:** As the SBA moves forward toward real-time trading it may adopt a pre-trade automated compliance monitoring system. Ownership of such a system

should reside with someone within the investment department, and not with one of the Asset Class Chiefs. We believe that adoption of an automated centrally located compliance monitoring system would necessitate the establishment of a separate investment compliance position that should report to the Deputy Executive Director in his capacity as Chief Investment Officer ("CIO"). The continuing role of the Office of Internal audit should include periodic evaluations of the manual and automated investment compliance monitoring systems and processes of the investment departments.

**Recommendation 8:** Specific compliance audits should be determined through the OIA's annual planning process as described in the next section of our report. This process would include the Investment Plan<sup>DC</sup> in the audit universe and thus it would become subject to risk assessment and audit. The overall scope of compliance auditing should include the SBA's processes that are designed to ensure compliance with organization policies, plans, procedures, laws, regulations, and contracts.

**3. Identify areas of internal auditing that are not included, or covered to a greater or lesser extent than they should be, in the current structure – include all areas of SBA reach and outsourcing.**

- **What are the more significant risk management functions performed by SBA staff and others that should be monitored by the compliance function and/or the internal auditing function? (This focus is not intended to be the equivalent of an organization wide risk assessment, but rather a high level summary.)**
- **What new or added roles and responsibilities should the function(s) be required to fill?**
- **Identify future requirements of compliance/internal audit as related to Defined Contribution implementation and monitoring.**

(These bullets were included in the scope of work in Section D below but are more appropriately addressed here.)

We noted above (in Sec. B.1) two areas where internal audit coverage needs improvement. These are: reviewing the reliability and integrity of financial and operating information and employing audit procedures capable of detecting indications of fraud or unethical acts. Additionally and significantly, regular and frequent coverage is needed in the SBA's Information Technology (IT) area. Audit emphasis may be required in this area since it may involve significant risk exposure for the Board. Typical audits of IT include the Data Center, systems software, application systems, systems development, end-user computing, integration, telecommunications, and networks.

Staff indicated in our interviews that the DC Plan staff size might be between 4 and 6 persons. A review of information from other public retirement trusts indicates that their internal auditors are not dedicated to the defined contribution plans. Rather, the regular audit staff in the normal course of its auditing responsibilities performs the necessary internal auditing in the DC area. If the SBA moves to increase audit staff to the size recommended in this report, the eventual level of staffing should then be adequate to perform the internal audits of the DC Plan.

**Recommendation 9:** Internal audits of the DC plan should be focused on two general areas: first, normal internal auditing that includes staff processes relative to the Investment Plan, and second, contractual monitoring of external service providers for the Investment Plan. Like the other auditable areas of the SBA, determination of what and when to audit in these categories would be based upon the risk assessment.

Deciding on the appropriate level of internal audit coverage is problematic for most organizations. Indeed, one of the most significant challenges confronting internal audit management is how to maximize auditing effectiveness with limited resources. In meeting this challenge, thorough planning is essential to facilitate the efficient use of staff time and to schedule worthwhile audit activities. We discuss below four integrated stages of the planning process: risk assessment, audit plans, staff analysis, and budgeting.

#### *Overall Audit Approach*

The audit approach (long and short term) should be based on a careful assessment of the key risks facing the SBA, and should culminate in a prioritized audit schedule. Generally, the audit approach should follow these steps:

1. Determine the universe of auditable entities.
2. Perform a risk assessment.
3. Rank the auditable entities according to risk.
4. Estimate the audit time required for each auditable entity.
5. Develop and audit schedule based on the ranking and resources available.
6. Conduct the audits.

#### *Audit Universe*

Audit universes may be developed on a business cycle, functional, or operating entity basis. Two documents, or their equivalent, are necessary for the risk analysis and planning activities: the SBA's strategic plan and its technology plan. In addition, the Board, IAC, Executive Director and other members of the executive management

team should be interviewed. Development of the audit universe could consider the following sources:

- Business products, services, and organizational products.
- Company organization charts.
- The company telephone directory and post office box listing, if available.
- Lists of major information technology systems or applications.
- Senior management's responses to inquiries regarding major risk areas of the organization.
- Recent external auditor management comments.
- Executive management's input on reengineering quality, as well as self-assessment plans or potential opportunities.
- Charts of accounts.
- Any other applicable organization documentation (such as reports, planning documents, etc.).

