

Report Date: July 31, 2014

South Carolina Retirement System Investment Commission

Annual Investment Report Audit

For FYE June 30, 2013

To: Sarah Corbett, Executive Director
Jon Rychener, Director of Investment Reporting & Performance

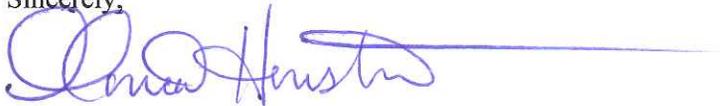
We recently completed a review of the internal controls and procedures related to the Retirement System Investment Commission's ("RSIC") Annual Investment Report (the "Report") for the fiscal year ending June 30, 2013. The South Carolina Code of Laws requires RSIC to provide annual reports to the legislature. To help ensure compliance with the statutory requirement prescribed in 9-16-90, it is incumbent upon RSIC staff to establish and monitor the effectiveness of internal controls.

Our audit was performed in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. In order to address the audit objectives we performed certain procedures which included, but were not limited to, those listed in the Approach and Methods section of this report.

Based on the work performed, we concluded that overall the fiscal 2013 Annual Investment Report was materially accurate and complete and complied with statutory requirements. We observed that the internal control structure is evolving and improvements are needed to clarify accountability and institute guidelines for preparing the Report. These improvements should enhance management's assurance of sustainable compliance year over year regardless of staff personnel changes. They also should contribute to the clarity, relevance, and usefulness of information communicated in the Report. We summarized and detailed the nature and extent of our observations in the "Executive Summary: Overall Process Evaluation" and in the "Action Matrix: Issues and Observations" sections of this report, respectively.

We would like to thank the RSIC Reporting, Communications, Investment, and Legal staff for their cooperation and assistance.

Sincerely,



Monica Houston, CPA
Chief Audit Officer

CC: Allen Gillespie, Audit Committee Chair
Ed Giobbe, Investment Commission Chair
Hershel Harper, Chief Investment Officer
Robert Feinstein, Chief Legal Counsel
Danny Varat, Public Information Officer
Geoff Berg, Internal Asset Management - Managing Director

Background

Background

South Carolina law requires the Retirement System Investment Commission (RSIC) to provide an annual report to the State Budget and Control Board, the Speaker of the House of Representatives, the President Pro tempore of the Senate, and other appropriate officials and entities. The report is called the Annual Investment Report (AIR). It reports as of fiscal year end the total investment portfolio value, portfolio asset allocation, the value and investment returns for each investment in the portfolio for the most recent one, three, and five year periods, the investment and administrative expense related to investing and managing the portfolio, and management's overview of the portfolio. The Report also provides detailed appendices by asset category listing relevant valuation information for each investment in the category.

Multiple RSIC departments including Investment Reporting and Performance, Communications, Legal, Compliance, and IT participate in production of the AIR. Primary responsibility resides with the Investment Reporting and Performance staff to validate 3rd party financial information and to prepare the AIR schedules; the Communications staff has primary responsibility for the compilation and printing of the report. The custodian bank, BNY Mellon Asset Servicing, under a global custody agreement between itself and the South Carolina State Treasurer, provides consolidated recordkeeping services for all portfolio custody and non-custody securities. The Commission's consultant, HewittEnnisKnupp (HEK), provides a letter for inclusion in the AIR presenting the total portfolio value, the absolute and relative performance returns, and the ending period asset allocation.

The Commission per the Governance Policy Manual does not have a specifically defined oversight role for the AIR. The Commission Chairman writes or edits, as appropriate, the Chairman Report and signs a cover memo to distribute the printed AIR. The Commission as a whole exercises no other involvement or oversight in the preparation and distribution of the AIR.

RSIC reporting staff begins preparation of the Annual Investment Report approximately August 15th when the Custodian provides performance return and portfolio holdings information. The reporting staff coordinates with PEBA, the Custodian, HEK, and other internal resources to produce the financial information for the Report. With concurrence of the COO and the Public Information Officer, the Director of Investment Reporting and Performance provided the final version of the Annual Investment Report for the period ending June 30, 2013 on January 3, 2014. The Director emailed the final version to the IT manager on January 6, 2014, requesting he post it to the RSIC website. The IT department posted the AIR to the RSIC website on January 06, 2014. The Operations Officer delivered the printed AIR with the Commission Chairman's cover memo dated January 15, 2014, to required legislators per 9-16-90(B). The statutes do not specify a distribution date.

