

PERFORMANCE AUDIT REPORT

Kansas Public Employees Retirement System: Examining Investments in Tallgrass Technologies, Inc.: Part I

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
June 1991**

Legislative Post Audit Committee

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 \$6 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 governmental 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. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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PERFORMANCE AUDIT REPORT

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: EXAMINING INVESTMENTS IN TALLGRASS TECHNOLOGIES, INC.: PART I

OBTAINING AUDIT INFORMATION

This audit was conducted by Leo Hafner, Allan Foster, and Ron Green, Senior Auditors, and Jim Davis, Auditor, of the Division's staff. If you need any additional information about the audit's findings, please contact Mr. Hafner at the Division's offices.

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Kansas Public Employees Retirement System: Examining Investments in Tallgrass Technologies, Inc., Part I

Summary of Legislative Post Audit's Findings

What investment policies governing direct placements were in effect when moneys were invested in Tallgrass Technologies, and did the Tallgrass investments comply with those policies? In general, the investments made in Tallgrass Technologies complied with specific requirements for investments within the Kansas Investment Fund. However, the circumstances and timing of some individual investment transactions raise questions about whether those investments complied with the "prudent man rule" in the general investment policy adopted by the Retirement System's Board of Trustees.

What was the financial condition of Tallgrass Technologies before and during the time that Retirement System money was invested in the company? Tallgrass Technologies had experienced rapid growth in sales and income in the early 1980's, but that growth had already begun to slow before April 1986, when Reimer and Koger Associates made the first investment in Tallgrass. Reimer and Koger loaned Tallgrass additional money to pay the principal and interest on previous loans they had made to the company, and bought \$1.6 million worth of stock from minority shareholders even though the company's financial condition had deteriorated seriously. Tallgrass has not made a profit since fiscal year 1985, and its liabilities exceeded assets by nearly \$4 million at the end of fiscal year 1990.

What rate of return has the Retirement System earned on its investment in Tallgrass Technologies, and how much has the investment manager been paid to manage that investment? Assuming the principal of all loans will eventually be repaid and the stock of the company has a value equal to what Reimer and Koger paid for it, then the annual rate of return on the investment has ranged from zero to about nine percent. However, it appears that the loans made to the company may never be repaid, and the cost of the stock may never be recouped, thereby resulting in a loss on the investment of about \$14 million. Although fees paid to Reimer and Koger were based on the entire Kansas Investment Fund, we estimated that fees associated with the Tallgrass investment totaled about \$292,000.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials. These findings are supported by a wealth of data, not all of which could be included in this report. These data may allow us to answer additional questions or to further clarify the issues raised

in the report. To answer remaining questions as directed by the Legislative Post Audit Committee, we will be issuing one additional report concerning the Retirement System's investment in Tallgrass Technologies.

A handwritten signature in cursive script that reads "Barbara J. Hinton". The signature is written in black ink and is positioned above the printed name and title.

Barbara J. Hinton
Deputy Legislative Post Auditor

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: EXAMINING INVESTMENTS IN TALLGRASS TECHNOLOGIES, INC., PART I

The Board of Trustees of the Kansas Public Employees Retirement System (KPERS) has allowed direct placement investments in companies having an impact on the Kansas economy since the mid-1970s. Direct placement investments are investments arranged directly with companies whose securities are not publicly traded. The intent behind making such investments is to provide financing to those companies which will stimulate job growth and economic development in Kansas.

With the creation of the Kansas Investment Fund in the mid-1980's, the Board of Trustees broadened the types of permissible direct placements to include investments in new or expanding businesses. Previously, to be eligible for investment, companies were required to be ongoing businesses in sound financial condition. The direct placement investments made since the creation of the Kansas Investment Fund usually took the form of "mezzanine" financing. This term is generally used to describe financing that is provided after a company's start-up phase, before it has established a track record that makes it eligible for regular bank financing. Hence, these investments involve a higher degree of risk than more traditional investments such as stock in publicly traded companies. Accordingly, investors demand a higher potential rate of return on these types of investments. Direct placement investments are authorized by law for the Retirement System. As of the end of March 1991, the Kansas Investment Fund was valued at \$249.2 million, or about six percent of the Retirement Fund's total portfolio.

Recently, a number of legislative concerns have been raised about losses and potential losses resulting from direct placement investments. It was recently revealed that \$65 million was lost on an investment in Home Savings Association, and there are significant concerns about potential losses on other direct placement investments. Allegations of impropriety concerning several of these investments also have been made.