The audit universe should include information technology systems or applications within, or as, audit entities.

The audit universe should also reflect careful consideration of the appropriate size and number of audit entities (e.g., too detailed or too general, too many or too few, inconsistencies between different areas in the organization, logical division of systems or areas, etc.)

A suggested listing of possible auditable functions of the Board of Administration is suggested in this report in Appendix C.

#### *Audit Risk Assessment*

The term risk refers to the probability that an event or action may adversely affect the SBA. Risk is an inherent part of business and has the potential to impair the SBA's performance, financial strength, and ability to provide quality services and investment returns. Some of the possible effects of risk are:

- An erroneous decision from using incorrect, untimely, incomplete, or otherwise unreliable information
- Erroneous record keeping, inappropriate accounting, fraudulent financial reporting, financial loss, and exposure
- Failure to adequately safeguard assets
- Customer dissatisfaction, negative publicity, and damage to the SBA's reputation
- Failure to adhere to organizational policies, plans, and procedures, or not complying with relevant laws and regulations
- Acquiring resources uneconomically or using them inefficiently or ineffectively
- Failure to accomplish established objectives and goals for operations or programs

Selecting the indicators of risk used in preparation of the risk assessment requires professional judgment. The Chief of Internal Audit should incorporate information from his/her experience, the Board, Executive Director, senior management, external auditors, laws and regulations, industry trends, prior audit findings, and analysis of financial and operating data.

Once the audit universe and risk indicators are determined, each area should be rated for risk. Risk ratings have an objective component that may be rated numerically and a subjective component that may be rated low, moderate, or high. The functions with most risk are usually where internal audit resources are focused. Thus, over time, the Board and Executive Director achieve the coverage and comfort sought from the internal auditing function. The auditor should also share the process with the SBA's risk management officer to avoid duplication of

effort. We caution that the SBA's overall *business* risks that are of concern to management may differ significantly from the *audit* risks that are of concern to the internal auditor.

The Chief of Internal Audit may consider the following general indicators of risk (among others). APPFA has held professional development sessions on this topic, including more specific factors used by other pension trust funds.

- Characteristics inherent to investments:
  - Creditworthiness of issuers and counter-parties
  - Market volatility and capitalization
  - Nature of operations and management
  - Legal complexity
  - Degree of liquidity
- Effectiveness of internal controls
- Geographical dispersion of operations
- Volume of transactions
- Time lapsed since the last audit
- Results of prior audits
- Acceptance of findings by management
- Level and complexity of computerization
- Etc.

The OC's lack of a written and systematic risk assessment may have several negative. These may include:

- Lack of long-term direction for the department
- Poor perception of the office in the eyes of the rest of the SBA
- Inefficient use of resources on areas of low or moderate risk
- Inadequate support/justification for adding resources
- Poor quality of information supplied to ED, IAC, and Board on risks addressed and risks not addressed (residual risk)

**Recommendation 10:** The OC should move as soon as possible to develop a written and systematic risk assessment that forms the basis for its audit planning process.

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*Audit Plan*

The annual audit plan should be based on the analysis of risk. The plan should include the number of audit hours for each audit entity; the percentage of hours allocated to audits, special requests, and administrative categories; consideration of whether and how changes to and capabilities of the audit staff were considered in developing the audit plans; coordination with other audit groups (i.e., AG & OPPAGA), management comments from the most recent external audit; and any major planned changes and strategic opportunities. The plan should consider other impacts such as leave time, training and management requests.

**Recommendation 11:** The Board (or its audit committee) and/or the Executive Director should approve the annual audit plan. The auditing plan should also consider the type of audit to be conducted in the area. For example, internal audit departments frequently perform operational auditing of several different types. The SBA could benefit significantly from audits that are designed to evaluate economy, efficiency, and effectiveness.

Refer to Appendix B for a summary of typical services provided by internal audit departments.

*Staffing Analysis and Budgeting*

The size of the audit staff and budget may not permit complete coverage of the audit cycle based on the risk assessment.

