PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION OF COLORADO

Financial And Compliance Audit
Year Ended December 31, 2001

With Reports Of Independent Accountants

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CONTAINED IN THIS DOCUMENT

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SECTION 1 .2-3-103 (2), CRS, 1980 Repl. Vol., as amended, states in part:

All reports shall be open to public inspection except for that portion of any report containing recommendations, comments, and any narrative statements which **is released only upon the approval of a majority vote of the committee (emphasis supplied).**

SECTION 2. 2-3-103.7 (1), CRS, 1980 Repl. Vol., as amended, states in part:

Any state employee **or other individual acting in an oversight role as a member of a committee, board, or commission** who willfully and knowingly discloses the contents of any report prepared by or at the direction of the state auditor's office prior **to the release of such report by a majority vote** of the committee as provided in section 2-3-103 (2) is guilty of a misdemeanor and, upon conviction thereof, shall be punished by a fine of not more than five hundred dollars.

To the Participants and Retirement Board of the
Public Employees' Retirement Association of Colorado and the
Legislative Audit Committee:

We have completed our audit of the general-purpose financial statements of the Public Employees' Retirement Association of Colorado ("PERA") as of and for the year ended December 31, 2001, and have issued an unqualified report thereon dated May 17, 2002. Our audit was conducted in accordance with auditing standards generally accepted in the United States.

We were engaged to conduct our audit pursuant to Section 24-51-204(6), C.R.S., which authorizes the State Auditor to conduct or cause to conduct audits for PERA. The accompanying Table of Contents sets forth the reports we have issued as part of our audit. Our audit opinion is located in the Comprehensive Annual Financial Report.

Denver, Colorado,
May 17, 2002.

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PUBLIC EMPLOYEES' RETIREMENT

ASSOCIATION OF COLORADO

DECEMBER 31, 2001

REPORT NO. 1433

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PUBLIC EMPLOYEES' RETIREMENT

ASSOCIATION OF COLORADO

AUDIT REPORT SUMMARY

DECEMBER 31, 2001

Purpose And Scope

The scope of our work was to perform an audit of the financial statements of Public Employees' Retirement Association of Colorado ("PERA") for the year ended December 31, 2001. Our audit was conducted in accordance with auditing standards generally accepted in the United States.

In addition, the scope of the engagement included a report on the internal control structure based solely on an assessment of control risk made as part of the audit of the financial statements.

Summary of Major Audit Comments

Auditor's Responsibility Under Auditing Standards Generally Accepted in the United States

- Our audit was conducted in accordance with auditing standards generally accepted in the United States and was designed to provide reasonable, rather than absolute, assurance that the financial statements are free of material misstatement.

- We issued an unqualified opinion.

Accounting Policies

- In 2001, PERA adopted Governmental Accounting Standards Statement No. 34 "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments."

- No other changes in accounting policies were adopted for the year ended December 31, 2001.

Accounting for Estimates

- The preparation of financial statements require management to make estimates that affect the amounts reported in the financial statements and accompanying notes and supplementary schedules.

  Significant estimates made by management include valuation of certain investments not traded on exchanges for which a quoted market price exists, valuation of certain real estate investments, the actuarial valuation of its assets and liabilities and certain self-insured liabilities of the Health Care Fund.

Unusual Transactions and Contingencies

- We noted no unusual transactions that have a material effect on the financial statements.

- We noted no material contingencies that were not disclosed in the financial statements.

Audit Adjustments

- There were no proposed audit adjustments.

Other Matters

- We noted no material errors or irregularities, or possible material illegal acts.

- We noted no material weaknesses in internal control.

- We had no disagreements with management on financial accounting and reporting matters and auditing procedures.

- We are not aware of any opinions obtained by management from other independent accountants.