To address these concerns, a Joint Committee on KPERS Investment Practices was established by the 1991 Legislature. The Joint Committee is carrying out a broad investigation of the Retirement System's investment practices, focusing in particular on direct placement investments. At the Joint Committee's request, the Legislative Post Audit Committee authorized this audit of one of the direct placement investments—Tallgrass Technologies, Inc. To provide timely information to the Joint Committee, this audit will be issued in several parts. This first part of the audit addresses the following questions:

- 1. What investment policies governing direct placements were in effect when moneys were invested in Tallgrass Technologies, and did the Tallgrass investments comply with those policies?**

2. **What was the financial condition of Tallgrass Technologies before and during the time that Retirement System money was invested in the company?**
3. **What rate of return has the Retirement System earned on its investment in Tallgrass Technologies, and how much has the investment manager been paid to manage that investment?**

To answer these questions, we reviewed the Retirement System's investment policy statements issued since 1975 that govern direct placement investments. We assembled a history of the Retirement System's investments in Tallgrass Technologies and checked for compliance with the investment policies in effect at the time each investment was made. In addition, we examined the financial requirements that were placed on Tallgrass in connection with the Retirement System's investments, and determined whether Tallgrass complied with those requirements. We reviewed audited financial statements for fiscal years 1983 through 1990, and charted financial trends for the company over those years. We also reviewed income generated from the investment in Tallgrass and estimated the investment manager's fees associated with this investment.

In conducting this audit, we followed the applicable government auditing standards set forth by the U.S. General Accounting Office. One of those standards states that individual auditors should be free from impairments to independence, and should maintain an independent attitude and appearance. Although all members of the Division's staff are members of the Retirement System, we are confident that no impairment to independence occurred. We also made every possible effort to provide for and maintain an independent attitude and appearance while conducting this audit.

In general, we found that the investments made in Tallgrass Technologies complied with specific requirements for investments within the Kansas Investment Fund. However, the circumstances and timing of some of the investments raise questions about whether those investments complied with the intent of general investment policy the Board of Trustees established for all investments made on behalf of the Retirement System. We also found that Tallgrass Technologies had experienced rapid growth in sales and income in the early 1980s, but that growth had already begun to slow in the year before Reimer and Koger Associates—an investment management firm hired to handle investments for the Retirement System—made the first investment in Tallgrass. Reimer and Koger continued to make additional investments in the company even though the company's financial condition deteriorated seriously. Later, Reimer and Koger exchanged the debt for common stock, thereby changing the Retirement System from the position of creditor to 90 percent owner of the company. Finally, assuming the principal of all loans will eventually be repaid and the stock of the company has a value equal to what Reimer and Koger paid for it, then the annual rate of return on the investment has ranged from 0 to 9.2 percent. However, it appears that the loans made to the company may never be repaid, and the cost of the stock may never be recouped, thereby resulting in a net loss on the investment of more than \$14 million. These and other findings will be discussed in the sections that follow.

What Investment Policies Governing Direct Placements Were in Effect When Moneys Were Invested in Tallgrass Technologies, and Did the Tallgrass Investments Comply with Those Policies?

In 1984, the Retirement System's Board of Trustees created the Kansas Investment Fund. The purpose of this Fund was to use a portion of the Retirement System's total investment portfolio for direct placement investments in companies, such as Tallgrass Technologies, Inc., that would have a favorable impact on the Kansas economy. The Retirement System's previous direct placement funds—the Kansas Debt Fund and Kansas Equity Fund—had also been used to invest in Kansas companies. When these funds were merged to form the Kansas Investment Fund in 1984, investments in new or expanding businesses became permissible. While the Board of Trustees is ultimately responsible for the investment of Retirement System moneys, neither the Board nor its staff have been involved in day-to-day investment decisions. Such decisions have been delegated to investment managers. The Board delegated management responsibility for the Kansas Investment Fund to Reimer and Koger Associates of Overland Park, Kansas.

Tallgrass Technologies is one of the investments of the Kansas Investment Fund. Tallgrass is a Kansas corporation located in Overland Park, Kansas. The company designs, assembles, and markets mass storage systems for microcomputers. Its products include tape drives, disk drives, and combined tape/disk systems. The company is privately held, which means that its stock is not publicly traded on any stock exchange. Founded in 1981, the company experienced explosive sales growth during the early 1980s. Retirement System investments in Tallgrass Technologies were made through the Kansas Investment Fund and, accordingly, were subject to the specific requirements the Trustees had established for that Fund. Those investments were also subject to the general investment policies of the Retirement System.

We reviewed the investment policies that were in place when Reimer and Koger made investments in Tallgrass Technologies and found that those investments appeared to have been made in accordance with the specific requirements the Board of Trustees established for the Kansas Investment Fund. However, some individual transactions raise questions as to whether the investments fulfilled the intent of the Board's general statements of investment policy. In addition, the Retirement System had no formal procedures or established practices for ensuring that investment managers followed certain policies established by its Board of Trustees.

Investments in Tallgrass Technologies Were Made in Accordance With Specific Kansas Investment Fund Requirements, But May Not Have Fulfilled the Intent of General Investment Policies

Reimer and Koger Associates made investments in Tallgrass Technologies on behalf of the Retirement System between April 1986 and March 1990. Although the

Definitions of Financial Terms Used in This Audit Report

Bond. Basically an IOU or promissory note of a corporation. A bond is evidence of a debt on which the issuing company usually promises to pay the bondholders a specified amount of interest for a specified length of time, and to repay the principal amount of the loan on the expiration date.