**Recommendation 12:** In event that the size of the audit staff and budget may not permit complete coverage of the audit cycle based on the risk assessment, the Chief of Internal Audit should make the Executive Director aware of the

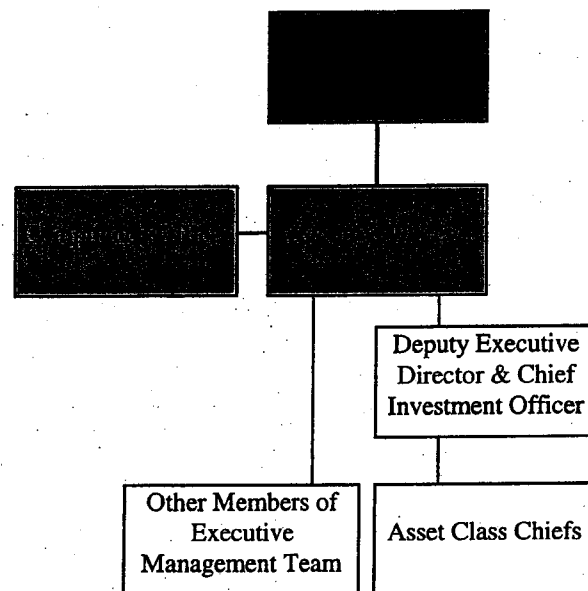
(potential) effects of the reduced audit coverage. Also, the Chief of Internal Audit and Executive Director should be satisfied that the process used to defer or reschedule audits is reasonable. If the decision regarding audit coverage is not resolved, the Chief of Internal Audit and Executive Director should report the matter to the Board for resolution.

The preceding considerations can help guide the Office of Internal Audit through this most important aspect of managing the internal auditing department and ensure that its internal and outsourced resources are used efficiently and effectively and that residual risk is understood and communicated.

**C. Analysis of current hierarchy and structure of reporting of the compliance function**

- 1. Identify and evaluate how the current structure fosters or does not foster independence of the compliance review function from the areas reviewed?**
- 2. Identify and evaluate how the current structure allows or does not allow for the compliance reviewer to report freely to the appropriate level within the organization.**

**The Current Reporting Structure**



This reporting structure *does* foster independence of the OC from the functions it audits in all cases except for audits of Executive Director performance. While this is not considered the 'best' practice, fully 24% of the public pension trusts surveyed report to the executive officer alone, as discussed below.

The current structure *does not* allow for the compliance reviewer to report freely to the appropriate level within the organization as regards performance of the Executive Director.

**Recommendation 13:** If the SBA decides to continue with the current direct report to the ED, we would strongly recommend a dotted-line reporting arrangement with the Board that satisfies the three concerns addressed in the next section of our report.

**D. Analysis of options for the best fit going forward regarding the structure, roles and responsibilities of the compliance and/or internal auditing functions within the SBA**

- What are other PERS and state boards of administration doing in this area and what best practices are followed by SBA's peers?
- How should the compliance/internal audit function be structured (formal & informal) within the SBA and/or with its designated committees/advisors?

A survey of 41 public retirement trusts having internal auditing functions indicates that fully 34% of Chief Audit Executives report only to the Board of Trustees or Audit Committee of the Board, 24% report only to the Executive Director, and 41% have a reporting relationship with both the Board of Trustees and Executive Director. In the present structure the CO reports to the Executive Director. This structure is in keeping with only 24% of the PERS surveyed and it does not provide for three key processes involving the Board that are generally conducive to maximum independence of an internal audit office. These are:

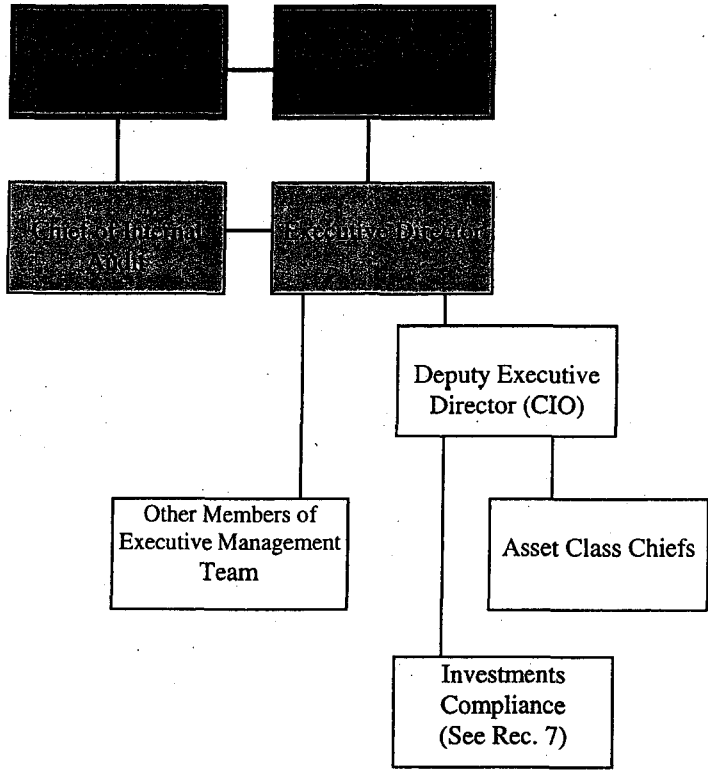
1. Presentation of the annual audit plan to the Board for review and approval;
2. Periodic update of progress towards completion of the annual audit plan;
3. Responsibility of the Board to review and approve the hiring and firing of the Chief of Internal Audit.