<u>Summary of Progress in Implementing Prior Year Audit Recommendations</u>

The recommendation for the year ended December 31, 2000 has been implemented as of December 31, 2001.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	PERA Response	Implementation Date
1	IV-1	Establish a formal review process on reconciliations of financial information	Agree	2002
2	IV-4	Perform reconciliations on externally managed investments	Agree	2002
3	IV-5	Establish monitoring control over 401(k) loan and distribution calculations	Agree	2002
4	IV-7	Improve controls over salary limitations of highly compensated members	Agree	2002
5	IV-8	Improvements to the disaster and business recovery plan	Partially Agree	2002
6	IV-10	Follow established approval process for firewall changes	Partially Agree	2002

ORGANIZATION AND FUNCTIONS OF PERA

The Public Employees' Retirement Association of Colorado ("PERA") was established in 1931 under Title 24, Article 51 of the Colorado Revised Statutes. PERA administers cost-sharing multiple-employer defined benefit plans for the State and School Division Trust Fund, Municipal Division Trust Fund and Judicial Division Trust Fund. PERA also administers a cost-sharing multiple-employer defined benefit healthcare plan, the Insurance Dividend Reserve, and a multiple-employer Internal Revenue Code Section 401(k) defined contribution plan. The purpose of the Division Trust Funds is to provide benefits to members at retirement or disability, or to their beneficiaries in the event of death. Members of PERA are employed by public employers located in the State of Colorado and affiliated with PERA.

Responsibility for the organization and administration of the Division Trust Funds, Healthcare Trust Fund, Voluntary Investment Program and Insurance Dividend Reserve is placed with the Board of Trustees of PERA.

CURRENT YEAR FINDINGS AND RECOMMENDATIONS

We have audited the financial statements of the Public Employees' Retirement Association of Colorado ("PERA") for the year ended December 31, 2001, and have issued our report thereon dated May 17, 2002. In planning and performing our audit of the financial statements, we considered PERA's internal control solely to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. We have not considered internal control since May 17, 2002.

Our procedures were designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist.

Recommendations noted in connection with the December 31, 2001 audit are detailed as follows:

Reconciliation of Financial Information

In August 2001, the Information Systems Division developed an automated tool to reconcile equity and fixed income trades on a daily basis. The two primary reconciliation functions performed by the tool are the reconciliation of holdings and transactions with PERA's PORTIA investment application and data received and sent to The Northern Trust ("TNT") by PERA's brokers. Trade information is created internally for each trade using PORTIA. TNT receives trade information from the brokers. The reconciliation tool pulls this information daily from PORTIA and TNT, keying on the previous days settlement activity associated with each trade. Since August, the tool has processed approximately 17,000 trades.

The tool matches information based on 60 data fields captured from TNT and an undetermined number are available from PORTIA. All transactions are grouped into the following categories in the tool:

- Match: All fields used in the reconciliation of investment holdings (five data fields used) and investment transactions (seven data fields used) match exactly.
- Near Match: Investment CUSIP fields match, but a discrepancy exists in at least one field. (This category is only used for the investment holding reconciliations.)
- Orphan: Securities that do not have a match or near match. (This category is used only for the investment holding reconciliations.)
- Exceptions: Trades that do not have a match or near match. (This category is used only for the investment transaction reconciliations.)
- Delete: Data that is supplied by TNT that reflects a transaction that only the broker performs. In these cases, PERA will not have a matching transaction (e.g. money shifts in increments based on PERA's trade request for a lump sum).

The Investment Operations Division is responsible for investigating and resolving any mismatches identified by the tool on a daily basis. As the Investment Operations Division cannot change any trade information, it is sent to the trader at PERA to resolve the mismatch. Discrepancies are corrected through PORTIA, or the Investment Operations Division contacts TNT if the mismatch is an error on their part. A refresh feature in the reconciliation tool can be used to pull the updated information of existing investment transactions or holdings (from both PORTIA and TNT) into the tool so that entries that have been resolved can be matched. There is currently not a monitoring review process in place to ensure mismatches are investigated and resolved timely. Further, resolved mismatches should be reviewed for trends that could identify changes needed in the control process.