Objectives and Scope

Objectives

The objectives of this audit were to:

- Determine through testing whether the current AIR, as published complies with the statutory requirements outlined in Section 9-16-90 of the South Carolina Code of Laws.
- Determine whether adequate controls exist to ensure compliance with the SC statutory requirements and if such controls are effective.
- Determine whether adequate controls exist to ensure the accuracy, relevancy, and completeness of the information included within the Annual Investment Report (AIR) as of June 30, 2013.
- Determine the accuracy, relevancy, and completeness of the information included within the Annual Investment Report (AIR) as of June 30, 2013.

Scope

The audit objective is to provide an independent assurance that the AIR for the fiscal year ended June 30, 2013, complies with South Carolina statutes as outlined in 9-16-90 and that controls over the process to prepare and distribute the Report operated effectively. Internal Audit will examine the process in place for the preparation and distribution of the fiscal 2013 AIR. The process has not changed materially since fiscal 2013. The relevant date range for testing is from August 15, 2013 when preparation of the AIR began through January 15, 2014 when the RSIC staff distributed the printed AIR.

The review will include the following:

- Verification and validation of RSIC's compliance with the portions of South Carolina's statutory requirements related to annual investment reports.
- Assessment of the existence and quality of policy/guidelines for content, preparation, and distribution of the AIR.
- Evaluation of the review and approval process to finalize the AIR for publication.
- Documentation of internal controls within the process that ensure compliance, accuracy, and completeness.

Scope Exclusions

Areas outside of the scope of this audit include:

- Validation of the Custodian's (BNY Mellon) data and the Consultant's (HEK) report. IAC performed no additional review or testing of the amounts provided by BNY Mellon or HEK in regards to the Annual Investment Report. IAC relied upon the reports procured and relied upon by the RSIC reporting staff from BNY Mellon and from HEK, an internationally recognized management consultant firm.

Approach and Methods

Summary of Audit Procedures Performed

Procedures performed included:

- Reviewed Title 9, Chapters 1 and 16 of the South Carolina Code of Laws (as enacted or approved during the 1986 through 2013 Sessions of the General Assembly) with specific attention paid to paragraph 90 in Chapter 16.
- Reviewed the South Carolina RSIC Annual Investment Reports for the periods 2009-2010, 2010-2011, 2011-2012, and 2012-2013.
- Reviewed supporting documentation related to the AIR:
 - BNY Mellon files for the fiscal 2013 AIR Appendices A-H
 - Quarterly Investment Reports from fiscal 2013 posted to the RSIC public website
 - Consultants (Hewitt EnnisKnupp) AIP Compliance Letter (dated September 12, 2013) and presented to the Commission September 26, 2013
 - RSIC reporting, compliance, and IT policies and procedures posted to the intranet
- Interviewed key personnel including, the Executive Director, the Director of Investment Reporting and Performance, the Public Information Officer, two Reporting Analysts, the Fixed Income Analyst, Chief Legal Counsel, and the Operations Officer.
- Independently compared the fiscal 2013 AIR to the statutory requirements in 9-16-90 B.

Control Structure

Summary of Control Strengths

- The overall portfolio valuation and rate of return as well as the aggregated asset category valuations and rates of return are computed by the Custodian.
- The Consultant summarizes in a letter to the Governor, the Budget and Control Board, and the Members of the General Assembly of South Carolina the results of their review of the overall retirement plan's structure and performance of the investment portfolio for the fiscal year ended (FYE) June 30, 2013.
- The RSIC reporting staff monitor valuations and rates of return monthly and reports to the Commission on a quarterly basis. The staff presented results for the quarter ended June 30, 2013 on September 26, 2013.

Summary of Control Opportunities

Revisions need to be made to the RSIC "Reporting Cycle Data-Framework and Procedures" to ensure the "Annual Report" section complies with 9-16-90. Further, to help ensure statutory compliance and provide guidance for new staff, the "Annual Report" section of the RSIC "Reporting Cycle Data-Framework & Procedures" should be enhanced to include:

- Staff position accountable for each section of the AIR;
- Steps to certify the accuracy and completeness of section data and a standard method for staff to evidence completion of their reasonableness/validity checks; and
- Identification of management staff accountable to sign off on the final schedule for each section.