A structure that allows these three processes to take place should also naturally allow for the Board to meet privately with the Chief of Internal Audit if necessary.

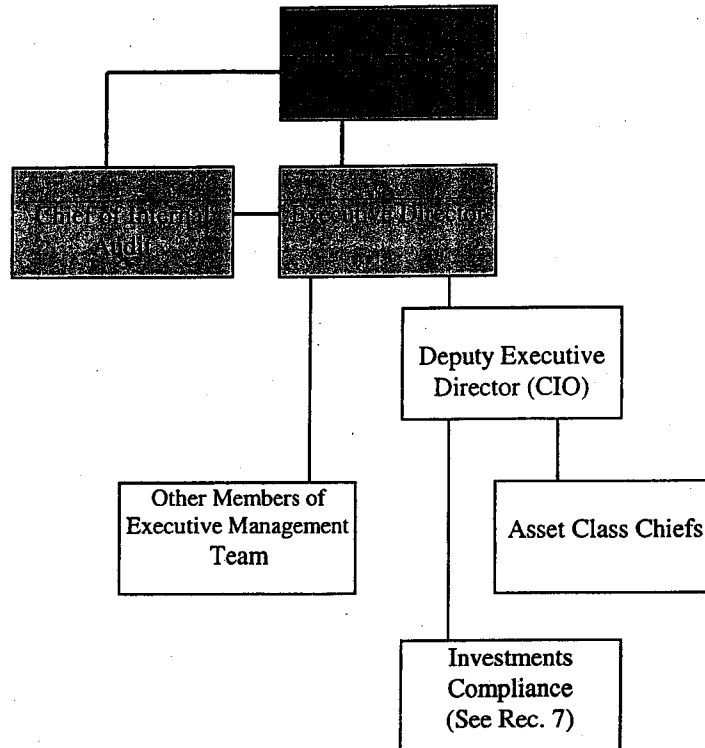
**Recommendation 14:** Although SBA's current organizational structure for internal audit reporting is similar to some other public retirement trusts, the best practice would be for the Board to adopt an organizational structure that provides a reporting relationship with the Chief of Internal Audit. One possible reporting option would establish an Audit Committee of the Board as a standing committee. The Board could appoint an audit committee composed of individuals who are independent of the day-to-day management of the SBA and who have the necessary combination of (audit, accounting, financial, investment) expertise to perform their review function effectively. Refer to the diagram below: Reporting Option 1.)

There are several possible structures that could be adopted but the Board alone can determine which is most practical. An audit committee would also provide a mechanism for the oversight of, and interaction with, other audit entities.

**Recommended Reporting Option 1 – Internal Audit Reports Administratively to the ED, Directly to Audit Committee of the Board**



**Reporting Option 2 – Internal Audit Reports Administratively to the ED, Directly to Board**



Note: While this option has a direct report to the Board it may not be practical to implement.

- What resources are needed to implement the recommended structure?
- What qualifications should those individuals possess?

**Adequacy of Staffing Level**

No additional resources are needed to implement the recommended structure. However, additional resources are needed for the OIA to meet its responsibilities. A survey of the 41 public retirement trusts indicates the average size of the internal auditing professional staff is

2% of total staff size. Refer to Appendix A. At its present level of staffing (2) the OC does not have the resources internally to fulfill its responsibilities.

**Recommendation 15:** The new OIA staff size should increase to a total of four professionals in order to be at the *average* size for public retirement trust funds.

#### **Adequacy of Staff Experience**

In addition, the survey indicates that fully 87% of all internal audit staff across all of the respondents has one or more professional designations (CPA, CIA, CISA, CFE). When at its full complement of staff, they should collectively hold from 4 to 6 professional designations. Refer to Appendix A. Again, this is only to be at the average of other public retirement trusts.

