



# **FINANCIAL AND COMPLIANCE AUDIT REPORT**

**Kansas Public Employees Retirement System  
Fiscal Year 2004**

**A Report to the Legislative Post Audit Committee  
By Berberich Trahan & Co., a certified public accounting firm  
under contract with the Legislative Division of Post Audit  
State of Kansas  
December 2004**

# ***Legislative Post Audit Committee***

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## ***Legislative Division of Post Audit***

**The Legislative Post Audit Committee** and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$8 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of government agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U. S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. These audit standards have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the representatives, three are appointed by the Speaker of the House and two are appointed by the House Minority Leader.

As part of its audit responsibilities, the Division is charged with meeting the requirements of the Legislative Post Audit Act which address audits of financial matters. Those requirements call for two major types of audit work.

First, the Act requires an annual audit of the State's financial statements. Those statements, prepared by the Department of Administration's Division of Accounts and Reports, are audited by a certified public accounting firm under contract with the Legislative Division of Post Audit. The firm is selected by the Contract Audit Committee, which comprises three members of the Legislative Post Audit Committee (including the Chairman and Vice-Chairman), the

Secretary of Administration, and the Legislative Post Auditor. This audit work also meets the State's audit responsibilities under the federal Single Audit Act.

Second, the Act provides for a regular audit presence in every State agency by requiring that audit work be conducted at each agency at least once every three years. Audit work done in addition to the annual financial statement audit focuses on compliance with legal and procedural requirements and on the adequacy of the audited agency's internal control procedures. These compliance and control audits are conducted by the Division's staff under the direction of the Legislative Post Audit Committee.

### **LEGISLATIVE POST AUDIT COMMITTEE**

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Senator Bill Bunten  
Senator Anthony Hensley  
Senator Dave Kerr  
Senator Chris Steineger

Representative John Edmonds, Vice-Chair  
Representative Tom Burroughs  
Representative Bill McCreary  
Representative Frank Miller  
Representative Dan Thimesch

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Barbara J. Hinton, Legislative Post Auditor

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LEGISLATURE OF KANSAS  
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December 7, 2004

To: Members, Legislative Post Audit Committee

Senator Derek Schmidt, Chair  
Senator Bill Bunten  
Senator Anthony Hensley  
Senator Dave Kerr  
Senator Chris Steineger

Representative John Edmonds, Vice-Chair  
Representative Tom Burroughs  
Representative Bill McCreary  
Representative Frank Miller  
Representative Dan Thimesch

This report contains significant findings, conclusions, and recommendations from the completed financial-compliance audit of the Kansas Public Employees Retirement System covering fiscal year 2004. This audit was conducted by Berberich Trahan & Co., a certified public accounting firm under contract with the Legislative Division of Post Audit.

The report emphasizes certain information relating to employer contribution rates, the unfunded actuarial liability, and the death and disability program. We would be happy to discuss this report with any legislative committees, individual legislators, or other State officials.

A handwritten signature in black ink that reads "Barbara J. Hinton". The signature is written in a cursive, flowing style.

Barbara J. Hinton  
Legislative Post Auditor





Berberich Trahan & Co., P. A.

Certified Public Accountants

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

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FINANCIAL AND COMPLIANCE AUDIT REPORT

YEAR ENDED JUNE 30, 2004

with

INDEPENDENT AUDITORS' REPORT

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM  
FINANCIAL AND COMPLIANCE AUDIT REPORT

Year Ended June 30, 2004

TABLE OF CONTENTS

|   | <u>Page</u> |
|---|-------------|
| Introduction  | 1           |
| Audit Findings and Recommendations  | 2 - 3       |
| Status of Prior Year Findings and Recommendations   | 3           |
| Independent Auditors' Report  | 4 - 5       |
| Management's Discussion and Analysis  | 6 - 11      |
| Basic Financial Statements:   |             |
| Statement of Plan Net Assets  | 12          |
| Statement of Changes in Plan Net Assets   | 13          |
| Notes to Basic Financial Statements   | 14 - 35     |
| Required Supplementary Information:   |             |
| Schedule of Employer Contributions  | 36          |
| Schedule of Funding Progress  | 37          |
| Actuarial Valuation   | 38          |
| Supplementary Information:  |             |
| Schedule of Contributions   | 39          |
| Schedule of Administrative Expenses   | 40          |
| Schedule of Investment Income by Asset Class  | 41          |
| Schedule of Investment Fees and Expenses  | 42          |
| Investment Summary  | 43          |
| Expenses by Type  | 44          |
| Cash Receipts and Disbursements   | 45          |
| Report on Internal Control Over Financial Reporting and on Compliance and<br>Other Matters Based on an Audit of Financial Statements Performed in<br>Accordance With <i>Government Auditing Standards</i> | 46          |

## INTRODUCTION

The Kansas Public Employees Retirement System (the System or KPERS) provides a systematic retirement plan, as well as group life and disability insurance coverage for Kansas public employees who are Plan members. Plan membership generally requires that a person be employed by a participating employer for more than one year. The System is actually an umbrella organization administering the following three statewide retirement systems under one plan, as provided by K.S.A. 74, Article 49: the Kansas Public Employees Retirement System, the Kansas Police and Firemen's Retirement System, and the Kansas Retirement System for Judges.

In order to pay the various retirement, disability and death benefits to eligible System members and beneficiaries, the System accumulates assets by receiving employer and employee contributions, and by receiving earnings on its investments. The System maintains six reserves used to accumulate contributions and earnings, and to pay benefits. Investment decisions are made by contracted investment management firms and are monitored by the System's investment staff. Employer contribution rates are recommended by the System's actuary. Employee contribution and benefit formulas are legislated by State statute.

The audit work performed fulfills the annual audit requirements mandated by the Public Employees Retirement Act.

## AUDIT FINDINGS AND RECOMMENDATIONS

### Emphasis of Certain Matters Contained in the Financial Statements

We would like to emphasize three matters which involve actuarial valuations since our report does not contain the actuary's valuation report.

Employers' Contributions - As can be seen on the chart on page 36, the percentage contributed in 2004 versus the annual actuarial recommended contribution was 74.0%. The basic reason for the current difference is that legislation has limited the amounts that employers are required to contribute for State/School employees and Local employees. The actuarial impact on the unfunded actuarial liability was \$ 178 million for the year ended June 30, 2004.

Unfunded Actuarial Accrued Liability - In the schedule of funding progress on page 37, the unfunded actuarial accrued liability at December 31, 2003 is reflected at \$ 3.59 billion which is up from \$ 2.83 billion at December 31, 2002. On page 32 there is a table showing the changes in the unfunded actuarial liability for the year ended December 31, 2003.

The funding objective of the system is to establish contribution rates that over time will remain relatively level, as a percentage of payroll, and to pay off the unfunded liability by the year 2033. During 2003 and 2004, certain actions were taken by the Legislature and the Board of Trustees to address long-term funding issues. See page 10 for further discussion. It should be noted that the actuarial report has the following sentences: "Prior actuarial valuation reports have addressed concerns about the long term funding of KPERS. KPERS' funded status has improved due to legislation, Board action and strong investment performance in 2003. The State has reached equilibrium (statutory rate is equal to the actuarial rate) and, given the current statutory caps, the School and Local groups are projected to reach equilibrium before the end of the amortization period (2033). The System is in actuarial balance and long term funding has improved dramatically. Due to the use of an asset smoothing method and the delayed reflection of market experience in the actuarial value of assets, it is expected that additional actuarial losses will be reflected in the unfunded actuarial liability over the next few years. This will result in an increase in the unfunded actuarial liability and a corresponding increase in the contribution for the unfunded actuarial liability payment, but the System is expected to remain in actuarial balance if all actuarial assumptions are met going forward. For the School and Local groups, the shortfall between the actuarial and statutory contribution rates will produce additional increases in the unfunded actuarial liability. As a result, the actuarial contribution rate for these groups is expected to increase until equilibrium is reached."

We encourage the reading of the actuarial valuation report as it provides a look at the System over the long term while the financial statements in this report give a “snapshot” picture of the System’s financial position at June 30, 2004.

Death and Disability Program – In prior years there have been periodic moratoriums on contributions to the Group Insurance Reserve. As of June 30, 2004 the balance in the reserve was less than fully funded. The employers resumed the historical contributions to this fund beginning July 1, 2004. However, funding at this level is not sufficient to keep this fund solvent after June 30, 2005. We understand the Board of Trustees will recommend program changes to the Legislature. See pages 10 and 11 for further discussion.

### **STATUS OF PRIOR YEAR FINDINGS AND RECOMMENDATIONS**

#### **Emphasis of Certain Matters Contained in the Financial Statements**

See current year findings and recommendations.



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## INDEPENDENT AUDITORS' REPORT

The Board of Trustees  
Kansas Public Employees Retirement System:

We have audited the accompanying statement of plan net assets of the Kansas Public Employees Retirement System (the System), a component unit of the State of Kansas, as of June 30, 2004, and the related statement of changes in plan net assets for the year then ended. These basic financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the basic financial statements referred to above present fairly, in all material respects, the plan net assets of the Kansas Public Employees Retirement System as of June 30, 2004, and the changes in plan net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 3, 2004 on our consideration of the System's internal control over financial reporting and on our tests on its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 6 through 11 and the Required Supplementary Information on pages 36 through 38 are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements. The supplementary information included on pages 39 through 45 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This supplementary information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

*Berberick Trahan & Co., P.A.*

September 3, 2004

## **Management's Discussion & Analysis**

This section presents management's discussion and analysis of the Kansas Public Employees Retirement System financial performance during the fiscal year ended June 30, 2004.

The Kansas Public Employees Retirement System (KPERS, the Retirement System, or the System) is an umbrella organization administering the following three statewide pension groups under one plan, as provided by chapter 74, article 49 of the Kansas Statutes:

- Kansas Public Employees Retirement System
- Kansas Police and Firemen's Retirement System
- Kansas Retirement System for Judges

All three systems are part of a governmental, defined benefit, contributory plan covering substantially all Kansas public employees. The Kansas Retirement System for Judges is a single employer group, while the other two are multi-employer, cost-sharing groups. The State of Kansas and Kansas school districts are required to participate, whereas participation by local political subdivisions is optional but irrevocable once elected.

### **Financial Highlights**

- The System's net assets increased by \$ 1.5 billion or 16.8% from \$ 8,930,442,322 to \$ 10,427,142,572.
- As of December 31, 2003, the date of the most recent actuarial valuation, the Retirement System's funded ratio was 75.2%.
- The unfunded actuarial liability increased from \$ 2.829 billion at December 31, 2002, to \$ 3.586 billion at December 31, 2003.
- On a market value basis, this year's investment return rate was 15.4%, compared with last year's return of 4.0%.
- Monthly benefits paid to retirees and beneficiaries increased 4.8% from \$ 646 million in fiscal year 2003 to \$ 677 million in fiscal year 2004.
- The State of Kansas issued \$ 540.25 million in pension obligation bonds, and KPERS received net proceeds of \$ 479.1 million in fiscal year 2004. These bonds funded a portion of the KPERS state and school groups' unfunded actuarial liability.