Common Stock. Securities which represent an ownership interest in a corporation.

Convertible. A bond, debenture, or preferred share which may be exchanged for common stock or another security, in accordance with the terms of the issue.

Debenture. A promissory note backed by the general credit of a corporation and usually not secured by a mortgage or lien on any specific property.

Demand Grid Note. A loan made at a specified rate of interest for an indefinite time, with both principal and interest payable on demand of the lender. The borrower can request funds as needed, and is charged interest only on the outstanding loan balance.

Direct Placement. An investment arranged directly with a company that does not have stock traded on any public stock exchange. The investment could take the form of a loan (such as a promissory note), a bond, or a stock purchase.

Dividend. The payment designated to be distributed pro rata among the shares of stock outstanding. (In the case of Tallgrass Technologies, no dividends have been distributed to the Retirement System since it became a shareholder.)

Equity. The ownership interest of common and preferred stockholders in a company.

Equity Related Securities. Investments in common or preferred stock of a company.

Fixed Income Securities. Investments that have a specified return in the form of interest for the lender, such as bonds, debentures, or loans.

Interest. Payments a borrower pays to a lender for the use of money. A corporation pays interest on its bonds to its bondholders.

Maturity. The date on which a loan, a bond, or a debenture comes due and is to be paid off.

Net Worth. The amount of a firm's total assets minus its total liabilities. This is also referred to as owner's equity or retained earnings.

Promissory Note. A written promise to pay or repay a specified sum at a stated time or on demand.

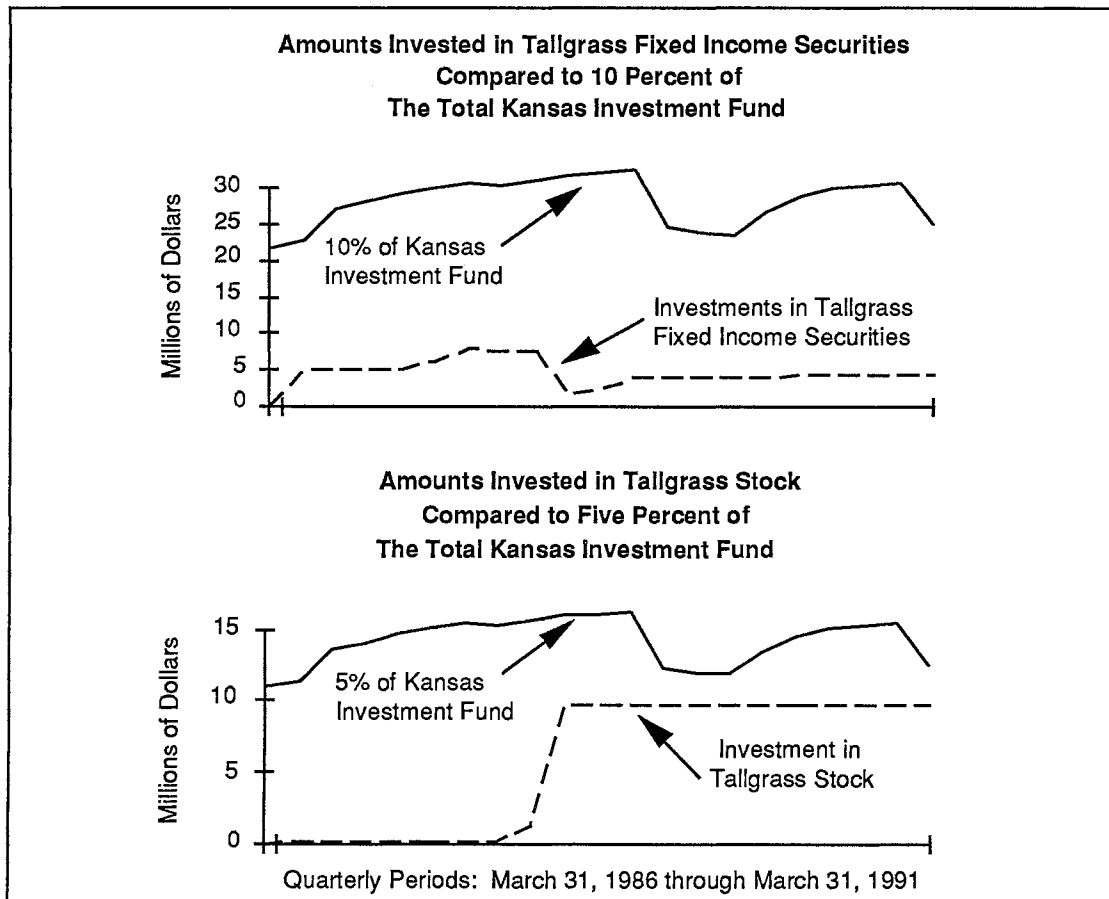
Subordinated Debenture. A debenture that has lower priority than other debentures previously issued by the company. In event of the firm's failure, the subordinated debenture holders' claims will not be honored until the specified senior debt claims have been completely satisfied.