The SBA is in need of a professional audit team that is not only the right size and appropriately accredited, it also needs a team that has experience in its industry---namely, investments. The vacancy of the CO position is an opportunity for the SBA to hire someone at the head of the new OIA that can that is experienced in the business of an institutional investor. An qualified investment auditor should then be able to train new staff to effectively audit investments. Further, the complexity of the SBA's Information Technology necessitates periodic internal control audits. However, current staff in the office is not qualified to perform these audits.

**Recommendation 16:** The SBA should hire as its Chief of Internal Audit a person with experience in the investment field. See our suggested position description at Appendix D.

**Recommendation 17:** The SBA should hire an auditor who is qualified to audit the complexities of the SBA's information technology services. A person with the CISA (Certified Information Systems Auditor) may be a candidate for this task.

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### **Working Smart**

The current economic and fiscal environment is such that the Office of Internal Audit also needs to “work smart.”

**Recommendation 18:** The OIA should implement techniques that are designed to foster efficiency in internal auditing. When the staff size increases to the recommended number, efforts should be made to implement “process auditing” (replaces traditional audits of transactions and segmented activities) including integration of all significant aspects of the process (including IT audit work). Working smart could also include streamlining the audit process/practices, staff empowerment, use of technology (the OC has IDEA software and is trained in its use), self-assessments, team audits, and other opportunities to reduce audit cycle time and improve cost-effectiveness. Working smart also includes continuing its current policy of outsourcing. See next section.

- **What resources could be outsourced?**

Opinions differ depending on whom you ask. The range of outsourcing can extend from none to all of internal audit. The main objective is to achieve economy and efficiency through a balanced approach, while maintaining the appropriate level of oversight and independence. We believe that the best approach to outsourcing is “co-sourcing,” which is outsourcing selected audits and participating in the audit with the outside vendor. If feasible, co-sourcing includes an SBA internal auditor on the outsourced project. This enables the internal audit office to benefit from on the job training in a new area. It appears that the office has effectively used both outsourcing (Real Estate audit) and co-sourcing (Securities Lending).

This question of what to outsource would be more appropriately addressed if a risk assessment had been prepared.

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**Recommendation 19:** In the absence of a valid risk assessment on which to base outsourcing decisions, our inclination would be to outsource the Data Center audit. However, there may be other audits that are more appropriate.

### **III. Conclusion**

It is not at all unusual for an organization to make adjustments to operations and policies coincident with a significant change to the organization. Certain events, including the departure of the Compliance Officer, have led SBA management to consider such adjustments in its operations, and specifically in the role of the compliance office. We trust that the recommendations, structure and roles of a future Office of Internal Audit, as we have presented them in this report provide sufficient guidance to the SBA management team as it moves forward to meet the new challenges of these and the days ahead.

**IV. Appendix**

- A. Summary of PERS Internal Audit Staff Sizes, Professional Designations, and Reporting Relationships**
- B. Summary of Services Provided by the Internal Audit Department**
- C. Possible Auditable Functions at the State Board of Administration**
- D. Sample Position Description for the Chief of Internal Audit**
- E. Summary of Recommendations**
- F. Need for Pre-trade Compliance Monitoring**

**Appendix A - Summary of PERS Internal Audit Staff Sizes, Professional Designations, and Reporting Relationships**

Summary of Sample Results			Results Applied to SBA
Sample Population n=41			
<b><u>Total Staff</u></b>	<b><u>8,835</u></b>	<b><u>100%</u></b>	<b><u>217</u></b>
<b><u>Audit Staff</u></b>	<b><u>168</u></b>	<b><u>2%</u></b>	<b><u>4</u></b>
<b><u>Audit Staff Professional Designations</u></b>			
CPA	78	46%	2 to 4
CIA	44	26%	1 to 2
CISA	23	14%	1 to 2
CFA	<u>1</u>	<u>1%</u>	
	146	87%	4 to 6
<b><u>Audit Reports to:</u></b>			
Board	14	34%	
Executive	10	24%	
<b><u>Both</u></b>	<b><u>17</u></b>	<b><u>41%</u></b>	
	41	100%	

Based on APPFA's 2001 Survey of PERS. Florida SBA is a member of APPFA.