### **Overview of the Financial Statements**

This discussion and analysis is an introduction to the System's basic financial statements, which comprise the following components:

- 1) Basic financial statements
- 2) Notes to basic financial statements
- 3) Required supplementary information
- 4) Supplementary information.

The information available in each of these sections is briefly summarized as follows:

### **(1) Basic Financial Statements**

A Statement of Plan Net Assets as of June 30, 2004 and a Statement of Changes in Plan Net Assets for the fiscal year ended June 30, 2004 are presented with previous year's comparative information. These financial statements reflect the resources available to pay benefits to retirees and other beneficiaries as of year-end, as well as the changes in those resources during the year.

### **(2) Notes to Basic Financial Statements**

The financial statement notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements. Information available in the notes to the basic financial statements is described below.

- Note 1 provides a general description of the Retirement System, as well as a description of the plan benefits and an overview of the contributions that are paid by employers and members. Information regarding a breakdown of the number of participating employers and members is also provided.
- Note 2 provides a summary of significant accounting policies, including the basis of accounting, investments, including investing authority, investment risk categorizations, and the method used to value investments, and additional information about cash, securities lending, and derivatives. In the Reserves section of Note 2 is information regarding the Retirement System's required reserves. The various reserves include the Members Accumulated Contribution Reserve, Retirement Benefit Accumulation Reserve, Retirement Benefit Payment Reserve, Group Insurance Reserve, the Expense Reserve, and the Optional Term Life Insurance Reserve.
- Note 3 provides information about System funding policies and employer contributions made to the System by the three different funding groups.
- Note 4 describes the System capital expenditure commitments to real estate and alternative investments. This section also generally describes the potential System contingencies.

### **(3) Required Supplementary Information**

The required supplementary information consists of two schedules and related notes concerning the funded status of the pension plans administered by the Retirement System.

### **(4) Supplementary Information**

Supplementary schedules include detailed information on contributions by employer coverage groups, administrative expenses, an investment income summary, a schedule of investment fees and expenses, an investment summary, a schedule of expenses by type, and a schedule of cash receipts and disbursements.

## Financial Analysis of the Retirement System

The System provides benefits to the State of Kansas and other Kansas local and school employees. Benefits are funded by member and employer contributions and by investment earnings. Net assets held in trust for benefits at June 30, 2004 amounted to \$ 10,427,142,572, an increase of \$ 1.49 billion (16.8%) from \$ 8,930,442,322 at June 30, 2003. Following are two summary schedules, Plan Net Assets and Changes in Plan Net Assets, comparing information from fiscal years 2004 and 2003:

### Summary Comparative Statements of Plan Net Assets

|  | As of<br>June 30, 2004   | As of<br>June 30, 2003  | Percentage<br>Change |
|--|--------------------------|-------------------------|----------------------|
| <b>Assets</b>                          |                          |                         |                      |
| Cash and deposits                      | \$ 3,611,466             | \$ 5,261,095            | (31.36) %            |
| Receivables                            | 1,452,424,569            | 1,538,278,206           | (5.58)               |
| Investments at fair value              | 10,759,162,291           | 9,388,170,382           | 14.60                |
| Invested securities lending collateral | 2,078,302,191            | 1,860,279,374           | 11.72                |
| Capital assets and supplies inventory  | 2,503,441                | 2,421,701               | 3.38                 |
| <b>Total assets</b>                    | <b>14,296,003,958</b>    | <b>12,794,410,758</b>   | <b>11.74</b>         |
| <b>Liabilities</b>                     |                          |                         |                      |
| Administrative costs                   | 828,108                  | 904,441                 | (8.44)               |
| Benefits payable                       | 1,313,956                | 1,325,501               | (0.87)               |
| Securities purchased                   | 1,788,417,131            | 2,001,459,120           | (10.64)              |
| Securities lending collateral          | 2,078,302,191            | 1,860,279,374           | 11.72                |
| <b>Total liabilities</b>               | <b>3,868,861,386</b>     | <b>3,863,968,436</b>    | <b>0.13</b>          |
| <b>Net assets</b>                      | <b>\$ 10,427,142,572</b> | <b>\$ 8,930,442,322</b> | <b>16.76 %</b>       |

### Summary Comparative Statements of Changes in Plan Net Assets

|   | Year Ended<br>June 30, 2004 | Year Ended<br>June 30, 2003 | Percentage<br>Change |
|---|-----------------------------|-----------------------------|----------------------|
| <b>Additions</b>                              |                             |                             |                      |
| Contributions                                 | \$ 944,703,176              | \$ 456,210,770              | 107.08 %             |
| Net investment income (loss)                  | 1,331,971,630               | 322,252,818                 | 313.33               |
| Net income from securities lending activities | 4,254,284                   | 3,803,825                   | 11.84                |
| Total net investment income (loss)            | 1,336,225,914               | 326,056,643                 | 309.81               |
| Other miscellaneous income                    | 182,113                     | 82,257                      | 121.40               |
| Total additions (net reductions)              | 2,281,111,203               | 782,349,670                 | 191.57               |
| <b>Deductions</b>                             |                             |                             |                      |
| Monthly retirement benefits                   | 676,918,614                 | 645,716,079                 | 4.83                 |
| Refunds of contributions                      | 41,179,470                  | 39,608,946                  | 3.97                 |
| Death benefits                                | 8,685,182                   | 7,826,064                   | 10.98                |
| Insurance premiums and benefits               | 50,396,392                  | 53,829,235                  | (6.38)               |
| Administrative expenses                       | 7,231,295                   | 7,215,024                   | 0.23                 |
| Total deductions                              | 784,410,953                 | 754,195,348                 | 4.01                 |
| <b>Net increase (decrease)</b>                | <b>1,496,700,250</b>        | <b>28,154,322</b>           | <b>5,216.06</b>      |
| Net assets, beginning of year                 | 8,930,442,322               | 8,902,288,000               | 0.32                 |
| Net assets, end of year                       | \$ 10,427,142,572           | \$ 8,930,442,322            | 16.76 %              |

Additions to the System's net assets held in trust for benefits include employer and member contributions, as well as investment income. Total contributions to the System increased from \$ 456.2 million in fiscal year 2003 to \$ 944.7 million in fiscal year 2004. The \$ 488.5 million increase in contributions is mainly attributed to pension obligation bonds issued by the State of Kansas in fiscal year 2004.

The System recognized a net investment gain of \$ 1.336 billion for the 2004 fiscal year, compared with a net investment gain of \$ 326 million for the 2003 fiscal year. Total return for the portfolio was positive 15.4%. System net investments amounted to \$ 10.38 billion at June 30, 2004, which was \$ 1.49 billion (16.8%) more than the \$ 8.89 billion in total System investments at June 30, 2003. The Retirement System's one, three, five, and ten year investment performance against the assumed rate of investment return are shown in the chart below.

| <u>One Year</u> | <u>Latest 3 Years</u> | <u>Latest 5 Years</u> | <u>Latest 10 Years</u> | <u>Assumed Rate of Return</u> |
|-----------------|-----------------------|-----------------------|------------------------|-------------------------------|
| 15.40%          | 4.56%                 | 3.80%                 | 9.60%                  | 8.00%                         |

At June 30, 2004, the System held \$ 5.6 billion in U.S. equity and international equity securities, an increase of \$ 1.06 billion from the 2003 fiscal year. U.S. equity and international equity securities earned returns of approximately 19.9% and 27.4%, respectively, for the 2004 fiscal year. These compare with the Retirement System's benchmark returns of 20.5% and 30.3%, respectively.

The System held \$ 3.7 billion in U.S. debt and international debt securities, an increase of \$ 426 million from the 2003 fiscal year. The TIPS portfolio return for 2004 was positive with a return of 5.6% which matched the benchmark return of 5.6%. The performance of the System's other fixed income securities during fiscal year 2004 was 3.1% compared with the benchmark of 2.3%. Real estate investments increased \$ 83 million to \$ 706.9 million at June 30, 2004. Real estate investments returned approximately 15.9% for the 2004 fiscal year, versus the benchmark real estate return of 13.3%. The System held \$ 537.9 million in alternative investments, which was a \$ 54.8 million increase from June 30, 2003. Alternative investments earned a return of approximately 18.7% for the 2004 fiscal year, compared to the benchmark alternative investment return of 15.0%. At June 30, 2004, the System held \$ 182.5 million in short-term investments, which was a decrease of \$ 197.3 million from June 30, 2003.

The System earns additional investment income by lending investment securities to brokers. The brokers provide collateral to the System and generally use the borrowed securities to cover short sales and failed trades. The Retirement System invests cash collateral received from the brokers in order to earn interest. For fiscal year 2004, net securities lending income amounted to \$ 4.3 million compared with \$ 3.8 million in fiscal year 2003.

Deductions from net assets held in trust for benefits include retirement, death and survivor benefits, and administrative expenses. For the 2004 fiscal year, retirement, death, and insurance benefits amounted to \$ 777.2 million, an increase of \$ 30.2 million (4.0%) from the 2003 fiscal year. The increase in benefit payments was a result of an increase in the number of retirees. For the 2004 fiscal year, System administrative expenses amounted to \$ 7.23 million compared with \$ 7.22 million in fiscal year 2003. The ratio of System administrative expenses to the number of members (approximately \$ 29 per member) continues to be very cost efficient for a statewide retirement plan.

## **Funding Status**

An actuarial valuation of the Retirement System's assets and benefit obligations is performed annually. At the date of the most recent actuarial valuation, December 31, 2003, the funded status decreased to 75.2% from 77.6% at December 31, 2002. The unfunded actuarial liability was \$ 3.586 billion at December 31, 2003, compared with \$ 2.829 billion at December 31, 2002. This decrease in funded status relates primarily to a change in the actuarial cost method to the Entry Age Normal (EAN) method for all three groups.

The System's consulting actuary has recommended that future employer contributions be increased to improve the long-term funding of the KPERS State/School and Local groups. During the 2003 legislative session, legislation was passed that increased the statutory cap on employer contributions of the State/School group to 0.40% in fiscal year 2006, with subsequent increases of 0.50% in fiscal year 2007 and 0.60% in fiscal year 2008 and beyond. During fiscal year 2004, the following were adopted as part of the comprehensive plan to address the funding status of the Retirement System:

- The Legislature raised the statutory cap on annual employer contribution rate increases from 0.15% for local employers to 0.4% in 2006, 0.5% in 2007, and 0.6% in 2008 and beyond.
- The State of Kansas issued \$540.25 million in pension obligation bonds, and KPERS received net proceeds of \$479.1 million in fiscal year 2004.
- The Legislature split the KPERS State/School group into two separate groups (the State employees group and the School employees group) for actuarial calculations and determining of employer contribution rates.
- The Retirement System's Board of Trustees implemented the actuarial components of the new funding plan by adopting the traditional Entry Age Normal actuarial cost method and a five-year asset smoothing method.

It has been KPERS objective to develop a consensus among the Legislature, Governor, and other interested parties on a comprehensive funding plan to ensure the System's financial health. The passage of 2003 and 2004 legislation for employer contribution rate increases and issuing pension obligation bonds were significant steps in this plan. During the 2004 interim, the Legislature's Joint Committee on Pensions, Investments, and Benefits will continue to study the long-term funding plan for the System. KPERS is working with the Joint Committee to analyze a range of plan design alternatives for possible consideration by the Governor and Legislature in 2005.