The Investment Operations Division has two employees that have administrative permission on the tool. The administrative permission allows each employee to establish tolerances or limits that the tool utilizes to find matches. For instance, tolerances or limits on certain fields could be established that would allow the tool to reconcile trades that match on all fields but have a discrepancy of less than $1.00 in the Transaction Total Amount field. If the tolerances or limits are set too high or changed without the knowledge of individuals relying on the control process, the control procedure is not effective. Presently, there is no formal process for ensuring all changes to tolerances or limits are reviewed for appropriateness and approved. Although no specific errors or findings were found in connection with our testing, the control process should not allow the individuals responsible for performing the reconciliations to establish or change the limits. The following fields have variable tolerances or limits and are capable of being changed by these two employees:

- Holdings Market Price
- Holdings Market Value
- Holdings Tax Cost Base
- Transaction Total Amount

Currently there is no formal communication between the Investment Operations Division and the Accounting Division with respect to reconciliation issues. Although the Accounting Division also performs month-end and year-end reconciliations of the investment holdings between PORTIA and TNT, the reconciliation tool used by the Investment Operations Division is an important process in the control structure and any issues or unresolved transactions should be communicated by the Investment Operations Division to the Accounting Division.

Recommendation No. 1:

We recommend that PERA:

a. Establish a review process of the resolved mismatches to ensure resolved transactions are corrected appropriately and timely as well as to look for trends in the exceptions that could lead to control process improvements.
b. Establish a formal process for the review and approval of tolerance changes in the tool. Individuals who are responsible for resolving the differences should not have access to change the tolerances.
c. Ensures that the Investment Operations Division communicates with the Accounting Division, at least on a month-end and year-end basis, any discrepancies that have not been resolved.

Management Response:

Colorado PERA will review the reconciliation process to ensure accuracy and research system capabilities for performing trend analysis to further improve our procedures. Colorado PERA has established a policy that any changes to tolerance limits be formally approved by management and made by the Information Systems Division.

On a monthly basis, the Investment Operations Division prepares a spreadsheet with any discrepancies between PORTIA and Northern Trust and forwards that spreadsheet to the Accounting Division and to Northern Trust. Also, monthly meetings have been held between PERA's Accounting Division, Northern Trust, and PERA's Investment Operations Division to discuss any month-end differences and the process to correct those differences.

External Manager Reporting

PERA currently contracts with nine external managers, managing fifteen portfolios relating to international investments. As of December 31, 2001, PERA had approximately $4.4 billion of investments managed by these external managers representing approximately 15% of PERA's investment portfolio. The Northern Trust ("TNT") is the custodian of ten of the international investments that are publicly traded and reports the value of the investments on a monthly and annual basis. All of the international managers are asked to reconcile their quarterly and annual reports to the TNT reports. As TNT is the custodian and ultimate holder, PERA relies on TNT's reporting, and does not perform any reconciliations between the international managers' reports and TNT's reports. The Investment Operations Division has requested these reconciliations from all the international managers; however, they are received sporadically, if at all.

Recommendation No. 2:

We recommend that PERA:

a. Establish formal policies to ensure reconciliations on international investments are performed by external managers and reviewed. PERA should obtain reconciliations from the external managers, and, in cases where no reconciliations are provided, PERA should perform the reconciliation internally.

b. Include submission of these reconciliations as a requirement of the contract as the contracts with the external managers are re-negotiated to ensure the reconciliations are received timely.

Management Response

Colorado PERA will establish an internal policy requiring the managers to reconcile their managers' records to Northern Trust records and to provide Colorado PERA with a copy of the reconciliation results. Colorado PERA will assume responsibility for the reconciliation of the two sets of records when the manager does not provide the reconciliation.