## Appendix B - Summary of Typical Services Provided by Internal Audit Departments

### TYPICAL INTERNAL AUDIT SERVICES

- Internal Control Audits

This includes evaluation of the adequacy and effectiveness of the organization's system of internal control.

- Compliance Audits

This includes compliance with policies, plans, procedures, laws and regulations. The Internal Audit unit may conduct compliance audits that include these areas and may also assess compliance with various agreements, contracts or consents.

- Financial Audits

This includes review of the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information. It is likely the Generally Accepted Auditing Standards (GAAS) and/or Generally Accepted Government Auditing Standards (GAGAS) would be followed on financial audits. This includes examination of financial transactions, accounts and reports and statistical data. The usual output of this audit is an opinion as to the fairness with which financial and related statistical data is presented in accordance with generally accepted accounting principles (GAAP).

- Investigative Audits

These audits include employing procedures capable of detecting indications of fraud or unethical acts, evaluating indications or reported incidents of fraud or unethical acts and investigating when appropriate.

- Contract Compliance Audits

These audits include the review and evaluation of others with whom agreements have been negotiated, and assessment of the compliance with the provisions of those contracts.



•Operational Audits

Operational audits are designed to:

- appraise the economy and efficiency with which resources are employed
- review operations or programs to ascertain whether results are consistent with established objectives and goals, are being carried out as planned, and are effective.

To accomplish these objectives, several variants of the operational audit may be conducted:

•Operational Audit - Effectiveness and Results

Review of accomplishments or extent of effectiveness of resources utilized in a given program or effectiveness of a given program to meet stated or implied organizational objectives

•Operational Audit - Economy and Efficiency

Review of economy and efficiency in the use of resources to achieve intended results

•Operational Audit - Accounting System

Assessment of the appropriateness, economy, and efficiency of accounting systems and procedures. Assessment of the consistency of systems and procedures with accepted and established principles, practices, and guidelines.

OTHER COMMON SERVICES

- Systems Development Reviews
- Internal Controls Advisory Services
- Coordinate Efforts of External Auditors
- Assist in Due Diligence Efforts
- Assist in Responding to External Audit Reports
- Advise on Accounting & Auditing Language in Contracts

## Appendix C - Possible Auditable Functions at the State Board of Administration

This listing was developed from our experience with public retirement trust funds and from reading SBA documents. **This list may include areas that are not relevant to the SBA.**

A final list of auditable functions should be determined by the Chief of Internal Audit from survey work and discussions with management and representatives of the Board. Once the list is final, each area should be rated for risk. Risk ratings have an objective component that may be rated numerically and a subjective component that may be rated low, moderate, or high. The functions with most risk are usually where internal audit resources are focused.

Bonus award program	Money managers
Budget	Non-traditional
Cash management	Other fund investments
Corporate actions	Other fund management
Corporate governance	Payroll
Custodial banking	Performance measurement
Derivatives - Currency forwards	Personnel
Derivatives - MBS	Private placements
Derivatives - Options	Purchasing
Derivatives - Swaps	Real estate - commingled
Disaster prevention & recovery	Real estate - equity
Equities - Emerging markets	Real estate - mortgages
Equities - International	Real estate management
Equities - Growth	Real estate program
Equities - Indexed	Records management
Equities - LBOs/Venture capital	Regulatory reporting
Equities - Value	Reporting to the Board
Fixed assets	Securities lending
Fixed Income - Emerging	Securities movement & safekeeping
Fixed Income - International	Soft dollars
Fixed Income - Public bonds	Special programs
Fund accounting & reporting	STIF management
Insurance	STIF investments
Inter-organization reconciliations	Trading commissions
Inter-system reconciliations	Transaction amortization account
IT management	Transaction processing
IT systems	Travel
Legal fees	

The list of auditable functions can be shortened or lengthened as required. The above is provided for discussion only.