## **Death & Disability Program**

The Retirement System administers the group insurance reserve fund as described in Note 2 of the notes to the basic financial statements. The actuary performs an annual actuarial valuation of this fund, with the last valuation completed for June 30, 2003. Legislation passed by the 2003 Legislature placed another moratorium on contributions to this fund for all of fiscal year 2004. As of June 30, 2004, the fund had assets of \$ 29.2 million. Employers resumed the historical contributions (0.6% of payroll) to this fund beginning July 1, 2004. However, funding at this level is not sufficient to keep this fund solvent after June 30, 2005.

In order to address the financial viability of this fund, the Board of Trustees will recommend program changes to the Legislature's Joint Committee on Pensions, Investments and Benefits. The program changes under consideration include (1) increasing the contribution rate to 1%, and (2) plan design modifications to reduce future program costs. Any changes to funding and plan design adjustment will require legislation in the 2005 session, with implementation in fiscal year 2006.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

STATEMENT OF PLAN NET ASSETS

June 30, 2004

With Comparative Totals for June 30, 2003

|   | <u>2004</u>              | <u>2003</u>             |
|---|--------------------------|-------------------------|
| <u>ASSETS</u>   |                          |                         |
| Cash and deposits:  |                          |                         |
| Cash  | \$ 54,643                | \$ 47,507               |
| Deposits with insurance carriers  | 3,556,823                | 5,213,588               |
| Total cash and deposits   | <u>3,611,466</u>         | <u>5,261,095</u>        |
| Receivables:  |                          |                         |
| Contributions   | 40,332,275               | 35,120,391              |
| Investment income   | 42,778,358               | 40,963,683              |
| Sale of investment securities   | 1,369,313,936            | 1,462,194,132           |
| Total receivables   | <u>1,452,424,569</u>     | <u>1,538,278,206</u>    |
| Investments at fair value:  |                          |                         |
| Domestic equities   | 3,513,446,210            | 3,024,580,762           |
| International equities  | 2,136,913,681            | 1,621,533,252           |
| Cash and equivalents  | 182,506,767              | 379,764,010             |
| Fixed income  | 3,681,472,192            | 3,255,500,484           |
| Alternative investments   | 537,928,156              | 483,143,921             |
| Real estate   | 706,895,285              | 623,647,953             |
| Total investments at fair value   | <u>10,759,162,291</u>    | <u>9,388,170,382</u>    |
| Invested securities lending collateral  | 2,078,302,191            | 1,860,279,374           |
| Capital assets and supplies inventory   | 2,503,441                | 2,421,701               |
| Total assets  | <u>14,296,003,958</u>    | <u>12,794,410,758</u>   |
| <u>LIABILITIES</u>  |                          |                         |
| Administrative costs  | 828,108                  | 904,441                 |
| Benefits payable  | 1,313,956                | 1,325,501               |
| Securities purchased  | 1,788,417,131            | 2,001,459,120           |
| Securities lending collateral   | 2,078,302,191            | 1,860,279,374           |
| Total liabilities   | <u>3,868,861,386</u>     | <u>3,863,968,436</u>    |
| Net assets held in trust for pension benefits (a schedule of funding progress for the plan is presented on page 37) | <u>\$ 10,427,142,572</u> | <u>\$ 8,930,442,322</u> |

See accompanying notes to basic financial statements.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM  
STATEMENT OF CHANGES IN PLAN NET ASSETS

Fiscal Year Ended June 30, 2004  
With Comparative Totals for Fiscal Year Ended June 30, 2003

|  | 2004              | 2003             |
|--|-------------------|------------------|
| Additions:                                     |                   |                  |
| Contributions:                                 |                   |                  |
| Member contributions                           | \$ 230,349,955    | \$ 224,746,447   |
| Employer contributions                         | 714,353,221       | 231,464,323      |
| Total contributions                            | 944,703,176       | 456,210,770      |
| Investments:                                   |                   |                  |
| Net appreciation in fair value of investments  | 1,087,128,878     | 85,233,479       |
| Interest                                       | 132,004,016       | 145,411,285      |
| Dividends                                      | 91,477,150        | 76,508,361       |
| Real estate income, net of operating expenses  | 39,514,695        | 31,217,255       |
| Other investment income                        | 565,492           | 557,611          |
|  | 1,350,690,231     | 338,927,991      |
| Less investment expense                        | (18,718,601)      | (16,675,173)     |
| Net investment income                          | 1,331,971,630     | 322,252,818      |
| From securities lending activities:            |                   |                  |
| Securities lending income                      | 23,020,103        | 25,878,944       |
| Securities lending expenses:                   |                   |                  |
| Borrower rebates                               | (17,697,447)      | (20,861,098)     |
| Management fees                                | (1,068,372)       | (1,214,021)      |
| Total securities lending activities expenses   | (18,765,819)      | (22,075,119)     |
| Net income from securities lending activities  | 4,254,284         | 3,803,825        |
| Total net investment income                    | 1,336,225,914     | 326,056,643      |
| Other miscellaneous income                     | 182,113           | 82,257           |
| Total additions                                | 2,281,111,203     | 782,349,670      |
| Deductions:                                    |                   |                  |
| Monthly retirement benefits paid               | (676,918,614)     | (645,716,079)    |
| Refunds of contributions                       | (41,179,470)      | (39,608,946)     |
| Death benefits                                 | (8,685,182)       | (7,826,064)      |
| Insurance premiums and benefits                | (50,396,392)      | (53,829,235)     |
| Administrative expenses                        | (7,231,295)       | (7,215,024)      |
| Total deductions                               | (784,410,953)     | (754,195,348)    |
| Net increase                                   | 1,496,700,250     | 28,154,322       |
| Net assets held in trust for pension benefits: |                   |                  |
| Balance, beginning of year                     | 8,930,442,322     | 8,902,288,000    |
| Balance, end of year                           | \$ 10,427,142,572 | \$ 8,930,442,322 |

See accompanying notes to basic financial statements.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS

June 30, 2004

1 - Plan Description

Plan Membership

The Kansas Public Employees Retirement System (the Retirement System, or the System) is a body corporate and an instrumentality of the State of Kansas. The Retirement System is an umbrella organization administering the following three statewide pension groups under one plan, as provided by K.S.A. 74, Article 49: the Kansas Public Employees Retirement System (KPERS), the Kansas Police and Firemen's Retirement System (KP&F), and the Kansas Retirement System for Judges (Judges). All three systems are part of a tax-exempt, defined benefit, contributory plan covering substantially all public employees in Kansas. The Kansas Retirement System for Judges is a single employer group, while the other two are multi-employer, cost sharing groups. The State of Kansas and Kansas schools are required to participate, while participation by local political subdivisions is optional but irrevocable once elected. Participating employers and Retirement System membership are as follows:

Number of participating employers:

|                        | <u>KPERS</u> | <u>KP&amp;F</u> | <u>Judges</u> |
|------------------------|--------------|-----------------|---------------|
| State of Kansas        | 1            | 1               | 1             |
| Counties               | 105          | 24              | -             |
| Cities                 | 358          | 49              | -             |
| Townships              | 53           | -               | -             |
| School Districts       | 304          | -               | -             |
| Libraries              | 116          | -               | -             |
| Conservation Districts | 82           | -               | -             |
| Extension Councils     | 80           | -               | -             |
| Community Colleges     | 44           | -               | -             |
| Recreation Commissions | 38           | -               | -             |
| Hospitals              | 29           | -               | -             |
| Cemetery Districts     | 13           | -               | -             |
| Other                  | 156          | -               | -             |
|                        | <hr/>        | <hr/>           | <hr/>         |
| Total                  | <u>1,379</u> | <u>74</u>       | <u>1</u>      |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

1 - Plan Description (Continued)

Plan Membership (Continued)

Membership by retirement systems:

|  | <u>KPERS</u>          | <u>KP&amp;F</u>      | <u>Judges</u>     | <u>Total</u>          |
|--|-----------------------|----------------------|-------------------|-----------------------|
| Retirees and beneficiaries currently receiving benefits              | 55,509                | 3,456                | 159               | 59,124                |
| Terminated employees entitled to benefits but not yet receiving them | 8,055                 | 76                   | 13                | 8,144                 |
| Inactive members not entitled to benefits                            | 32,158                | 1,011                | 2                 | 33,171                |
| Current employees  | <u>141,401</u>        | <u>6,494</u>         | <u>250</u>        | <u>148,145</u>        |
| Total  | <u><u>237,123</u></u> | <u><u>11,037</u></u> | <u><u>424</u></u> | <u><u>248,584</u></u> |

Plan Benefits

Members (except KP&F members) with 10 or more years of credited service may retire as early as age 55 (KP&F members may be age 50 with 20 years of credited service) with an actuarially reduced monthly benefit. Normal retirement is at age 65, age 62 with 10 years of credited service, or whenever a member's combined age and years of credited service equal 85 "points" (KP&F members' normal retirement ages are age 60 with 15 years of credited service, age 55 with 20 years, age 50 with 25 years, or any age with 32 years of service). Monthly retirement benefits are based on a statutory formula that includes final average salary and years of service. When ending employment, members may withdraw their contributions from their individual accounts, including interest. Members who withdraw their accumulated contributions lose all rights and privileges of membership. Members choose one of seven options to receive their monthly retirement benefits. At retirement a member may receive a lump-sum payment of up to 50% of the actuarial present value of the member's lifetime benefit. His or her monthly retirement benefit is then permanently reduced based on the amount of the lump sum. Benefit increases, including ad hoc post-retirement benefit increases, must be passed into law by the Kansas Legislature. Benefit increases are under the authority of the Legislature and the Governor of the State of Kansas.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

1 - Plan Description (Continued)

Plan Benefits (Continued)

Active members (except KP&F members) are covered by basic group life insurance. The life insurance benefit is 150% of the annual compensation rate at the time of an active member's death. Generally, in cases of death as a result of an on-the-job accident, for KPERS members there is a \$ 50,000 lump sum benefit and a monthly benefit payable to a surviving spouse, minor children, or dependent parents (in this order). Service-connected accidental death benefits are in addition to any life insurance benefit. There is a \$ 4,000 death benefit payable to the beneficiary(ies) upon the death of a retired member under any of the three systems.