Accountability needs to be defined and a policy established for approval of the final version of the AIR by RSIC senior management.

Guidelines for the content of qualitative sections can enhance the clarity, relevance, and usefulness of the Report. Consider the following in developing the guidelines:

- Limiting the qualitative information to notable achievements and/or material changes during the fiscal year;
- Highlighting prospective information with a caution statement;
- Scrubbing the information to eliminate repetitive information that appears in multiple places in the Report; and
- Limiting the Chairman Report to investment performance highlights, challenges during the past fiscal year, performance relative to the policy benchmarks, performance relative to the prior year, key operational enhancements, key Commission and RSIC staff personnel changes, legislative changes, and outlook for the upcoming fiscal year.

Framework for Rating Risk of Audit Observations

When evaluating control gaps and developing observations, we used a framework to prioritize our observations. We used the framework to rate observations from the review. Each observation was assigned a risk/prioritization rating of “High”, “Medium”, or “Low”. The rating is an evaluation of the significance of an individual issue that is being reported. We intend that the rating assist management in prioritizing their efforts to implement recommendations and to provide a measure of the risk involved with each issue.

These criteria take into account the processes, systems, functions, and other internal and external factors that are affected. They are not intended to be all-inclusive.

High

Management should address the observation promptly because it could have a significant adverse impact on the integrity of the RSIC’s internal controls. This implies that management should take immediate and sustained action to remediate the finding and mitigate the associated risk. If the overall risk assessment of a process area has been evaluated at a “High”, this rating assessed to an individual finding may take on an increased level of significance. The criteria used to assess the risk rating should include any **one or all** of the following:

- A control weakness appears to undermine the overall integrity of a system or process because it compromises the achievement of the controls and business objectives.
- The financial impact of a control weakness may be significant, or appears to have the potential to be significant.
- Adequate compensating controls do not exist to mitigate risks identified.
- Key controls or compensating controls do not appear to be functioning as designed, or they appear to be nonexistent.
- The current process does or could violate critical regulatory requirements or internal policies.
- Adequate segregation of duties does not exist leading to the potential for material errors and omissions and potential fraudulent activity.
- Potential or existing weaknesses in the system of internal controls previously identified through audit activities have not been sufficiently corrected and/or adequate mitigating controls have not been implemented.
- Significant policies and procedures do not exist, or current practices are not in-line with documented and approved policies and procedures, which could potentially undermine the system of internal control.
- Management has the ability to override significant systems driven controls.
- The control weakness or potential control weakness may have a significant adverse impact on RSIC’s reputation.

Corrective Action: Immediate and basic improvements with ongoing management involvement and monitoring until controls are substantially improved. Dependent on the complexity of the issue, management should attempt to begin implementing its corrective action plans within 30 days from the date the issue was surfaced within the report.

Medium

Management should address the observation in a reasonable time frame because it could have an adverse impact on the integrity or effectiveness of the RSIC's internal controls, but it is not likely to have a critical, immediate and significantly adverse impact. This implies that management should institute plans to remediate the finding and pay attention to the associated risk. The criteria used to assess the risk rating should include any **one or all** of the following:

- A control weakness may not undermine the overall integrity of the system or process, but it appears to compromise a component of the system or process that is designed to achieve a business or control objective.
- The financial impact of a control weakness appears to be moderate, but it does not appear to have the potential for a broad impact on the corporation's financial position.
- Key controls do not appear to be functioning as designed, or appear to be nonexistent, but compensating controls exist to mitigate the risks identified.
- Policies and procedures exist but have not been recently reviewed and updated. Management has documented action plans to correct gaps within a reasonable timeframe.
- The current process could violate less critical regulatory requirements or internal policies.

Corrective Action: Implement improvement plans with ongoing management involvement and monitoring until controls are substantially improved. Dependent on the complexity of the issue, management should attempt to begin implementing its corrective action plans within 60 days from the date the issue was surfaced within the report.

Low

A risk/prioritization rating of low applies to an observation that does not have a significant adverse impact on the RSIC's internal controls. Management should consider implementing recommended actions. The criteria used to assess the risk rating should include any **one or all** of the following:

- Key controls and processes may be non-existent, however, significant compensating controls exist and the risk of potential weaknesses in the overall system of internal control is insignificant.
- Although sufficient compensating controls exist where weaknesses are noted, enhancements to existing processes or systems would improve effectiveness and/or efficiency.
- The financial impact of a control weakness, or potential for financial impact, appears to be limited in its amount and extent; or non-existent.