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### **Appendix D - Sample Position Description for the Chief of Internal Audit**

The Chief of Internal Auditing at the Florida SBA requires a professionally trained and experienced internal auditor to fulfill the role. The Chief is responsible for the development and implementation of a comprehensive internal financial, operational, and compliance audit program that includes, in addition to administrative management of the internal audit function, an audit risk assessment and evaluation of internal controls, policies, and information systems. Additionally, this position is responsible for reporting conditions that pose a risk of loss and for bringing to management's attention any irregularities, fraud or other acts that are subject to detection through the application of normal audit procedures. Presently, the Chief reports to the Executive Director. The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

Essential duties and responsibilities include the following, and any other duties that may be assigned from time-to-time by the Executive Director or the Board:

- Conduct reviews of the investment process to ensure investment operations are in compliance with applicable laws, regulations, management policies and guidelines, and Board of Trustee directives.
- Review data processing procedures for information security and processing improvements.
- Evaluate effectiveness of procedures and policies, internal controls, resource utilization, performance, cost effectiveness and strategic and operating plans.
- Perform compliance audits to determine execution of policies and directives.
- Interpret accounting theories and fiscal rules and policies.
- Verifies accounting records are maintained in accordance with reporting requirements.
- Prepares various audit reports.
- Carries out other special examinations as necessary.
- Coordinates external annual audit.
- Follows up on recommendations to determine that action to implement change has occurred by affected management.
- Periodically, and upon request, provides the Executive Director and the Board of Trustees with information reports.

The Internal Auditor should have a minimum of a Bachelor's degree in accounting, finance, business administration or closely related field and a minimum of five years of professional internal auditing experience, preferably in institutional investing, financial services, or public pension investment trust funds. The successful candidate will also have achieved professional designations such as CPA and/or CIA.

**Appendix E - Summary of Recommendations**

Recommendation	Page
<b>Recommendation 1:</b> The Executive Director should clarify the identity and role of the OC by renaming it to the Office of Internal Audit ("OIA") and changing the title of its director from Compliance Officer, which is limiting, to Chief of Internal Audit. [Professional standards refer to the head of the internal auditing function as the Chief Audit Executive ("CAE")]. Additionally, the ED should 're-communicate' the OIA's responsibilities through issuance of a formal Charter, and through the ED's regular communications with management and staff. <sup>7</sup>	
<b>Recommendation 2:</b> The Mission should include reviewing the reliability and integrity of financial and operating information.	
<b>Recommendation 3:</b> This should be clarified as follows: Evaluating SBA processes and procedures used by operating units to ensure compliance with laws, regulations, policies, and procedures.	
<b>Recommendation 4:</b> Specific responsibilities should include employing audit procedures capable of detecting indications of fraud or unethical acts.	
<b>Recommendation 5:</b> The OC should act in such a role and in cooperation with the CFO.	
<b>Recommendation 6:</b> The Mission Statement and General Objectives of the department as they appear in the Chapters 1 & 2 of the Manual, should be incorporated into a formal charter and issued above the signature of the Executive Director.	
<b>Recommendation 7:</b> As the SBA moves forward toward real-time trading it will likely adopt a pre-trade automated compliance monitoring system. Ownership of such a system should reside with someone within the investment department yet not one of the Asset Class Chiefs. We believe that adoption of an automated centrally located compliance monitoring system will necessitate the establishment of a separate investment compliance position that should report to the Deputy Executive Director in his capacity as Chief Investment Officer ("CIO"). The role of the Office of Internal audit should include periodic evaluations of the manual and automated investment compliance monitoring systems and processes of the investment departments.	
<b>Recommendation 8:</b> Specific compliance audits should be determined through the OIA's annual planning process as described in the next section of our report. This process would include the Investment Plan in the audit universe and thus it would become subject to risk assessment and audit. The overall scope of compliance auditing should include the SBA's processes that are designed to ensure compliance with organization policies, plans, procedures, laws, regulations, and contracts.	
<b>Recommendation 9:</b> Internal audits of the DC plan should be focused on two general areas: first, normal internal auditing that includes staff processes relative to the Investment Plan, and second, contractual monitoring of external service providers for the Investment Plan. Like the other auditable areas of the SBA, determination of what and when to audit in these categories would be based upon the risk assessment.	
<b>Recommendation 10:</b> The OC should move as soon as possible to develop a written and systematic risk assessment that forms the basis for its audit planning process.	
<b>Recommendation 11:</b> The Board (or its audit committee) and/or the Executive Director should approve the annual audit plan. The auditing plan should also consider the type of audit to be conducted in the area. For example, internal audit departments frequently perform operational auditing of several different types. The SBA could benefit significantly from audits that are designed to evaluate economy, efficiency, and effectiveness.	