Defined Contribution Loans

All PERA members who contribute to the Defined Contribution 401(k) Plan ("401(k) Plan"), may apply to the 401(k) Plan for a loan. When the loan is approved by the 401(k) Plan, it is subject to the following provisions, which are established by the PERA Board of Trustees based on the Internal Revenue Service guidelines:

1. The amount of a loan to a member from the member's account cannot exceed the lesser of
    a. $50,000 reduced by the highest outstanding balance of loans from the 401 (k) Plan during the one-year period ending on the day before the date on which such loan was made, or
    b. the greater of $10,000 or one-half the balance in the member's account, or
    c. the member's account balance
2. The minimum amount of a loan is $1,000, plus any fees
3. A member cannot have more than three loans outstanding at any time

Automatic Data Processing, Inc. ("ADP") is the third party record keeper for the 401(k) Plan. ADP is responsible for recording all transactions that occur in the 401(k) Plan including establishing the loans. In October 2001, PERA discovered that a few members had taken out loans that did not follow the first provision. The problem arose for account balances between $10,000 and $20,000. For instance, if a member had an account balance of $16,000, the maximum amount of the loan should be $10,000. Instead, the member was allowed to take out a loan for greater than $10,000 or up to the balance in the account. PERA contacted ADP in January 2002, and the system's calculation was corrected going forward. However, as of May 2002 PERA's legal and accounting departments had not been notified of the exceptions, nor had an analysis been performed to determine the number of individuals and amount of excess loans that occurred in 2001.

In addition to the calculation of loans, we noted ADP is also responsible under its contract with PERA for the calculation of distributions. Although no exceptions were found in connection with our audit, there is no monitoring control in place at PERA to oversee ADP's calculation of distributions.

Recommendation No. 3:

We recommend that PERA:

a. Establish a monitoring process for all new loans and distributions to ensure the amounts are calculated based on the provisions set by the PERA board.
b. Establish a process whereby PERA's legal department and other departments as necessary are notified of violations to any provisions of PERA to determine the appropriate corrective action.

Management Response

There is no evidence that any Internal Revenue Code or plan violations occurred with respect to distributions. Colorado PERA staff reviews all distribution requests to ensure that a distributable event has occurred before making the distribution.

While Code and plan violations occurred with respect to loans, Colorado PERA staff has worked diligently with our outside record-keeper ADP to correct the systems error that allowed these violations to occur. Staff will continue to monitor the situation to ensure that this error is resolved. Colorado PERA has required ADP to contact all 401(k) members affected to resolve any tax liability issues.

In addition, the Internal Revenue Service has a process in place for the correction of loan violations. If this process is followed, no penalties are assessed. Colorado PERA staff will follow this process for correction.

ADP put together a spreadsheet of all loans issued so far in 2002 and then ran limit testing and found no violations, indicating that the programming problems have been corrected. Going forward in 2002, Colorado PERA staff will monitor a statistically significant random sample of loans on a monthly basis to ensure compliance with governing provisions regarding loans. Procedures have already been established to ensure that management is notified of any violations of provisions.

Defined Benefit Highly Compensated Members

PERA is required to follow the contribution limitations established under Internal Revenue Code ("IRC") Section 401(a)(17) per Title 24 Article 51 Section 401 of the Colorado Revised Statutes. The salary limitation in 2001 was $170,000. Therefore, contributions should cease once the employee reaches a salary of $170,000. The Information Systems Division is responsible for running a report titled Contribution Limitations Under IRC Section 401(a)(17) (the "Report") on a monthly basis to identify those highly compensated individuals who will exceed the salary limitations. The Internal Audit Division discovered the Report was not generating the correct information early in 2001, and the Information Systems Division was notified to fix the Report. In July 2001, the Report was modified and the Internal Audit Division presumed the Report was generating the information properly. In May 2002, in connection with our audit testing, we discovered an individual who had been allowed to make contributions on the portion of the salary exceeding the limit. After conversation with the Benefits Division of PERA and the Information Systems Division, we discovered the Report had not been fixed by the Information Systems Division. The Information Systems Division promptly fixed the program when notified, and generated a Report for 2001 indicating five individuals had exceeded the $170,000. The employers of four of the individuals properly stopped the contributions without notification from PERA. However, one individual's salary exceeded the limitation by approximately $12,000, resulting in the improper withholding of approximately $960.