Board of Trustees has amended its policies from time to time, there were certain specific requirements for investments of the Kansas Investment Fund—as well as general investment policies applicable to all Retirement System investments—in effect during the entire period in which investments were made in Tallgrass Technologies. (See Appendix A for a summary of the evolution of direct placement investment policies).

Investments in Tallgrass Technologies were made in accordance with the specific requirements for the Kansas Investment Fund. Requirements for Kansas Investment Fund investments, such as Tallgrass, included the following provisions:

- At the time of purchase, equity-related securities (such as stock) of any one company could not exceed five percent of the total value of the Kansas Investment Fund.
- At the time of purchase, fixed income securities (such as bonds) of any one company could not exceed 10 percent of the total value of the Kansas Investment Fund. (Securities of the United States Government or its agencies excepted.)

We found that both of these requirements were followed. From the time of the initial Tallgrass investments in April 1986 through the most recent investment in March 1990, the total value of the Kansas Investment Fund was well in excess of \$200 million. Amounts invested in Tallgrass stock were never more than five percent of the value of the Kansas Investment Fund. Likewise, amounts invested in Tallgrass fixed income securities never were more than 10 percent of the value of the Fund. A comparison of the amounts invested in Tallgrass stock and fixed income securities with total value of the Kansas Investment Fund is shown in the following charts.



As the charts show, total investments in Tallgrass stock and fixed income securities were in compliance with the percentage limitations set by the Board of Trustees.

Compliance with the intent of the Board's general statement of investment policy may be questionable. In addition to specific requirements for the Kansas Investment Fund, the Board of Trustees' statement of investment policy also contained general provisions applicable to all Retirement System investments. These general provisions contain the Board's standard for investment—which is mandated by K.S.A. 74-4921(4)(a):

In investing and reinvesting moneys in the fund and in acquiring, retaining, managing, and disposing of investments of the fund there shall be exercised the judgment and care under the circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

This standard is commonly known as the “prudent man rule.”

Additional provisions of the Board's statement of investment policy instructed investment managers to give due consideration to the preservation of capital and to invest moneys to achieve a total return level necessary to maintain the fiscal soundness of the fund. The Board acknowledged that direct placements have a higher associated risk than more traditional investments, but nevertheless stated its intention that direct placement investments be made “with prudence and good judgment” (underlining added). Investments in Tallgrass may have been made in accordance with these general statements of policy, but the circumstances and timing of some individual investment transactions raise questions about whether those transactions were made with prudence and good judgment, giving due consideration to the preservation of capital.

For example, after the company had acquired a large debt load, Reimer and Koger exchanged loans for shares of stock, making the Retirement System an owner rather than a creditor, and placing it behind other creditors in claims to the assets of the company. Even after Tallgrass repeatedly failed to make required payments, Reimer and Koger loaned additional moneys to Tallgrass despite the company having few assets to cover those loans. Finally, Retirement System moneys were used to purchase Tallgrass stock from minority shareholders at a time when the company's financial condition was worsening, thus committing even more investment capital that went to those sellers and not to the company.

Because of time constraints and a lack of complete documentation, we were unable to consider all of the information available to Reimer and Koger at the time the various Tallgrass investment decisions were made. However, the decisions noted above appear to be questionable and raise the possibility that some of the investments in Tallgrass may not have been made using prudence and good judgment.

The Retirement System Had No Procedures For Ensuring That Certain Reporting Requirements For Investment Managers Were Followed

In its Procedures For Investment Managers, the Retirement System's Board of Trustees has required investment managers to make regular reports to the Board. These reporting requirements included:

- monthly letters to the individual trustees and the Executive Secretary discussing the month's activity, highlights, unusual situations, and whatever else is necessary to provide a brief overview of the manager's portfolio
- quarterly letters to individual trustees who requested them and to the Executive Secretary containing such things as an economic overview, a review of investment activities, and approximate current income yield of the portfolio (a copy of each letter was also to be sent to the Investment Performance Measurement and Evaluation Consultant)
- copies of all investment transaction memoranda (such as buy and sell orders)
- quarterly summaries by major classification of securities under management, a detailed listing of all securities under management, and a cash reconciliation

Retirement System staff stated that they reconcile quarterly reports from investment managers with the records provided by the custodian bank and maintain those reports on file. However, Retirement System staff admitted they have not set up formal procedures or established practices to ensure that monthly and quarterly letters are received on a timely basis. In our review of Retirement System files, we found no such letters for any investments made by Reimer and Koger through the Kansas Investment Fund. Retirement System staff had no explanation for not having these letters. Such letters would appear to be an important way for the Board of Trustees and its staff to stay informed about investment performance. Without them, the Board may not have all the information necessary to adequately oversee Retirement System investments.