Active members (except KP&F and Judges members) are also covered by the provisions of the disability income benefit contract. Annual disability income benefits are based on two-thirds of the annual rate of compensation at the time of disability, less primary social security benefits, one-half of worker's compensation, and any other employment-related disability benefit. The minimum monthly benefit is \$ 100. There is a waiting period of 180 continuous days from the date of disability before benefits can be paid. During the period of approved disability, the member continues to have group life insurance coverage and to accrue participating service credit.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS

(Continued)

### 1 - Plan Description (Continued)

#### Contributions

Member contributions (from four percent to seven percent of gross compensation), employer contributions and net investment income fund Retirement System reserves. Member contribution rates are established by state law and are paid by the employee according to the provisions of Section 414(h) of the Internal Revenue Code. State law provides that the employer contribution rates be determined based on the results of each annual actuarial valuation. The contributions and assets of all three systems are deposited in the Kansas Public Employees Retirement Fund established by K.S.A. 74-4921. All of the retirement systems are funded on an actuarial reserve basis (see Note 3). For fiscal years beginning in 1995, State of Kansas legislation placed a statutory limit of 0.1% of payroll on annual increases in the contribution rates for KPERS employers. During the 1995 legislative session, the statutory limits were increased to 0.2% of payroll over the prior year for fiscal years beginning in 1996 for state and school employers. The statutory increase for local units of government was amended to limit increases to no more than 0.15% over the prior year for calendar years beginning in 1997. Annual increases in the employer contribution rates related to subsequent benefit enhancements are not subject to these limitations. Legislation passed in 2003 amended the annual increases in future years. The statutory cap for the State/School group will increase to 0.4% in fiscal year 2006, with subsequent increases of 0.5% in fiscal year 2007 and 0.6% in fiscal year 2008 and beyond. Legislation passed in 2004 amended the annual increases in future years for local employers. The statutory cap for the Local group will increase to 0.4% in calendar year 2006, with subsequent increases of 0.5% in fiscal year 2007 and 0.6% in fiscal year 2008 and beyond. The amortization period for the unfunded liability of all three systems is 40 years from July 1, 1993.

Employer contributions for group life insurance and long-term disability income benefits are set by statute at 0.6% of covered payroll for KPERS and 0.4% for Judges. However, legislation passed in 2000 and 2001 placed a moratorium on contributions related to the group life insurance and disability benefits effective for the period April 1, 2000 through December 31, 2001. Calendar year 2002 and 2003 legislation placed additional moratoriums on contributions to this fund. Moratoriums were in effect for the period July 1, 2002 through December 31, 2002 and the period of April 1, 2003 through June 30, 2004.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS

(Continued)

### 2 - Summary of Significant Accounting Policies

#### Reporting Entity

The Kansas Public Employees Retirement System is a component unit of the State of Kansas. A nine-member board of trustees administers the Retirement System: four trustees are appointed by the Governor, one by the President of the Senate, one by the Speaker of the House of Representatives, two are elected by Retirement System members, and one is the elected State Treasurer. The Board of Trustees appoints the executive director, who is the Retirement System's managing officer.

#### Basis of Accounting

The Retirement System's financial statements are prepared on the accrual basis in accordance with accounting principles generally accepted in the United States of America. Member and employer contributions are recognized in the period in which the contributions are due. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

#### New Accounting Standard

In an effort to provide the public with better information about the risks that could potentially impact a government's ability to provide services and pay its debts, the Government Accounting Standards Board (GASB) has published Statement No. 40, *Deposit and Investment Risk Disclosures*, which the Retirement System adopted for the year ended June 30, 2004. The new accounting guidance requires that state and local governments communicate key information about deposit and investment risks, since deposits and investments are frequently the largest assets on a government's balance sheet. Under GASB Statement No. 40, state and local governments are required to disclose information covering four principal areas: (1) investment credit risk disclosures, including credit quality information issued by rating agencies, (2) interest rate disclosures that include investment maturity information, such as weighted average maturities or specific identification of the securities, (3) interest rate sensitivity for investments that are highly sensitive to changes in interest rates (example, inverse floaters, enhanced variable-rate investments and certain asset-backed securities), and (4) foreign exchange exposures that would indicate the foreign investment's denomination.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

### 2 - Summary of Significant Accounting Policies (Continued)

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Method Used to Value Investments

Investments are reported at fair value. Securities traded on a national or international securities exchange are valued at the last reported sales price at current exchange rates. The fair value of real estate investments is based on independent appraisals. Investments that are not publicly traded are reported at estimated fair value.

#### Cash and Deposits

Cash deposits are classified in three categories of credit risk to give an indication of the level of risk assumed by the Retirement System. The three categories of credit risk are:

1. Insured or collateralized with securities held by the State Treasurer or its custodian in the name of the State of Kansas,
2. Collateralized with securities held by the pledging financial institution's trust department or custodian in the name of the State of Kansas, and
3. Uncollateralized.

As of June 30, 2004, cash deposits of \$ 54,643 held by the State Treasurer were in credit risk category "1". The Retirement System's deposits with its insurance carriers were \$ 3,556,823 at June 30, 2004, and were in credit risk category "3".

#### Investments

Investments and the investment process are governed by K.S.A. 74-4921. The Board of Trustees maintains a formal Statement of Investment Policy, which addresses the governing provisions of the law, as well as specifying additional guidelines for the investment process.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

Statutory authority for the Retirement System's investment program is provided for in K.S.A. 74-4901, et. seq., effective July 1, 1993. The Retirement Act addresses the following areas:

- Establishes the structure of the Board of Trustees, defines the Trustees' responsibilities and imposes the prudent expert standard upon the Trustees' actions with respect to managing the assets of the Retirement System.
- Requires that the assets be invested to preserve capital and solely to provide benefits to members and the members' beneficiaries.
- Limits the possible allocation of common stock to 60% of the total book value of the fund.
- The annual allowance for new alternative (non-publicly traded) investments is limited to 1% of the market value of the total investments assets of the fund as measured from the end of the preceding calendar year.
- Establishes limits on the structure of future investments in real estate or alternative investments.
- Requires that the Board develop investment policies and objectives for the investment and reinvestment of fund assets.
- Authorizes the Board to hire qualified professionals/firms to assist in investing the fund and requires that such professionals/firms obtain errors and omissions insurance coverage and fidelity bond insurance coverage.
- Authorizes the Board to pay for the services of retained professionals/firms at the rates fixed by the Board, excluding any reimbursement for expenses and subject to the provisions of the appropriations acts.
- Provides for an annual audit and requires that the Board annually examine the investment program, specific investments and its policies and practices.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

At June 30, 2004, the Retirement System did not have investments (other than those issued by the U.S. government) in any one organization representing 5% or more of the System's assets.

The Retirement System's permissible investment categories include equities, fixed income securities, cash equivalents, real estate, derivative products, and alternative investments. In fulfilling its responsibilities, the Board of Trustees has contracted with 13 investment management firms and a master global custodian.

Presently the Retirement System has investments in the financial futures market. Futures contracts are contracts for delayed delivery or receipt of securities in which the seller agrees to make delivery and the buyer agrees to take delivery at a specified future date, of a specified instrument, at a specified price. Market risk arises due to market price and interest rate fluctuations that may result in a decrease in the fair value of futures contracts. Futures contracts are traded on organized exchanges and require initial margin in the form of cash or marketable securities. Daily, the net change in the futures contract value is settled in cash with the exchanges. Holders of futures contracts look to the exchange for performance under the contract. Accordingly, the credit risk due to nonperformance of counterparties to futures contracts is minimal. At June 30, 2004, the Retirement System had futures contracts with a fair value of approximately \$ 182,100,000. Cash equivalents and short-term investments in amounts necessary to settle the futures contracts were held in the portfolio so that no leverage was employed, in accordance with the Statement of Investment Policy.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

The Retirement System's Statement of Investment Policy authorizes participation in a securities lending program administered by the master global custodian, Mellon Trust. The System receives income from the loan of the securities, in addition to the income which accrues to the System as owner of the securities. The securities loans are open contracts and therefore could be terminated at any time by either party. The types of securities lent include U.S. Government securities, domestic and international equities, and domestic and international bonds. The borrower collateralizes the loan with either cash or government securities of 102% of fair value on domestic securities and 105% of fair value on international securities loaned. Cash collateral is invested in the Retirement System's name in a dedicated short-term investment fund consisting of investment grade debt securities. The System does not have the ability to pledge or sell collateral securities without a borrower default. At June 30, 2004, the maturities of securities in this dedicated bond portfolio are as follows: 43% of the fair value of the securities mature within 30 days; 19% mature between 31 and 180 days; and 38% mature after 180 days. The custodian provides for full indemnification to the Retirement System for any losses that might occur in the event of borrower default. Therefore, the Retirement System does not incur any credit risk as it relates to this activity. The securities on loan are marked to market daily to ensure the adequacy of the collateral. The fair value of securities on loan was \$ 2,136,687,810 and \$ 1,827,580,110 as of June 30, 2004 and 2003, respectively. Collateral held by the Retirement System was \$ 2,173,652,076 and \$ 1,881,337,715 as of June 30, 2004 and 2003, respectively. Net income produced from securities lending activities was \$ 4,254,284 and \$ 3,803,825 for fiscal years 2004 and 2003, respectively.

The Retirement System's international investment managers utilize forward contracts to hedge the exposure of the international investments to fluctuations in foreign currency. Active international investment managers use forward contracts to enhance returns and/or to control volatility. The Retirement System also contracts with a currency overlay manager to manage the currency exposure to the System's passive international equity portfolio. Currency risk arises due to foreign exchange rate fluctuations. Forward foreign exchange contracts are negotiated between two counterparties. The Retirement System could incur a loss if its counterparties failed to perform pursuant to terms of their contractual obligations. Controls are established by the investment managers to monitor the creditworthiness of the counterparties.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

All forward foreign currency contracts are carried at fair value by the Retirement System. As of June 30, 2004, the System had sold forward currency contracts with a fair value of \$ 1,134,208,839 and had bought forward currency contracts with a fair value of \$ 1,135,939,821. Purchases of forward currency contracts are liabilities reported in Securities Purchased, and sales of forward currency contracts are receivables included in Sale of Investment Securities in the Statement of Plan Net Assets.

The Retirement System also participates in option contracts. These contractual agreements give the purchaser the right, but not the obligation, to purchase or sell a financial instrument at a specified price within a specified time. Options strategies used by the Retirement System are designed to provide exposures to positive market moves and limit exposures to interest rate and currency fluctuations.

The Retirement System internally manages a Treasury Inflation Protected Securities (TIPS) portfolio. TIPS are fixed income securities issued by the U.S. Treasury that pay a fixed coupon rate plus an adjustment for subsequent inflation. At June 30, 2004, the Retirement System had invested in TIPS with a fair value of approximately \$ 964,900,000.

*Custodial credit risk.* Custodial credit risk is the risk that when, in the event a financial institution or counterparty fails, KPERS would not be able to recover value of deposits, investments or collateral securities that are in the possession of an outside party. One hundred percent of the Retirement System's investments are held in the System's name and are not subject to creditors of the custodial bank.

*Concentration risk.* The Retirement System does not have any investments representing 5% or more of total assets in any single issuer other than the U.S. Government.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

*Currency risk.* Currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The Retirement System's investments at June 30, 2004 were distributed among the following currencies:

| <u>Currency</u>    | <u>USD Equivalent</u>    | <u>Percent</u> |
|--------------------|--------------------------|----------------|
| Australian Dollar  | \$ 69,404,592            | 0.54%          |
| British Pound      | 551,877,947              | 4.30%          |
| Danish Krone       | 6,331,633                | 0.05%          |
| Euro Currency Unit | 769,024,409              | 5.99%          |
| Hong Kong Dollar   | 39,001,395               | 0.30%          |
| Japanese Yen       | 546,497,841              | 4.26%          |
| Malaysian Ringgit  | 1,647,635                | 0.01%          |
| New Zealand Dollar | 2,310,069                | 0.02%          |
| Norwegian Krone    | 8,939,084                | 0.07%          |
| South Korean Won   | 1,715,768                | 0.01%          |
| Singapore Dollar   | 19,978,019               | 0.16%          |
| Swedish Krona      | 44,647,334               | 0.35%          |
| Swiss Franc        | 160,309,642              | 1.25%          |
| Thailand Baht      | 7,392,874                | 0.06%          |
| U.S. Dollar *      | 10,608,386,240           | 82.64%         |
|                    | <u>\$ 12,837,464,482</u> |                |

\* Includes securities lending collateral of \$2,078,302,191.