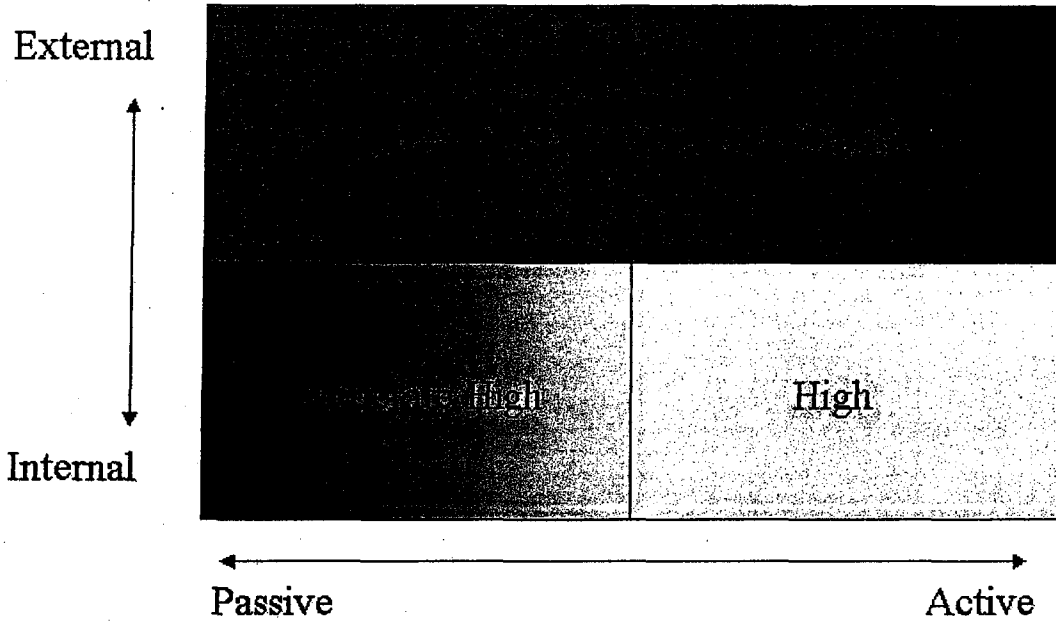
<sup>7</sup> The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board. (Standards for the Professional Practice of Internal Auditing, Attribute Standard 1000. The Institute of Internal Auditors.

<p><b>Recommendation 12:</b> In event that the size of the audit staff and budget may not permit complete coverage of the audit cycle based on the risk assessment, the Chief of Internal Audit should make the Executive Director aware of the (potential) effects of the reduced audit coverage. Also, the Chief of Internal Audit and Executive Director should be satisfied that the process used to defer or reschedule audits is reasonable. If the decision regarding audit coverage is not resolved, the Chief of Internal Audit and Executive Director should report the matter to the Board for resolution.</p>	
<p><b>Recommendation 13:</b> If the SBA decides to continue with the current direct report to the ED, we would strongly recommend a dotted-line reporting arrangement with the Board that satisfies the three concerns addressed in the next section of our report.</p>	
<p><b>Recommendation 14:</b> Although SBA's current organizational structure for internal audit reporting is similar to some other public retirement trusts, the best practice would be for the Board to adopt an organizational structure that provides a reporting relationship with the Chief of Internal Audit. One possible reporting option would establish an Audit Committee of the Board as a standing committee. The Board could appoint an audit committee composed of individuals who are independent of the day-to-day management of the SBA and who have the necessary combination of (audit, accounting, financial, investment) expertise to perform their review function effectively. Refer to the diagram: Reporting Option 1.) There are several possible structures that could be adopted but the Board alone can determine which is most practical. An audit committee would also provide a mechanism for the oversight of, and interaction with, other audit entities. (See diagram in body of report.)</p>	
<p><b>Recommendation 15:</b> The new OIA staff size should increase to a total of four professionals in order to be at the <i>average</i> size for public retirement trust funds.</p>	
<p><b>Recommendation 16:</b> The SBA should hire as its Chief of Internal Audit a person with experience in the investment field. See our suggested position description at Appendix D.</p>	
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<p><b>Recommendation 19:</b> In the absence of a valid risk assessment on which to base outsourcing decisions, our inclination would be to outsource the Data Center audit. However, there may be other audits that are more appropriate.</p>	

Appendix F – Need for Pre-trade Compliance Monitoring

### Compliance System Need Matrix

#### Management Style



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Note: A third dimension not depicted is the complexity of investment guidelines for the portfolio. The more detailed and restrictive the guidelines are, the greater the need for a pre-trade compliance system.

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