Corrective Action: Management may determine that cost-saving measures are available but the time and effort required may be extensive. Additionally, Management may determine alternative ways of addressing the issues identified. If management has determined that it will address the issues and dependent on the complexity, management should attempt to begin implementing its corrective action plans within 120 days from the date the issue was surfaced within the report.

Other – Best Practice and or Process Improvement Opportunities

In addition, we may report additional observations and recommendations to management that would improve performance or internal controls through the adoption of a particular best practice. Often, these observations and recommendations are quick “wins” that the RSIC can implement in an efficient manner and without significant incremental cost to RSIC. In our judgment, these issues may enhance RSIC’s internal control environment, but they do not pose a significant risk to the effectiveness or integrity of RSIC’s internal controls.

Risk Acceptance

A risk acceptance of “No” in this report indicates that management agrees with the observation and will make recommended improvements or propose alternative steps to reduce the risk(s) identified.

A risk acceptance of “Yes” in this report indicates that management disagrees with the observation and declines to make suggested improvements or to propose alternative steps to reduce the risk(s) identified. Management thereby implicitly agrees to accept the business impact and risks noted within the observation.

Executive Summary: Overall Process Evaluation

As part of our FYE 2014 Audit Plan, we evaluated the accuracy and appropriateness of the FYE 2013 AIR.

Based on the work performed, we concluded that overall the Annual Investment Report as of June 30, 2013 was materially accurate and complete and complied with statutory requirements. However, we noted the following observations during the audit:

	<u>Observation</u>	<u>Risk Rating</u>
1.	Several internal controls were determined to not be designed appropriately and thus were deemed ineffective in mitigating their relative risks	Medium (M)
2.	IA was not able to determine the existence and effectiveness of several internal controls due to lack of evidence. Additionally, IA testing found errors that would suggest that the internal control was not operating effectively	Medium (M)

Action Matrix: Issues and Observations

Observation #1 [Medium]

Several internal controls were determined to not be designed appropriately and thus were deemed ineffective in mitigating their relative risks as follow:

1. The RSIC Reporting Cycle Data Framework & Procedures does not adequately define procedures to prepare the AIR; it merely states what the requirements are.
2. Process for review and approval of Reporting policies and procedures is loosely established and undocumented.
3. The creation and existence of a cover letter listing the required recipients per 9-16-90(B) does not adequately provide evidence that the AIR was distributed to the required recipients per statute.

Risk/ Business Impact

Errors, irregularities, or noncompliance of a material nature could result in damage to RSIC public image, and loss of agency funding. Additionally not properly documenting processes could result in inefficient and ineffective use of resources.

Recommendation:

1. Revision of policies and procedures to include details that would ensure consistent preparation of AIR on an annual basis.
2. Establishment of policy and procedures relative to the updating, review, and approval of reporting policies and procedures.
3. Development of a procedure or process that would appropriately validate and document the distribution of the annual report.

Management Actions: Management will work to implement Audit's recommendation.

Owners: Sarah Corbett, Executive Director

Target Date: August 15, 2014

Risk Acceptance: No

Individual/(s) Responsible Jon Rychener, Director Investment Reporting & Performance

Target Date for Completion of Corrective Actions September 30, 2014

Action Matrix: Issues and Observations

Observation #2 [Medium]

IA was not able to determine the existence and effectiveness of several internal controls due to lack of evidence. Additionally, IA testing found errors that would suggest that the internal control was not operating effectively

Risk/ Business Impact

Errors, irregularities, or noncompliance of a material nature could result in damage to RSIC public image, and loss of agency funding. Additionally not properly documenting processes could result in inefficient and ineffective use of resources

Recommendation

Revision of policies and procedures to include details that would ensure consistent performance of internal controls and detail the appropriate documentation for evidence of performance.

Management Actions Management will work to implement Audit's recommendation.

Owners: Sarah Corbett, Executive Director

Target Date: August 15, 2014

Risk Acceptance: No

Individual/(s) Responsible Jon Rychener, Director Investment Reporting & Performance

Target Date for Completion of Corrective Actions September 30, 2014