What Was the Financial Condition of Tallgrass Technologies Before and During the Time that Retirement System Money Was Invested in the Company?

Tallgrass Technologies experienced rapid growth during the early 1980's and was able to finance that growth from profits generated from the business. The company's financial condition had begun to deteriorate before Reimer and Koger made the initial investment in the company. That decline continued and accelerated while the investment manager loaned the company additional money to pay off the principal and interest due on previous loans, purchased the stock of minority shareholders, and subordinated the Retirement System's investment by exchanging loans to the company for common stock, making the Retirement System the majority shareholder in the company. The company was still struggling in fiscal year 1991, showing cumulative losses totaling more than \$872,000 during the first nine months of the fiscal year. These findings are discussed more fully in the sections that follow.

Tallgrass Technologies Experienced Spectacular Growth In its Early Years, But Financial Problems Surfaced Just Before the Retirement System Invested in the Company

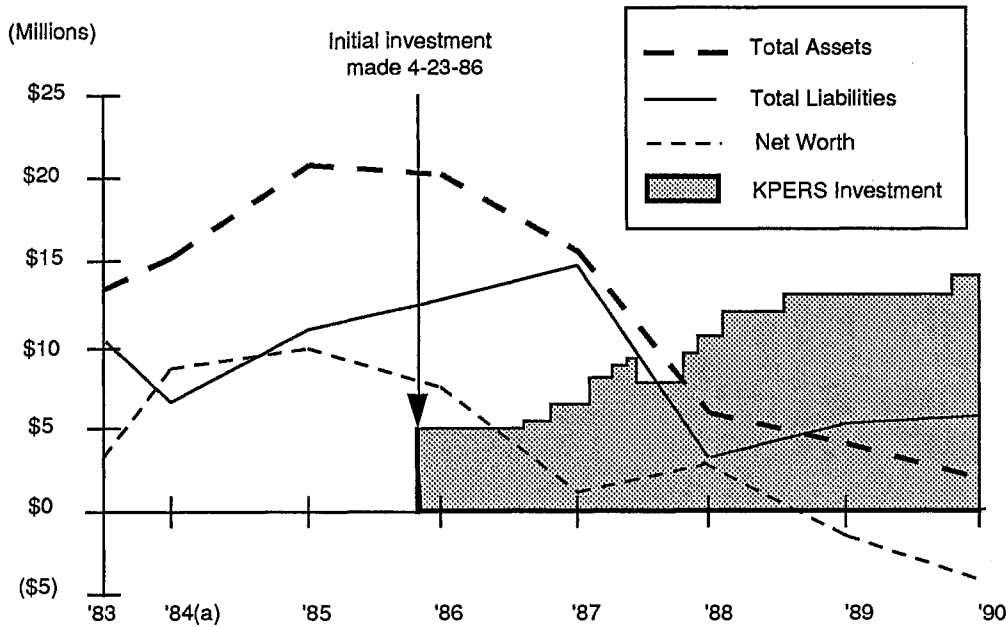
In 1981, Tallgrass' first year of operation, total sales were about \$30,000. Over the next four years, sales surged to a peak of \$51.6 million in the company's 1985 fiscal year. The charts on the facing page show the trends in sales, net income, assets, liabilities, and net worth for the three fiscal years immediately before the Retirement System invested money in the company, and for each available year since the investment was made.

At the time of the initial investment in Tallgrass Technologies, the company was beginning to experience a financial decline. Reimer and Koger Associates made the first investment in Tallgrass Technologies on behalf of the Retirement System in April 1986, two months before the end of the company's 1986 fiscal year. That investment consisted of the purchase of 45,000 shares of common stock from the company's founders for \$179,006 and the issuance of a ten-year convertible debenture with a face amount of \$4,950,000 paying interest at nine percent. Tallgrass was to pay back the principal of the debenture in three equal installments in 1994, 1995, and 1996. A complete history of the Retirement System's investments in Tallgrass Technologies can be found in Appendix B.