The Retirement System's asset allocation and investment policies include active and passive investments in international securities as shown above. The System's target allocation is to have 19% of assets invested in international equities (excluding securities lending collateral). The System was at 19.9% at June 30, 2004. Core Plus bond managers are allowed to invest up to 20% of their portfolio in non-dollar securities. The System utilizes a currency overlay manager to reduce risk by hedging up to 50% of the foreign currency for selected international equity portfolios. At June 30, 2004, the System's total foreign currency exposure was 14.4% hedged.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

*Credit risk.* Credit risk is the risk that an issuer or other counterparty to a debt investment will not fulfill its obligations. KPERS investment policies require Core and Core Plus managers to have at least 70% of holdings in investment grade securities. Each portfolio is required to maintain a reasonable risk level relative to its benchmark. System assets (in thousands) subject to credit risk are shown with current credit ratings below:

| Quality Rating | Commercial<br>Paper | Corporate           | Agency            | U.S.<br>Government  | Securities<br>Lending<br>Collateral | Total               |
|----------------|---------------------|---------------------|-------------------|---------------------|-------------------------------------|---------------------|
| NR             | \$ 123,561          | \$ 36,239           | \$ -              | \$ -                | \$ 581,309                          | \$ 741,109          |
| AAA            | -                   | 95,611              | 757,994           | 1,706,954           | 172,806                             | 2,733,365           |
| AA             | 27,115              | 209,551             | -                 | -                   | 1,091,769                           | 1,328,435           |
| A              | -                   | 104,099             | -                 | -                   | 232,418                             | 336,517             |
| BAA            | -                   | 263,630             | -                 | -                   | -                                   | 263,630             |
| BA             | -                   | 254,799             | -                 | -                   | -                                   | 254,799             |
| B              | -                   | 214,039             | -                 | -                   | -                                   | 214,039             |
| CAA            | -                   | 35,255              | -                 | -                   | -                                   | 35,255              |
|                | <u>\$ 150,676</u>   | <u>\$ 1,213,223</u> | <u>\$ 757,994</u> | <u>\$ 1,706,954</u> | <u>\$ 2,078,302</u>                 | <u>\$ 5,907,149</u> |

Commercial paper also includes repurchase agreements and other short-term securities. Agency securities are those implicitly guaranteed by the U.S. Government. U.S. Government securities are treasury securities and agencies explicitly guaranteed. Securities Lending Collateral are securities invested using cash collateral from the securities lending program, not pooled with any other institution's funds. Securities rated A1/P1 are included in AA on the table above. The Securities Lending Collateral class has the following policy requirements: to be rated A3/A- or better; Commercial paper must be A1/P1; Asset-backed securities must be AA3/AA- or better; Repurchase agreements must be 102% collateralized with A3/A- or A1/P1 or better securities and held by the custodial bank or third-party custodian.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Investments (Continued)

*Interest rate risk.* Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. KPERs investment policies requires Core and Core Plus managers to be within 20% of their benchmark duration, and all fixed portfolios shall maintain a reasonable risk level relative to their benchmarks. The same System assets as above are also subject to interest rate risk. These are shown below (in thousands) grouped by effective duration ranges:

| Effective Duration | Commercial<br>Paper | Corporate           | Agency            | U.S.<br>Government  | Securities<br>Lending<br>Collateral | Total               |
|--------------------|---------------------|---------------------|-------------------|---------------------|-------------------------------------|---------------------|
| 0-1 year           | \$ 150,676          | \$ 245,428          | \$ 356,246        | \$ 152,586          | \$ 2,078,302                        | \$ 2,983,238        |
| 1-3 years          | -                   | 188,111             | 159,336           | 181,235             | -                                   | 528,682             |
| 3-5 years          | -                   | 199,677             | 171,018           | 222,947             | -                                   | 593,642             |
| 5-10 years         | -                   | 423,961             | 63,611            | 105,227             | -                                   | 592,799             |
| 10-20 years        | -                   | 156,046             | 7,783             | 1,044,959           | -                                   | 1,208,788           |
|                    | <u>\$ 150,676</u>   | <u>\$ 1,213,223</u> | <u>\$ 757,994</u> | <u>\$ 1,706,954</u> | <u>\$ 2,078,302</u>                 | <u>\$ 5,907,149</u> |

Treasury Inflation Protected Securities (TIPS) comprise 94% of the U.S. Government 10-20 years group above. Total TIPS for all duration ranges were valued at \$964,902,976 at June 30, 2004. Securities Lending Collateral policy limits the maximum average portfolio maturity to 90 days, and only floating rate securities and fixed rate asset-backed securities may mature individually beyond 13 months.

Capital Assets and Supplies Inventory

Furniture, fixtures, and equipment are reported at historical cost, net of accumulated depreciation. These assets are depreciated on a straight-line basis over an average useful life of three to ten years with no salvage value. Accumulated depreciation on furniture, fixtures, and equipment as of June 30, 2004, was \$ 2,116,548. Office supplies inventory in the amount of \$ 34,396 is included, assuming the first-in, first-out method.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

### 2 - Summary of Significant Accounting Policies (Continued)

#### Capital Assets and Supplies Inventory (Continued)

In fiscal year 1999, the Retirement System purchased an office building and parking garage in Topeka, Kansas. Fifty percent of the floor space of the office building is used as the System's administrative headquarters and the remaining fifty percent is a real estate investment. The administrative portion of the building and parking garage are reported as a capital asset and are being depreciated. Accumulated depreciation on the administrative portion of the building and garage as of June 30, 2004 was \$ 1,701,395. The office building and garage are being depreciated over a period of 33 years using an accelerated method. The carrying value of the System's administrative headquarters was \$ 2,118,308 and \$ 2,298,620 as of June 30, 2004 and 2003, respectively.

#### Compensated Accrued Absences

Expenses for accumulated vacation and sick leave earned by Retirement System personnel are recorded when earned by the employee. In the event of termination of employment with the State of Kansas, an employee is compensated for vacation benefits accrued in varying amounts ranging from one to 30 days. Compensation for accumulated sick leave requires three conditions to occur: (1) accumulation of 800 hours; (2) minimum of eight years of credited service; and (3) termination with the State of Kansas on or after reaching retirement age. If all conditions are met, the employee will be compensated in accordance with applicable personnel regulations. The minimum amount of sick leave to be compensated is 30 days; the maximum amount is 60 days.

#### Reserves

K.S.A. 74-4922, K.S.A. 74-4927 and K.S.A. 74-49,110 define the title and use of the required Retirement System reserves. The law governing the Retirement System requires the actuary to make an annual valuation of the Retirement System's liabilities and reserves, to make a determination of the contributions required to discharge the Retirement System's liabilities and to recommend to the Board of Trustees employer contribution rates required to maintain the System on an actuarial reserve basis. The various reserves are:

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

2 - Summary of Significant Accounting Policies (Continued)

Reserves (Continued)

**The Members Accumulated Contribution Reserve** represents the accumulation of member contributions plus interest credited to individual member accounts of non-retired members. At the date of retirement the individual member's account is transferred to the Retirement Benefit Payment Reserve. After ending employment and applying for withdrawal, employee contributions plus accumulated interest are charged to this reserve. Interest is credited to active member accounts on June 30 each year, based on the balance in the account as of the previous December 31. The interest crediting rate, defined by statute as the actuarial interest assumption rate, was 8% for those who became members prior to July 1, 1993. For those who first became members after June 30, 1993, interest on employee contributions is credited at the rate of 4% per year. The balance at June 30, 2004 was \$ 3,893,911,309 and was fully funded.

**The Retirement Benefit Accumulation Reserve** represents the accumulation of employer contributions, net investment income not credited to any other reserve, and the actuarially computed prior service liability not yet funded. The balance at June 30, 2004 was \$ 4,517,110,565 and the unfunded liability was \$ 3,586,084,092.

**The Retirement Benefit Payment Reserve** represents the actuarially computed present value of future benefits for retired members plus interest credited for the current fiscal year based upon information as of the preceding January 1. The balance at June 30, 2004 was \$ 5,558,543,751 and was fully funded.

**The Group Insurance Reserve** represents employer contributions, which pay 100% of the cost of group life insurance and long-term disability coverage. Insurance premiums and benefits consist of: (1) claims paid under the insurance contract; and (2) deposits made by the Retirement System to pay disability benefits to eligible participants. An actuarial valuation of this fund was last completed for June 30, 2003. A moratorium on contributions was in place for all of fiscal year 2004. The balance at June 30, 2004 was \$ 29,182,453 and remains less than fully funded.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

### 2 - Summary of Significant Accounting Policies (Continued)

#### Reserves (Continued)

**The Expense Reserve** represents investment income which is sufficient to maintain a year-end account balance at two times the most recent fiscal year's administrative expense amount. The System's administrative expenses are financed from this reserve. The balance at June 30, 2004 was \$ 14,462,591 and was fully funded.

**The Optional Term Life Insurance Reserve** accumulates employee contributions to pay premiums for optional life insurance coverage and is charged annually with the cost of administering the program. The balance at June 30, 2004 was \$ 15,995 and was fully funded.

#### Budget

The Retirement System's annual operating budget is developed by the staff and approved by the Board of Trustees. It is sent to the State Budget Division for analysis and policy decisions and is included in the Governor's budget message to the Legislature. The Legislature adopts appropriation and expenditure limitations. When that process is complete, the System has an approved budget.

#### Retirement System Employees' Pension Plan

As an employer, the Retirement System participates in KPERS, a cost sharing, multi-employer defined benefit pension plan. KPERS provides retirement, disability, withdrawal and death benefits to plan members and beneficiaries as authorized by Kansas law. Funding is accomplished through member and employer contributions and investment earnings, according to Kansas law. Plan members are required to contribute 4% of their annual salary. KPERS contributed 4.58% of covered payroll for fiscal year 2004. For the period July 1, 2002 through March 31, 2003, KPERS contributed 4.98% of covered payroll. For the period April 1, 2003 through June 30, 2003, KPERS contributed 4.38% of covered payroll. Covered payroll was \$ 3,234,839 and \$ 3,224,719 for 2004 and 2003, respectively. KPERS contributed \$ 140,689 and \$ 138,557 for 2004 and 2003, respectively.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

### 2 - Summary of Significant Accounting Policies (Continued)

#### Non-Retirement Funds

The 2000 legislative session assigned to the Retirement System the investment responsibilities of two funds with non-retirement money. K.S.A. 75-5321(a) established the Senior Services Trust Fund which exists solely to provide income to the nursing facility service payment program, the home and community based nursing facility program, and the income eligible (home care) program. The Treasurer's Unclaimed Property Fund was established to provide investment earnings available for periodic transfer to the State Treasury for the credit of the State General Fund. Legislation was also provided to defray the reasonable expenses of administering these funds. During fiscal year 2003, investments for the Senior Services Trust Fund were liquidated and transferred to the State of Kansas Department on Aging. Investments under management for the Treasurer's Unclaimed Property Fund were \$ 114,500,430 at June 30, 2004.