Recommendation No. 4:

We recommend that PERA:

a. Direct the Internal Audit Division to establish a process to follow up on its requests to the different divisions to ensure the work and changes are completed correctly and in a timely manner.
b. Implement a procedure whereby the contribution limitation report is not only received and reviewed by the Internal Audit Division, but also received and reviewed by an individual in the Benefits Division as the division is responsible for reporting and gathering information for all the contributing employers.
c. Ensure the excess contributions are refunded in the appropriate manner.

Management Response

The contribution limitation only applies to employees hired after January 1996. The one individual whose salary exceeded the contribution limitation went undetected because of a programming error that gave the appearance of a successful report. The programming error has been corrected, and Colorado PERA has implemented an enhanced system of checks and balances to ensure that contribution limits are not violated.

Disaster and Business Recovery Plan

PERA has built an off-site location, located approximately 15 miles from the main PERA building, specifically to function as a Business Recovery Facility ("the Facility"). The Facility is utilized to house the back-up electronic information PERA generates and requires to run the organization. The Facility is approximately 20,000 square feet, and also contains a remote customer support group of 8 employees. Prior to opening the Facility, PERA contracted with Comdisco, a third party service provider, for business recovery services. The third party contract was terminated in April 2001, and PERA has assumed full responsibility for providing their own business recovery site, system readiness and maintenance, as well as the documentation and testing of the plan.

PERA has established a steering committee, comprised of 6 employees, to provide oversight and coordination of the Facility and the establishment of a written Disaster and Business Recovery Plan ("the Plan"). The steering committee's responsibilities include ensuring that the Facility is adequately equipped, milestones are established and monitored, documentation requirements are defined, and to facilitate coordination between the Information Systems Division and the other divisions of PERA.

We noted the following items that may affect PERA's ability to recover critical business operations in a complete and timely manner:

- System testing and documentation creation relating to the Plan is not complete. PERA estimates the initial completion and review of the Plan will be done by December 2002. However, defined milestones have not been established to ensure the necessary tasks will be completed in a timely manner. Subject to a comprehensive review, there is a risk that unknown or unforeseen risks may remain unidentified until the entire Plan is reviewed and executed.
- Key individuals involved in the execution of the Plan have not received updated instructions, such as their roles and responsibilities following a disaster, from the Steering Committee regarding the new Plan.
- All divisions at PERA have not been included in the development of the Plan. There is a risk that in the event of a disaster, unknown processes that are key to individual or groups daily job functions may not be recoverable by the Information Systems Division.
- The location of the Facility is relatively close to the main PERA business. In the event of certain types of disasters (nuclear, chemical or biological disasters), both locations could be rendered inoperable or inaccessible. We believe best practice would require that the Facility not be located in the same metropolitan area as the primary business. To mitigate this risk, PERA could also evaluate the costs and benefits of maintaining a periodic back-up of critical information in another metropolitan area.
- In the event of a disaster that rendered PERA's facilities or personnel inoperable, the State may need to assume the responsibility for carrying out PERA's pension fund responsibilities. Coordination for this type of effort with the State, as well as ensuring that the documentation is available at a level for someone to assume these responsibilities is not complete.

Recommendation No 5:

We recommend that PERA:

a. Establish milestones to ensure the system testing and Plan documentation of all areas contained within the Plan occurs in an efficient and timely manner.
b. Ensure the individuals involved in the execution of the Plan receive updated instructions, and all divisions are involved in the development of the Plan.
c. Assess the cost/benefit of maintaining a backup of critical information in a different metropolitan area on a periodic basis.
d. Coordinate with the State as to what its personnel's responsibilities would be in the event of an emergency.