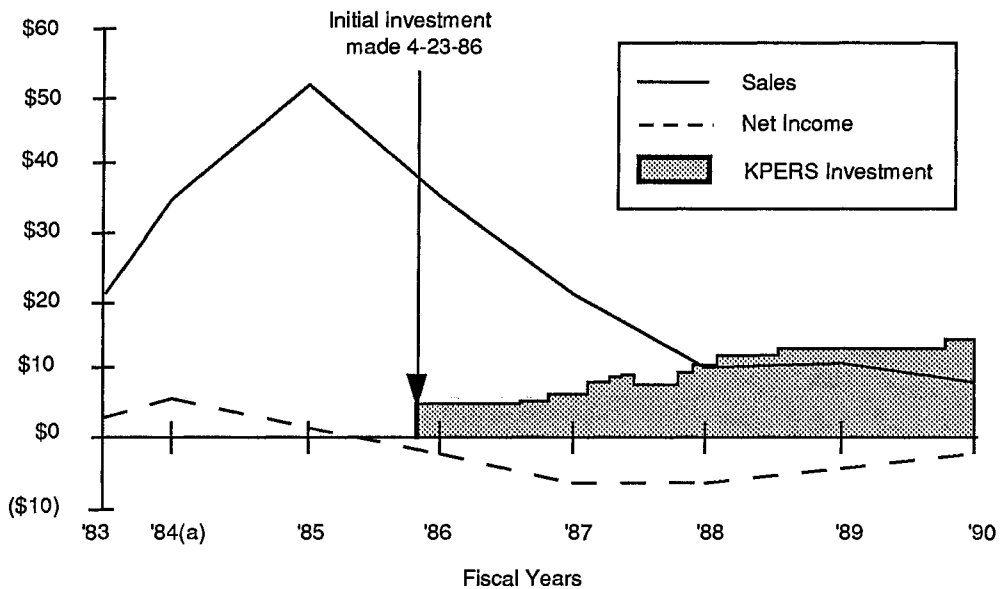
Investments in Tallgrass in relation to the company's financial condition over time can be seen in the charts on the facing page. As the charts show, total assets and net worth of the company were at their peak at the end of fiscal year 1985. Net income had already begun to decline during fiscal year 1985, the year before the investment was made. Fiscal year 1986 produced Tallgrass' first loss. For fiscal year 1986, the company reported sales of \$35.2 million (down nearly 32 percent from the previous year) and a net loss of \$2.5 million (compared with a prior year profit of \$1.3 million).

Tallgrass Technologies' Financial Performance Fiscal Years 1983 - 1990

Assets, Liabilities, and Net Worth



Sales and Net Income



(a) In 1984 Tallgrass Technologies changed the end of its fiscal year from December to June. Therefore, the amounts shown for that year represents only a six-month period.

When the initial investment was made in Tallgrass Technologies in April 1986, the firm's financial condition was already beginning to deteriorate. By the end of fiscal year 1990, the firm's assets had fallen to \$2 million, its net worth was -\$3.9 million, and it had not shown a profit since 1985.

Within two months after the initial investment was made, Tallgrass had breached financial covenants contained in the debenture agreement. The debenture agreement Tallgrass officials signed with Reimer and Koger Associates contained certain provisions related to Tallgrass' financial condition which had to be met or Reimer and Koger could accelerate payment of the principal of the debentures. One of those provisions required the company to maintain a tangible net worth of \$7.5 million. As of June 28, 1986, Tallgrass' tangible net worth was \$7.1 million. In its report on Tallgrass' financial statements for fiscal year 1986, the accounting firm of Peat, Marwick, Mitchell, and Co. (now KPMG Peat Marwick) noted that at June 28, 1986, the company was in default of its tangible net worth requirement and as a result required the company to classify substantially all of its long-term debt as currently due and payable. Reimer and Koger did not require the company to accelerate payment on the debenture as allowed by the debenture agreement, but instead made additional investments as Tallgrass' financial condition worsened.

Reimer and Koger Made Additional Investments As Tallgrass' Financial Decline Continued

During fiscal years 1987 through 1990, Tallgrass's financial condition deteriorated significantly. Sales slipped from \$21.4 million to \$8.4 million, cumulative losses totaled more than \$20 million, total assets of the company shrank from \$15.8 million to \$2 million, and stockholder equity declined from slightly more than \$1 million to a deficit of \$3.9 million. Beginning with fiscal year 1987, the certified public accountants who conducted the annual audit of Tallgrass' financial statements issued a disclaimer on those financial statements, citing among other things concerns about the company's ability to remain in existence.

During these four years, Reimer and Koger Associates advanced about \$7.8 million in additional funding to the company in the form of 11 loans, as shown on the facing page.

Reimer and Koger loaned the company additional Retirement System money to pay the principal and interest on previously existing loans. Only one loan (for \$1.5 million) was ever repaid in cash. However, on the day that loan was repaid, Reimer and Koger provided Tallgrass with \$450,000 in new funding and authorized the company to borrow an additional \$450,000. In other cases, the loans were refinanced together with all or part of the interest owed for newer and larger loans. For example, the loan on April 3, 1987 was made to pay off principal and part of the interest on the first two loans Reimer and Koger made to the company.

When that April 3, 1987 loan was made, the terms were less restrictive than those contained in the original loan. For example, the original loan required the company to maintain a tangible net worth of \$7.5 million. When the loan was refinanced by Reimer and Koger in April 1987, that requirement was reduced to \$3.9 million. In addition, it appears that Reimer and Koger did not require Tallgrass to count the amount owed to the Retirement System as part of its debt in computing certain ratios that had to be maintained to fulfill the loan agreement.