### 3 - Funding Policy

#### Funding

The law governing the Retirement System requires the actuary to make an annual valuation of the System's liabilities and reserves and determine the contribution required to discharge the System's liabilities. The actuary then recommends to the System's Board of Trustees the employer contribution rates required to maintain the Retirement System on the actuarial reserve basis.

Every three years, the actuary makes a general investigation of the actuarial experience under the System including mortality, retirement, and employment turnover. The actuary recommends actuarial tables for use in valuations and in calculating actuarial equivalent values based on such investigation. An actuarial experience study was conducted for the three years ending December 31, 2000. As a result of this study, the Board of Trustees adopted new assumptions in regard to retirement rates, mortality, and withdrawal rates.

In fiscal year 2004, the Kansas Legislature passed additional legislation impacting the funding of the Retirement System. The KPERS State/School group was split for actuarial purposes and calculating employer rates into two separate groups: State and School. The statutory cap for the Local Group effective in calendar year 2006 was raised to 0.4% with subsequent increases of 0.5% in calendar year 2007 and 0.6% in calendar year 2008. In addition, KP&F Tier I members may retire with unreduced benefits at any age after 32 years of service.

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## NOTES TO BASIC FINANCIAL STATEMENTS (Continued)

### 3 - Funding Policy (Continued)

#### Funding (Continued)

Legislation was also passed authorizing the Board of Trustees to select the actuarial cost method, the amortization method and the amortization period for all three systems. In fiscal year 2004, the Board of Trustees changed the actuarial cost method and asset valuation method for all the groups. The actuarial cost method for all groups was changed to Entry Age Normal (EAN) level percent of pay cost method. The prior actuarial cost method was Projected Unit Credit (PUC) for KPERS, the Aggregate Cost method with Supplemental Unfunded Actuarial Liability for KPF, and the Frozen Entry Age method for Judges. This change in actuarial cost method provides for a consistent valuation basis for all three plans and moves the Retirement System's funding method to the method most commonly used by public retirement systems.

The new asset valuation method calculates the difference between the actual return and the expected return (assumed rate of return) on the market value of assets each year. The difference is recognized evenly over a five-year period.

#### Legislation

In September 2003, the State of Kansas issued \$ 40,250,000 of Series 2003 H State pension funding bonds. Of the total amount of the bond issue, \$ 15,350,000 of the bond proceeds were used for the purpose of financing the unfunded actuarial liability of the TIAA group of members. In addition, the State of Kansas contributed an additional \$ 2,000,000 cash payment. The remaining bond proceeds of \$ 24,900,000 were used for the purpose of financing the unfunded actuarial liability of those members who retired prior to July 2, 1987, and are entitled to a Retirement Dividend payment pursuant to K.S.A. 74-49,109. Beginning in fiscal year 2005, the State's employer contribution rates for the State KPERS, School, State KPF and Judges groups will include an additional amount to finance the debt service payments for this portion of the bonds. KPERS will collect additional contributions for the debt service payments beginning in fiscal year 2005 and transfer these funds to the State of Kansas.

In February 2004, the State of Kansas issued \$ 500 million in pension obligation bonds, and KPERS received net proceeds of \$ 440.2 million in March 2004. The proceeds of these are used to assist with the financing of the unfunded actuarial liability for the State and School group. The debt service on the bonds will be paid by the State of Kansas in addition to the State's regular employer contributions.

The proceeds of the above-mentioned bond issuances are included in employer contributions on the Statement of Changes in Plan Net Assets.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

3 - Funding Policy (Continued)

Changes in Unfunded Actuarial Liability

The actuary has estimated the change in the unfunded actuarial liability between December 31, 2002 and December 31, 2003 can be attributed to the following (in millions):

|   |                 |
|---|-----------------|
| Unfunded Actuarial Liability, December 31, 2002 | \$ 2,829        |
| Effect of contribution cap/time lag             | 178             |
| Expected increase due to amortization method    | 47              |
| Loss from investment return                     | 140             |
| Demographic experience                          | (37)            |
| All other experience                            | 5               |
| Change in actuarial cost method                 | 1,147           |
| Change in asset valuation method                | (286)           |
| Change in benefit provisions - KP&F             | 3               |
| Receivable-bond proceeds                        | (440)           |
|   | <hr/>           |
| Unfunded Actuarial Liability, December 31, 2003 | <u>\$ 3,586</u> |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

3 - Funding Policy (Continued)

Contributions Required and Contributions Made

KPERS - The actuarially determined contribution rates are computed as a level percentage of payroll by the Retirement System's actuary. For the State/School and Correctional members, the results of June 30, 2000 and December 31, 2000 actuarial valuations provide the basis for Board certification of employer contribution rates for fiscal years 2003 and 2004, respectively. As explained in Note 1, legislation has limited the amounts that employers are required to contribute for State/School employees and Local employees, which has resulted in lower employer contribution rates, as compared to the actuarial determined rates. The actuarially determined employer contribution rates (not including the 0.6% contribution rate for the Death and Disability Program), and the statutory contribution rates for fiscal years 2003 and 2004 are as follows:

| <u>Fiscal Year</u> | <u>State/School</u> |                  | <u>Correction Employees</u> |                  |
|--------------------|---------------------|------------------|-----------------------------|------------------|
|                    | <u>Actuarial</u>    | <u>Statutory</u> | <u>Actuarial</u>            | <u>Statutory</u> |
| 2003               | 5.57%               | 4.38%            | 7.28/7.92%                  | 6.09/6.73%       |
| 2004               | 7.05%               | 4.58%            | 7.08/7.57%                  | 4.61/5.10%       |

The results of December 31, 2000 and December 31, 2001 actuarial valuations provide the basis for Board certification of local employer contribution rates for fiscal years beginning in 2003 and 2004, respectively. The actuarially determined employer contribution rates and statutory contribution rates for fiscal years 2003 and 2004 are as follows:

| <u>Fiscal Year</u> | <u>Local</u>          |                       |
|--------------------|-----------------------|-----------------------|
|                    | <u>Actuarial Rate</u> | <u>Statutory Rate</u> |
| 2003               | 4.13%                 | 3.07%                 |
| 2004               | 4.64%                 | 3.22%                 |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

3 - Funding Policy (Continued)

Contributions Required and Contributions Made (Continued)

KP&F - The uniform participating service rate for all KP&F employers was 6.86% for the fiscal year beginning in 2003 and 9.47% for the fiscal year beginning in 2004. KP&F employers also make contributions to amortize the liability for past service costs, if any, which are determined separately for each participating employer.

Judges - The total actuarially determined employer contribution rate is 12.26% of payroll for the fiscal year ended 2003 and 16.67% of payroll for the fiscal year ended in 2004.

The law specifies employee contributions as: each participating employer, beginning with the first payroll for services performed after the entry date, shall deduct from the compensation of each member an amount equal to 4% for KPERS members, 7% for KP&F members, and 6% for Judges members as the member's employee contributions. All required contributions have been made as follows:

|                            | (Expressed in Thousands)                   |  |   |
|----------------------------|--|--|---|
|                            | Employer and<br>Insurance<br>Contributions | Member<br>Contributions <sup>(1)</sup> | Contributions<br>as a Percent of<br>Covered Payroll |
| KPERS - State/School, TIAA | \$ 158,107                                 | \$ 148,293                             | 8.2%  |
| KPERS - Local              | 38,736                                     | 51,922                                 | 7.5%  |
| KP&F                       | 34,701                                     | 22,569                                 | 20.6%   |
| Judges                     | 3,729                                      | 1,090                                  | 22.6%   |
| Subtotal                   | <u>235,273</u>                             | <u>\$ 223,874</u>                      | <u>8.7%</u>   |
| TIAA Bond Proceeds         | 14,015                                     |  |   |
| 13th Check Bond Proceeds   | 24,900                                     |  |   |
| Pension Obligation Bonds   | <u>440,165</u>                             |  |   |
| Total                      | <u>\$ 714,353</u>                          |  |   |

(1) Member Contributions do not include Optional Life Insurance contributions of approximately \$ 6.5 million.

An estimated \$ 434 million of employer and employee contributions were made to cover normal cost, and an estimated \$ 19 million was made for the amortization of the unfunded actuarial accrued liability.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

NOTES TO BASIC FINANCIAL STATEMENTS  
(Continued)

3 - Funding Policy (Continued)

Historical Trend Information

Historical trend information, showing the Retirement System's progress in accumulating sufficient assets to pay benefits when due, is presented on page 37, and is titled "Schedule of Funding Progress."

4 - Commitments and Contingencies

As of June 30, 2004, the Retirement System was committed to additional funding of \$ 8,476,000 in the form of capital expenditures on separate account real estate holdings in the portfolio, \$ 270,089,000 for commitments on venture capital investments and \$ 53,001,000 for capital calls on real estate property trusts investments.

The Retirement System is a defendant in legal proceedings and claims arising out of the ordinary course of business. The Retirement System believes that it has adequate legal defenses and that the ultimate outcome of these actions will not have a material adverse effect on the Retirement System's financial position.

REQUIRED SUPPLEMENTARY INFORMATION

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

SCHEDULE OF EMPLOYER CONTRIBUTIONS

Fiscal Year Ended June 30, 2004

| Year<br>Ended<br>June 30, | Annual<br>Required<br>Contribution | Percentage<br>Contributed |
|---------------------------|------------------------------------|---------------------------|
| 1995                      | \$ 129,083,585                     | 100.2%                    |
| 1996 <sup>(1)</sup>       | 173,927,737                        | 82.5%                     |
| 1997                      | 199,521,423                        | 74.7%                     |
| 1998                      | 216,270,482                        | 77.3%                     |
| 1999                      | 256,813,541                        | 79.0%                     |
| 2000                      | 234,941,116                        | 80.6%                     |
| 2001                      | 277,096,692                        | 77.6%                     |
| 2002                      | 289,519,647                        | 79.7%                     |
| 2003                      | 311,365,296                        | 78.9%                     |
| 2004                      | 317,900,432                        | 74.0% <sup>(2)</sup>      |

(1) For fiscal years ending June 30, 1996 and after, the actual contributions for KPERS employers were substantially lower than the actuarially required amount, due to statutory limitations on annual increases as discussed in Note 1.