Management Response

The Business Recovery Facility and Colorado PERA's ability to recover from a disaster are above industry standards. In fact, Colorado PERA is unique among public pension plans in having such a facility and unrivaled in its business recovery capabilities. A December 2001 report by Gartner, Inc. entitled *Data Centers: Optimal Distances for Disaster Recovery*, states "There is no hard-fast, minimal-distance requirement between data centers; rather enterprises must evaluate the risks associated with various alternative sites. Increasing the distance between data centers reduces the risk that the two centers will be struck by the same disaster. However, putting too much distance between them increases the risk that employees will not travel to the disaster site if they or their families have been affected by the disaster."

The Colorado PERA Business Continuity Steering Committee agreed that establishing documented milestones would ensure that testing and Plan documentation would take place. At this time, quarterly goals and objectives are established. These goals/objectives include Plan updates, testing, and evaluation of software needs.

All division directors have been informed of the need to update divisional Plans to reflect the current environment, and a new Business Impact Survey has been conducted. As established within the quarterly milestone timeline, each division will be actively involved with updating divisional Plans, tabletop discussions, and off-site testing.

This recommendation does not take into consideration Colorado PERA's offsite tape storage of critical information contracted through Iron Mountain. The Iron Mountain offsite storage facility is located east of I-25 and Arapahoe Road near Centennial Airport at the southern end of the Denver Metropolitan area. The most current backup tapes are stored at this location that is over 30 miles from the recovery facility in Westminster. We believe that this location along with our headquarters building and the recovery facility mitigate our risk in this area.

Colorado PERA has begun the process of contacting the appropriate State representative to establish the State's level of involvement with our Plan in the event of an emergency.

Effectiveness of Firewall

PERA is currently using the Check Point Software Technologies Firewall and has been using this firewall for several years. The firewall is an important aspect of PERA's information system as it regulates the access and transfer of information to and from PERA's internal systems. There are three Information Systems Division employees that have administrative level permissions to configure and manage the firewall. Any changes made to the firewall are discussed and approved by the Information Systems Division manager; however, there have been instances where changes were made and the approval was obtained after the change took place. This increases the risk that inappropriate changes are made to the firewall. However, other mitigating controls include a contract with TruSecure Corporation to provide a thorough firewall evaluation and extensive penetration study from both sides of the firewall. The contract will start in January 2002 for a term of two years. In addition, the Information Technology Internal Auditor evaluates the firewall logs on a monthly basis for any suspicious activity. These logs are extracted into a database and an internally written program evaluates the logs.

Recommendation No. 6:

We recommend that PERA implement a formal review and approval change process to ensure that all changes are properly approved and in accordance with management's intentions prior to changes being made. The policy should address acceptable procedures and documentation practices to be followed in the event of emergencies when it may not be practical to follow standard policies.

Management Response

The Colorado PERA firewall is effective and there is no reason to believe otherwise. The auditors were unable to note any specific instances of firewall failure. The majority of changes to the firewall is mandated by our vendor, and are monitored and reviewed by Information Systems management. Based on this recommendation, a written policy has been implemented for the review and approval of firewall changes.

DISPOSITION OF PRIOR YEAR RECOMMENDATIONS

The following is the audit recommendation included in the Public Employees' Retirement Association of Colorado ("PERA") audit report for the year ending December 31, 2000, and their disposition as of December 31, 2001.

RECOMMENDATION	DISPOSITION
Perform timely reconciliations of all critical data related to option contracts to the custodian statements including reconciling key investment terms such as the number of contracts, ticker symbol description and fair value. In addition, we recommend evaluating existing technologies to determine whether the option contract reconciliation process can be automated	Implemented

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS ON INTERNAL CONTROL

To the Participants and Retirement Board of the
Public Employees' Retirement Association of Colorado and the
Legislative Audit Committee:

In planning and performing our audit of the financial statements of Public Employees' Retirement Association of Colorado for the year ended December 31, 2001, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control.

A material weakness is a significant deficiency in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. However, we noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of management, the board of trustees and the Legislative Audit Committee and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record upon release by the Legislative Audit Committee.

Denver, Colorado,
May 17, 2002.

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