**Summary of Loans Made to Tallgrass Technologies
1986-1990**

	Date	Amount of New Funding (a)
Original Loan	04-23-86	\$4,851,000
Additional Loans	02-13-87	270,000
	04-03-87	935,659
	07-20-87	1,500,000
	09-15-87	350,000
	10-19-87	100,000
	11-19-87	870,000
	04-07-88	297,308
	05-27-88	1,500,000
	08-12-88	1,000,000
	12-22-88	700,000
	03-16-90	<u>300,000</u>
Total Additional Loans		\$7,822,967

(a) The amounts shown here do not include principal and interest from previously existing loans that were refinanced when new loans were made. Hence, the amounts shown above represent only new loans to the company. Several of these loans were authorized on the dates shown but the principal may have been advanced to the company in installments over several months. For the purpose of this table, the total amount borrowed under these loans is counted as though all principal was advanced on the date the loan was authorized.

As time went on, Tallgrass was unable to repay principal or interest on amounts owed the Retirement System and the outstanding loans kept being rolled over into ever larger loans. This was the case for a \$1.5 million loan made in May 1988, which Reimer and Koger refinanced three months later as part of a \$2.5 million loan and then refinanced again four months later for \$3.3 million. Most interest on these loans has not been paid, but rather has been added to the principal of the loans outstanding. In all, \$946,095 in interest has been received in cash, and \$1,073,840 has been added to the outstanding balance of the loans. As of June 30, 1990, Reimer and Koger Associates directed the investment custodian to stop recording interest on any of the outstanding loans to Tallgrass because of the likelihood that the interest will never be paid.

Reimer and Koger loaned additional Retirement System money to Tallgrass even after the company had little in the way of assets to serve as collateral for the loans. By the end of fiscal year 1987, the company's assets exceeded its liabilities by slightly more than \$1 million. Over the course of the next fiscal year, Reimer and Koger made loans to Tallgrass that contained approximately \$4.6 million in new funding for the company, thereby leaving about \$3.6 million of those loans unsecured by available assets of the company.

Reimer and Koger also converted the loans to stock ownership, placing the Retirement System behind other creditors in the event of a bankruptcy filing. By the end of fiscal year 1988, Tallgrass' assets were approximately \$6 million and total

liabilities would have been nearly \$11 million, placing the company in a negative net worth position. At that time, Reimer and Koger converted approximately \$8 million worth of outstanding loans into 14.6 million shares of Tallgrass' common stock. The net effect of this conversion was to improve the appearance of Tallgrass' balance sheet by reducing total debt by \$8 million and increasing the stockholder's equity by a like amount. By making this conversion, Reimer and Koger changed the Retirement System's position from creditor to 90 percent owner. In so doing, Reimer and Koger placed the Retirement System behind the claims of other creditors in the event of a formal declaration of bankruptcy.

Reimer and Koger invested more than \$1.6 million of the Retirement System's money to buy out minority shareholders of the company at a time when the company was in serious decline. During fiscal year 1988, Tallgrass was experiencing its largest net loss and would have had a negative net worth if Reimer and Koger had not converted approximately \$8 million worth of loans into stock ownership prior to the end of that fiscal year. From April through September 1988, Reimer and Koger also purchased 5,607,022 shares of stock from minority shareholders for \$1,650,265, or an average of slightly more than 29 cents per share. The table below shows a summary of Reimer and Koger's purchases of Tallgrass stock from minority shareholders.

**Summary of Tallgrass Technologies Common Stock
Purchases from Minority Shareholders
1988**

<u>Date</u>	<u>Number of Shares</u>	<u>Cost</u>
04-07-88	3,470,475 shares	\$1,021,151
06-03-88	1,979,282 shares	582,899
06-22-88	106,190 shares	31,273
09-29-88	<u>51,075 shares</u>	<u>15,042</u>
Total	5,607,022 shares	\$1,650,365

These purchases did not benefit Tallgrass' financial condition because the proceeds from the sale went to the minority shareholders and not to the company. The result was to provide \$1.6 million dollars to several private individuals for stock that may ultimately have no value.

Tallgrass continues to struggle during the current fiscal year. After the majority of the outstanding loans were converted to stock in June 1988, Reimer and Koger provided another \$2 million of Retirement System money for new loans for the company. The last of those loans was for \$300,000 made in March 1990. Based on information currently available, it appears that Tallgrass is continuing its financial struggle in the current fiscal year. Monthly financial statements for the nine months ended March 1991, show that the company has incurred losses in each month and total losses for the nine months were more than \$872,000. However, it appears that fiscal year 1991 may produce the smallest net loss since the Retirement System invested in the company.

**What Rate of Return Has the Retirement System Earned
On Its Investment in Tallgrass Technologies,
And How Much Has the Investment Manager
Been Paid to Manage That Investment?**

The annual rate of return on the Retirement System's investment in Tallgrass Technologies has ranged from zero to 9.2 percent, depending on what is counted as income. Through June 1991, Tallgrass stock has produced no income for the Retirement System, and Tallgrass has paid less than half of the interest due on loans made by the Retirement System. In addition, it appears that the investment in Tallgrass may eventually result in a loss of about \$14 million to the Retirement System. The amount of compensation Reimer and Koger has received for the Tallgrass investment cannot be determined exactly, because fees were based on the total amount of funds managed and on the performance of the Kansas Investment Fund as a whole. Our best estimate is that Reimer and Koger has been paid about \$292,000 in fees related to the Tallgrass Technologies investment.