(2) The percentage contributed does not take into account the receipt of bond proceeds. See Note 3.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

SCHEDULE OF FUNDING PROGRESS

Fiscal Year Ended June 30, 2004

(Dollar amounts in thousands)

| Actuarial<br>Valuation<br>Date | Actuarial<br>Value of<br>Assets<br>(a) | Actuarial<br>Accrued<br>Liability<br>(AAL)<br>(b) | Unfunded<br>AAL<br>(UAAL)<br>(b-a) | Funded<br>Ratio<br>(a/b) | Covered<br>Payroll<br>(c) | UAAL as a<br>Percentage<br>of Covered<br>Payroll<br>[(b-a)/c] |
|--------------------------------|--|---|------------------------------------|--------------------------|---------------------------|---|
| 6/30/1995                      | \$ 5,510,957                           | \$ 6,991,029                                      | \$ 1,480,072                       | 79%                      | \$ 3,766,917              | 39%   |
| 6/30/1996                      | 6,158,755                              | 7,603,111   | 1,444,356                          | 81%                      | 3,945,207                 | 37%   |
| 6/30/1997                      | 6,875,918                              | 8,251,986   | 1,376,068                          | 83%                      | 4,108,320                 | 33%   |
| 6/30/1998                      | 7,749,203                              | 9,340,685   | 1,591,482                          | 83%                      | 4,273,627                 | 37%   |
| 6/30/1999                      | 8,601,876                              | 9,999,246   | 1,397,370                          | 86%                      | 4,480,717                 | 31%   |
| 6/30/2000                      | 9,568,275                              | 10,801,397  | 1,233,122                          | 89%                      | 4,684,768                 | 26%   |
| 12/31/2000 <sup>(1)</sup>      | 9,835,182                              | 11,140,014  | 1,304,832                          | 88%                      | 4,876,555                 | 27%   |
| 12/31/2001                     | 9,962,918                              | 11,743,052  | 1,780,134                          | 85%                      | 5,116,384                 | 35%   |
| 12/31/2002                     | 9,784,862                              | 12,613,599  | 2,828,736                          | 78%                      | 4,865,903 <sup>(2)</sup>  | 58%   |
| 12/31/2003                     | 10,853,462                             | 14,439,546 <sup>(3)</sup>                         | 3,586,084                          | 75%                      | 4,978,132                 | 72%   |

(1) The actuarial valuation date was changed to a calendar year basis.

(2) Beginning with the 12/31/2002 actuarial valuation, the unfunded actuarial liability of the TIAA group was eliminated. Therefore, covered payroll no longer includes the salaries of non-KPERS unclassified employees of the Board of Regents institutions previously included.

(3) Beginning with the 12/31/2003 actuarial valuation, the actuarial cost method was changed to the Entry Age Normal (EAN) method.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

ACTUARIAL VALUATION

June 30, 2004

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows.

|   | KPERs   | KP&F  | Judges  |
|---|---|---|---|
| Valuation date                            | 12/31/2003  | 12/31/2003  | 12/31/2003  |
| Actuarial cost method                     | Entry Age Normal  | Entry Age Normal  | Entry Age Normal  |
| Amortization method                       | Level Percent<br>closed   | Level Percent<br>closed   | Level Percent<br>closed   |
| Remaining amortization period             | 29 years  | 29 years  | 29 years  |
| Asset valuation method                    | Difference between<br>actual return and<br>expected return on<br>market value of assets<br>calculated yearly and<br>recognized evenly over<br>5-year period | Difference between<br>actual return and<br>expected return on<br>market value of assets<br>calculated yearly and<br>recognized evenly over<br>5-year period | Difference between<br>actual return and<br>expected return on<br>market value of assets<br>calculated yearly and<br>recognized evenly over<br>5-year period |
| Actuarial assumptions:                    |   |   |   |
| Investment rate of return <sup>(1)</sup>  | 8%  | 8%  | 8%  |
| Projected salary increases <sup>(1)</sup> | 4.0% - 9.8%   | 4.0% - 12.5%  | 5.5%  |
| Cost of living adjustments                | none  | none  | none  |

(1) Salary increases and investment rate of return include an inflation component of 3.5%.

SUPPLEMENTARY INFORMATION

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

SCHEDULE OF CONTRIBUTIONS \*

Fiscal Year Ended June 30, 2004

|   |    |                    |                           |
|---|----|--------------------|---------------------------|
| Kansas Public Employees Retirement System |    |                    |                           |
| State/school contributions:               |    |                    |                           |
| Members                                   | \$ | 148,293,435        |                           |
| Employers                                 |    | <u>160,145,687</u> |                           |
| Total state/school contributions          | \$ |                    | 308,439,122               |
| Local contributions:                      |    |                    |                           |
| Members                                   |    | 51,922,069         |                           |
| Employers                                 |    | <u>38,736,225</u>  |                           |
| Total local contributions                 |    |                    | 90,658,294                |
| Total contributions -                     |    |                    |                           |
| Kansas Public Employees Retirement System | \$ |                    | 399,097,416               |
| Kansas Police and Firemen's System        |    |                    |                           |
| State contributions:                      |    |                    |                           |
| Members                                   |    | 2,413,623          |                           |
| Employers                                 |    | <u>2,792,242</u>   |                           |
| Total state contributions                 |    |                    | 5,205,865                 |
| Local contributions:                      |    |                    |                           |
| Members                                   |    | 20,155,271         |                           |
| Employers                                 |    | <u>30,041,516</u>  |                           |
| Total local contributions                 |    |                    | <u>50,196,787</u>         |
| Total contributions -                     |    |                    |                           |
| Kansas Police and Firemen's System        |    |                    | 55,402,652                |
| Kansas Retirement System for Judges       |    |                    |                           |
| State contributions:                      |    |                    |                           |
| Members                                   |    | 1,090,382          |                           |
| Employers                                 |    | <u>3,557,360</u>   |                           |
| Total state contributions                 |    |                    | <u>4,647,742</u>          |
| Total contributions -                     |    |                    |                           |
| Kansas Retirement System for Judges       |    |                    | 4,647,742                 |
| Optional Life Insurance                   |    |                    |                           |
| Member contributions:                     |    |                    |                           |
| State employees                           |    | 3,478,445          |                           |
| Local employees                           |    | <u>2,997,374</u>   |                           |
| Total contributions                       |    |                    | <u>6,475,819</u>          |
| Total contributions -                     |    |                    |                           |
| Optional life insurance                   |    |                    | <u>6,475,819</u>          |
| Subtotal contributions and insurance      |    |                    |                           |
|   |    |                    | 465,623,629               |
| Bond proceeds                             |    |                    |                           |
|   |    |                    | <u>479,079,547</u>        |
| Grand total - all contributions           |    |                    |                           |
|   | \$ |                    | <u><u>944,703,176</u></u> |

\* Per legislation, employers were not required to remit the Group Life and Disability portion of the actual employer contribution rate from July 1, 2003 through June 30, 2004.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

SCHEDULE OF ADMINISTRATIVE EXPENSES

Fiscal Year Ended June 30, 2004

|                               |                |                     |
|-------------------------------|----------------|---------------------|
| Salaries and wages            |                | \$ 4,301,157        |
| Professional services:        |                |                     |
| Actuarial                     | \$ 189,109     |                     |
| Audit                         | 32,500         |                     |
| Data processing               | 420,751        |                     |
| Legal                         | 31,931         |                     |
| Other professional services   | <u>738,571</u> |                     |
| Total professional services   |                | 1,412,862           |
| Communication:                |                |                     |
| Advertising                   | 4,509          |                     |
| Postage                       | 209,195        |                     |
| Printing                      | 87,651         |                     |
| Telephone                     | <u>42,741</u>  |                     |
| Total communication           |                | 344,096             |
| Building administration:      |                |                     |
| Building management           | 75,422         |                     |
| Janitorial service            | 40,260         |                     |
| Office and equipment rent     | 20,602         |                     |
| Real estate taxes             | 79,535         |                     |
| Utilities                     | <u>53,824</u>  |                     |
| Total building administration |                | 269,643             |
| Miscellaneous:                |                |                     |
| Dues and subscriptions        | 30,971         |                     |
| Repair and service agreements | 74,687         |                     |
| Fees - other services         | 75,780         |                     |
| Supplies                      | 125,280        |                     |
| Temporary services            | 140,811        |                     |
| Travel                        | 103,079        |                     |
| Other miscellaneous           | 40,306         |                     |
| Depreciation                  | <u>312,623</u> |                     |
| Total miscellaneous           |                | <u>903,537</u>      |
| Total administrative expenses |                | <u>\$ 7,231,295</u> |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM  
SCHEDULE OF INVESTMENT INCOME BY ASSET CLASS

Fiscal Year Ended June 30, 2004

| Asset<br>Classification                          | Interest,<br>Dividends<br>and Other<br>Transactions | Gains<br>and<br>(Losses) | Total                   |
|--|---|--------------------------|-------------------------|
| Marketable equity securities:                    |   |                          |                         |
| Domestic equities                                | \$ 37,912,844                                       | \$ 556,796,969           | \$ 594,709,813          |
| International equities                           | 41,892,598  | 418,417,695              | 460,310,293             |
| Subtotal marketable equities                     | <u>79,805,442</u>                                   | <u>975,214,664</u>       | <u>1,055,020,106</u>    |
| Marketable fixed income securities:              |   |                          |                         |
| Domestic fixed income:                           |   |                          |                         |
| Government                                       | 54,992,976  | 10,398,063               | 65,391,039              |
| Corporate  | 72,606,460  | (22,663,540)             | 49,942,920              |
| Subtotal marketable fixed income                 | <u>127,599,436</u>                                  | <u>(12,265,477)</u>      | <u>115,333,959</u>      |
| Temporary investments                            | <u>3,920,686</u>                                    | <u>116,359</u>           | <u>4,037,045</u>        |
| Total marketable securities                      | <u>211,325,564</u>                                  | <u>963,065,546</u>       | <u>1,174,391,110</u>    |
| Real estate                                      | 39,514,695  | 47,177,107               | 86,691,802              |
| Alternative investments                          | <u>12,155,602</u>                                   | <u>76,886,225</u>        | <u>89,041,827</u>       |
| Total real estate and alternative<br>investments | <u>51,670,297</u>                                   | <u>124,063,332</u>       | <u>175,733,629</u>      |
| Other investment income:                         |   |                          |                         |
| Securities lending                               | 4,254,284   | -                        | 4,254,284               |
| Recaptured broker commissions                    | 355,830   | -                        | 355,830                 |
| Miscellaneous income                             | 209,662   | -                        | 209,662                 |
| Total other investment income                    | <u>4,819,776</u>                                    | <u>-</u>                 | <u>4,819,776</u>        |
| Total investment income                          | <u>\$ 267,815,637</u>                               | <u>\$ 1,087,128,878</u>  | <u>1,354,944,515</u>    |
| Manager and custodian fees and expenses:         |   |                          |                         |
| Investment manager fees                          |   |                          | (17,520,389)            |
| Custodian fees and expenses                      |   |                          | (611,580)               |
| Other investment expenses                        |   |                          | (586,632)               |
| Total investment fees and expenses               |   |                          | <u>(18,718,601)</u>     |
| Net investment income                            |   |                          | <u>\$ 1,336,225,914</u> |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

