

February 4, 2004

Members of the Administrative Retirement Committee  
Metropolitan Board of Public Education  
2601 Bransford Avenue  
Nashville, TN 37204

### **Report of Internal Audit Section**

Dear Administrative Retirement Committee Members:

We have recently completed a performance audit of the Metropolitan Nashville Teachers Retirement Fund (Teachers Pension Fund) investments. *Government Auditing Standards* issued by the Comptroller General of the United States define performance audits as follows:

Performance audits entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective criteria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues. Performance audits provide information to improve program operations and facilitate decision making by parties with responsibility to oversee or initiate corrective action, and improve public accountability.

A performance audit is different than a financial statement audit, which is limited to auditing financial statements and controls, without reviewing operations and performance. In performing this audit, we retained KPMG to work under our direction. Their final report dated January

2004, *Performance Audit of Metropolitan Nashville Public Schools Pension Plan*, accompanies this letter and is hereby submitted to you.

February 4, 2004

Administrative Retirement Committee

Page 2

Teachers Pension Fund assets fund the Teachers Retirement Plan. This plan was established for participants who elected to transfer from the old city education and county education retirement plans when the City of Nashville and Davidson County consolidated into the Metropolitan Government of Nashville and Davidson County in 1963. This plan was closed to new members in 1969 when new teachers hired became members of a pension plan administered by the Tennessee Consolidated Retirement System, and other school employees hired became members of Metro's pension plan. The Teachers Pension Fund is funded by participating employees, Metro, and the state, and it is administered by the Administrative Retirement Committee (ARC) of the Metropolitan Board of Public Education. Teachers Pension Fund plan assets at June 30, 2003 totaled \$98 million.

### **Objectives, Scope, and Methodology**

The primary objectives of this performance audit were as follows:

- Assess the adequacy of plan policies and adherence to those policies.
- Assess various aspects of operations surrounding plan management.
- Review the plan's target asset allocation policy.
- Analyze the plan's performance results and risk.
- Assess compliance with applicable laws, regulations and policies.
- Develop findings and recommendations for any areas where management or investment performance could be improved.

This audit focused primarily on the Teachers Pension Fund activity and investment performance during fiscal years 2002 and 2003 and on practices in place during that time. Certain analyses required the consideration of financial results, performance and operations outside of that time period.

The methodology employed throughout this audit was one of objectively reviewing various forms of documentation, including written policies and procedures, investment performance reports, contracts and various other forms of data, reports and information maintained by Metropolitan Nashville Public Schools and by other Metro departments. ARC members, management, and administrative personnel, as well as personnel from other Metro departments and other stakeholders, were interviewed. Data obtained from various sources were analyzed, and various aspects of performance, risk and operational practices were assessed.

We performed the audit procedures in accordance with generally accepted government auditing standards.

### **Findings and Recommendations**

The KPMG report addresses the Teachers Pension Fund policies, performance, and oversight and the resulting findings and recommendations in detail. Following is an overview of some of the more significant findings and recommendations included in their report.

1. KPMG found that there was heavy reliance placed on the consultant and that the ARC could benefit from having a staff person from within Metro who is highly experienced in investments oversee fund performance reporting and manage consultant, investment manager, and custodian services. KPMG recommended that these functions be performed by the Metropolitan Treasurer. This recommendation is consistent with an opinion issued by the Metropolitan Department of Law in December 2002 concluding that the Metropolitan Treasurer is required to have custody of the Teachers Pension Fund assets.
2. Although the firms providing investment consulting services have changed, the current investment consultant has been in place since 1988 without a competitive bid process. KPMG recommends that investment consultant services be competitively bid periodically. This recommendation is consistent with the

Metropolitan Board of Public Education procurement policy on purchases and contracts not requiring competition, as addressed in the Financial Procedures Manual, number 4401, issued November 2003.

February 4, 2004

Administrative Retirement Committee

Page 4

3. With regard to investment performance, KPMG found that the Teachers Pension Fund investment returns were in the top third of public plans over the past three years and in the top 1% of public plans over the past five years. However, these returns were achieved at a cost of excessive fund risk. The fund was in the top 25% of risk for all public plans for the three year period and in the top 5% of risk for all public plans for the five year period. KPMG recommended that the investment policies specifically address asset allocation and risk.
4. KPMG's analysis concluded that current investment manager fees were materially higher than those of similar plans. Had the fee arrangements been closer to the average of similar plans, the plan could have saved \$228,000 in investment manager fees over the past fiscal year. KPMG recommends that current investment management contracts be renegotiated and that future investment manager contracts be combined with Metro's where applicable to obtain more favorable pricing.

Detailed explanations of the above findings and the related recommendations, as well as several other findings and recommendations, are included in the KPMG report.

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Management's response to the audit recommendations is attached to this report.

February 4, 2004  
Administrative Retirement Committee  
Page 5

We greatly appreciate the cooperation and help provided by affected Metropolitan Nashville Public Schools staff and other Metro staff.

This report is intended for the information of the management of the Metropolitan Government of Nashville and Davidson County. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Internal Audit Section

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