SCHEDULE OF INVESTMENT FEES AND EXPENSES

Fiscal Year Ended June 30, 2004

|  |    |           |                   |
|--|----|-----------|-------------------|
| Domestic equity managers:                                |    |           |                   |
| Barclays Global Investors                                | \$ | 3,025,200 |                   |
| Capital Guardian Trust Co.                               |    | 343,828   |                   |
| Wellington Management Co.                                |    | 1,948,528 |                   |
| Subtotal domestic equity managers                        |    |           | \$ 5,317,556      |
| International equity managers:                           |    |           |                   |
| Alliance Capital Management                              |    | 1,000,875 |                   |
| Barclays Global Investors                                |    | 271,933   |                   |
| Lazard Freres Asset Management                           |    | 1,595,447 |                   |
| Morgan Stanley Asset Management                          |    | 1,637,130 |                   |
| Nomura Capital Management                                |    | 625,896   |                   |
| Subtotal international equity managers                   |    |           | 5,131,281         |
| Fixed income managers:                                   |    |           |                   |
| Loomis, Sayles & Co.                                     |    | 1,140,453 |                   |
| Pacific Investment Management Co.                        |    | 1,018,718 |                   |
| Payden & Rygel Investment Counsel                        |    | 800,858   |                   |
| Western Asset Management Co.                             |    | 863,864   |                   |
| Subtotal fixed income managers                           |    |           | 3,823,893         |
| Foreign currency overlay manager:                        |    |           |                   |
| Pareto Partners  |    | 1,177,981 |                   |
| Subtotal foreign currency overlay manager                |    |           | 1,177,981         |
| Real estate and alternative investment managers:         |    |           |                   |
| AEW Capital Management                                   |    | 1,312,527 |                   |
| Lend Lease   |    | 219,145   |                   |
| Portfolio Advisors                                       |    | 358,154   |                   |
| Morgan Stanley Prime Property Fund                       |    | 56,589    |                   |
| Subtotal real estate and alternative investment managers |    |           | 1,946,415         |
| Cash equivalent manager:                                 |    |           |                   |
| Payden & Rygel Investment Counsel                        |    | 123,263   |                   |
| Subtotal cash equivalent manager                         |    |           | 123,263           |
| Total investment management fees                         |    |           | 17,520,389        |
| Other fees and expenses:                                 |    |           |                   |
| Mellon Trust - custodian fees and expenses               |    | 611,580   |                   |
| Consultant fees  |    | 559,100   |                   |
| Litigation expenses                                      |    | 27,532    |                   |
| Subtotal other fees and expenses                         |    |           | 1,198,212         |
| Total investment fees and expenses                       | \$ |           | <u>18,718,601</u> |

# KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

## INVESTMENT SUMMARY (In Thousands)<sup>1</sup>

Fiscal Year Ended June 30, 2004

|  | June 30,<br>2003<br>Fair Value | Purchases<br>and Other<br>Increases | Sales<br>and Other<br>Decreases | June 30,<br>2004<br>Fair Value | Asset Mix<br>Fair Value |
|--|--------------------------------|-------------------------------------|---------------------------------|--------------------------------|-------------------------|
| Marketable securities:                               |                                |                                     |                                 |                                |                         |
| Domestic equities                                    | \$ 3,024,581                   | \$ 986,276                          | \$ (497,411)                    | \$ 3,513,446                   | 32.65%                  |
| International equities                               | 1,621,533                      | 1,260,835                           | (745,454)                       | 2,136,914                      | 19.86%                  |
| Total fixed income                                   | 3,255,500                      | 10,155,754                          | (9,729,782)                     | 3,681,472                      | 34.22%                  |
| Temporary investments <sup>(2)</sup>                 | 379,764                        | 21,593,784                          | (21,791,041)                    | 182,507                        | 1.70%                   |
| <b>Total marketable securities</b>                   | <b>8,281,378</b>               | <b>33,996,649</b>                   | <b>(32,763,688)</b>             | <b>9,514,339</b>               | <b>88.43%</b>           |
| Real estate and alternative investments:             |                                |                                     |                                 |                                |                         |
| Real estate  | 623,648                        | 155,902                             | (72,655)                        | 706,895                        | 6.57%                   |
| Direct placements and limited partnerships           | 483,144                        | 208,307                             | (153,523)                       | 537,928                        | 5.00%                   |
| <b>Total real estate and alternative investments</b> | <b>1,106,792</b>               | <b>364,209</b>                      | <b>(226,178)</b>                | <b>1,244,823</b>               | <b>11.57%</b>           |
| <b>Total investments</b>                             | <b>\$ 9,388,170</b>            | <b>\$ 34,360,858</b>                | <b>\$ (32,989,866)</b>          | <b>\$ 10,759,162</b>           | <b>100.00%</b>          |

(1) Amounts include changes in unrealized appreciation and excludes interest and dividend accruals. Amounts exclude security lending cash collateral of \$ 2,078,302,191 and \$ 1,860,279,374 at June 30, 2004 and 2003, respectively.

(2) Temporary investments include foreign currencies and securities maturing within 90 days of purchase date.

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

EXPENSES BY TYPE

Fiscal Year Ended June 30, 2004

| <u>Fiscal Year</u> | <u>Benefits</u> | <u>Withdrawals</u> | <u>Insurance</u> | <u>Administration</u> | <u>Total</u>   |
|--------------------|-----------------|--------------------|------------------|-----------------------|----------------|
| 1995               | \$ 333,924,392  | \$ 26,542,254      | \$ 35,873,212    | \$ 4,312,658          | \$ 400,652,516 |
| 1996               | 364,102,629     | 30,687,458         | 34,108,251       | 4,493,293             | 433,391,631    |
| 1997               | 396,660,948     | 36,761,626         | 36,048,625       | 4,659,099             | 474,130,298    |
| 1998               | 428,997,161     | 41,510,908         | 37,639,743       | 4,702,566             | 512,850,378    |
| 1999               | 472,571,948     | 40,860,950         | 41,892,190       | 5,442,410             | 560,767,498    |
| 2000               | 505,941,764     | 43,631,850         | 42,199,878       | 5,689,571             | 597,463,063    |
| 2001               | 558,901,552     | 43,967,623         | 46,456,603       | 6,843,434             | 656,169,212    |
| 2002               | 636,398,865     | 39,066,937         | 47,625,764       | 6,776,044             | 729,867,610    |
| 2003               | 653,542,143     | 39,608,946         | 53,829,235       | 7,215,024             | 754,195,348    |
| 2004               | 685,603,796     | 41,179,470         | 50,396,392       | 7,231,295             | 784,410,953    |

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM

CASH RECEIPTS AND DISBURSEMENTS

Fiscal Year Ended June 30, 2004

|                                      |                   |                      |
|--------------------------------------|-------------------|----------------------|
| Opening cash balance                 |                   | \$ 47,507            |
| Member contributions                 | \$ 221,497,869    |                      |
| Employer contributions               | 711,551,789       |                      |
| System recoveries                    | 189,668           |                      |
| Refund of advancements               | 671,048,824       |                      |
| Optional life insurance              | <u>6,441,633</u>  |                      |
| Total cash receipts                  |                   | 1,610,729,783        |
| Withdrawal of contributions          | 36,119,085        |                      |
| Payment to beneficiaries             | 13,516,042        |                      |
| Retirement benefits                  | 670,415,614       |                      |
| Retirant dividend payments           | 6,672,212         |                      |
| Group life insurance premiums        | 9,398,683         |                      |
| Optional life insurance premiums     | 6,387,733         |                      |
| Electronic funds transfer            | 23,460            |                      |
| Administrative expenses              | 7,374,879         |                      |
| Deposited with insurance carrier     | 33,000,000        |                      |
| Advanced to investment custodian     | 809,831,681       |                      |
| Investment manager fees and expenses | <u>17,983,258</u> |                      |
| Total disbursements made             |                   | <u>1,610,722,647</u> |
| Ending cash balance                  |                   | <u>\$ 54,643</u>     |



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## **REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Legislative Post Audit Committee  
Kansas State Legislature:

We have audited the financial statements of the Kansas Public Employees Retirement System, a component unit of the State of Kansas, as of and for the year ended June 30, 2004, and have issued our report thereon dated September 3, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Kansas Public Employees Retirement System's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition 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 misstatements caused by error 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Kansas Public Employees Retirement System's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of Legislative Post Audit, the Board of Trustees and management. This restriction is not intended to limit the distribution of this report, which upon acceptance by Legislative Post Audit, is a matter of public record.

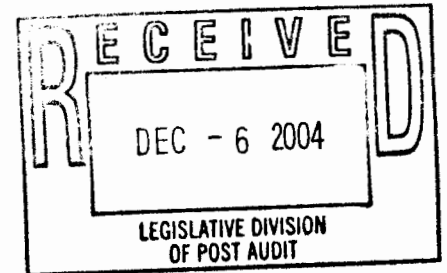
*Berberich Trahan & Co., P.A.*

September 3, 2004



December 3, 2004

Brad Koehn  
Berberich Trahan & Co., P.A.  
3630 SW Burlingame Road  
Topeka, Kansas 66611-2050



Dear Mr. Koehn,

Thank you for the opportunity to formally respond to the draft copy of your completed financial and compliance audit report. The Retirement System appreciates the professional approach taken by your firm during the engagement of this audit.

We are pleased that the report contains no findings or recommendations in regard to accounting procedures or internal controls. The Retirement System is also pleased to acknowledge the unqualified auditors' opinion contained in the audit.

This year's report emphasizes certain matters contained in the financial statements that require additional discussion and analysis. The first matter of concern is the level of employers' contributions. The 2003 and 2004 legislature addressed the limitations placed on employer contributions by increasing the annual capped increases placed on employer contributions. Beginning in Fiscal Year 2006, the capped increase for employer contributions will be allowed to increase by .40 percent; by .50 percent in Fiscal Year 2007; and by .60 percent in Fiscal Year 2008 and beyond. In addition, the State of Kansas issued \$500 million in pension obligation bonds in fiscal year 2004 to fund a portion of the state and school group unfunded liability.

Secondly, the audit report emphasizes the level and changes in the unfunded actuarial accrued liability. The unfunded liability reported at December 31, 2003 shows an increase of \$757 million from the amount reported at December 31, 2002. As noted on the *Changes in Unfunded Actuarial Liability* schedule on page 32, the increase was primarily due to changes in the actuarial valuation method. In 2004, legislation was passed allowing the Board of Trustees to adopt changes in the System's actuarial methods for all three retirement systems. Both the System's actuary (Milliman USA) and the actuary retained by the Legislature (William M. Mercer) have recommended changes in the System's actuarial cost method. The System's actuary recommended the adoption of the Entry Age Normal (EAN) method. The EAN method, used by over 74 percent of state retirement systems, assumes annual costs are equal to level premiums, expressed as a percent of payroll, needed from the members' entry age until retirement to fund the

Page Two

December 3, 2004

ultimate retirement benefit. In the short-term, it will increase the unfunded actuarial liability amounts and employer unfunded actuarial liability contribution rates. However, the normal cost rate will decline and the overall employer contribution rates will remain essentially the same as those produced using the system's prior actuarial valuation method (the projected unit credit method.)

In the past three years, the System's Board of Trustees and staff have worked extensively with the Legislature and Governor to develop a long-term funding plan for KPERS. Significant progress has been made on this funding plan through the increases in employer contribution rates and pension obligation bonds. However, challenges remain as employers begin budgeting for higher contribution rates. Progress on the funding plan needs to be monitored closely and additional contributions or plan design changes may be necessary in the future.

Finally, the audit report addresses the status of the Death and Disability Program. The Board of Trustees and staff are working with the Joint Committee on Pensions, Investments and Benefits on various program changes to ensure the solvency of this program. The program changes under consideration include (1) increasing the employer contribution rate and (2) plan design modifications. Any changes to funding and plan design adjustment will require legislative changes in the 2005 session, with implementation in Fiscal Year 2006.

We look forward to discussing the completed audit report with the members of the Legislative Post Audit Committee.

Sincerely,

  
Glenn Deck  
Executive Director