**Annual Rates of Return on the Tallgrass Investment
Have Ranged from Zero to About Nine Percent**

Over the last six years, the Retirement System has invested about \$14 million in Tallgrass Technologies. As of June 1991, the Retirement System had paid about \$9.8 million for Tallgrass stock, and had outstanding loans to Tallgrass of about \$4.2 million. The only returns the Retirement System has received have come in the form of interest. The amount of return, and the resulting rates of return, depend on what type of interest income is counted. We calculated the rates of return on two different bases:

- (1) Cash interest payments received by the Retirement System
- (2) Interest accrued on all loans made by the Retirement System
(the amount of interest that Tallgrass was obligated to pay)

In the first scenario, we counted interest actually received from Tallgrass Technologies. In the second, we counted all interest due, whether paid or not. In both situations, the underlying assumption is that the basic investment in Tallgrass is safe, and that the Tallgrass stock and loans have value nearly equal to the amount invested. The validity of these assumptions is discussed in the next section.

The rates of return under the two different methods are shown in the following table. As the table shows, the annual rates varied from zero to 9.2 percent. In each year, the returns based on interest paid were substantially lower than the returns based on interest accrued. The total amounts of interest during the entire period are also shown at the bottom of the table.

**Estimated Rates of Return
1986 - 1990**

<u>Calendar Year</u>	<u>Average Amount Invested in Tallgrass</u>	<u>Annual Rates of Return to the Retirement System</u>	
		<u>Based on Interest and Dividends Paid to KPERS</u>	<u>Based on Total Interest Accrued</u>
1986	\$3.5 million	5.7%	9.0%
1987	6.7 million	6.9	9.2
1988	10.1 million	2.9	4.9
1989	13.2 million	0.0	3.6
1990	13.9 million	0.0	2.0
Total Interest, 1986-1990		\$946,095 Paid	\$2,167,662 Accrued

The table shows that the rates of return declined after 1987. The major reason was that in mid-1988, nearly \$8 million in loans was converted to stock; the stock produced no income for the Retirement System, either in dividends or stock sales. The table also shows that Tallgrass paid \$946,095 in interest, or less than 44 percent of the \$2,167,662 in accrued interest on loans made by the Retirement System. Tallgrass has made no interest payments to the Retirement System since May 1988.

**If Tallgrass Stocks and Loans Have No Value,
The Retirement System Faces a Loss of About \$14 Million**

The previous section showed that actual rates of return on the Tallgrass investment have been meager, and have declined to zero in recent years. However, the non-receipt of Tallgrass interest payments is only the "tip of the iceberg" in terms of potential losses to the Retirement System. The investment manager wrote off \$600,000 of the value of the investment in June 1990. All indications point to the likelihood that the basic investment in Tallgrass is virtually worthless. If that is the case, the total loss of capital associated with the Tallgrass investment would be more than \$14 million.

Several sources have led us to the conclusion that the Retirement System is not likely to receive any further income on the Tallgrass investment, and that the investment probably has no value. First, the most recent financial statements showed that the company had about \$4 million more in debts than in assets. Second, the company's independent auditor (KPMG Peat, Marwick) has issued a disclaimer of opinion on the company's financial statements since 1987, citing, among other things, the firm's doubts that Tallgrass Technologies could continue as a going concern. Third, analyses done during the most recent financial audit of the Retirement System

showed that the auditing firm (Baird, Kurtz, and Dobson) reached the conclusion that the investment in Tallgrass was probably a total loss.

Reimer and Koger Was Not Paid Fees for Investments in Any Single Company, But We Estimated Fees Related to The Tallgrass Investment Were About \$292,000

For managing investments in the Kansas Investment Fund, Reimer and Koger received three types of fees—base management fees, income incentive fees, and gains incentive fees. Gains incentive fees are only paid when an investment is sold. Because the investment in Tallgrass Technologies has not been sold and no gains incentive fees have been paid on this investment, we will only deal with the first two types of fees. In addition to fees, Reimer and Koger also received reimbursement for expenses related to investments under management within the Kansas Investment Fund.

Base management fees were paid according to the amount of funds under management. Reimer and Koger received 0.5 percent of the first \$100 million managed, and 0.375 percent of any amounts in excess of \$100 million. Base management fees were paid quarterly in advance, based on the amount managed at the end of the preceding quarter. For example, if the Reimer and Koger had \$300 million under management in the Kansas Investment Fund for one year, its annual base management fees would have been \$1.25 million.

Income incentive fees were paid according to the amount of accrued income earned by investments in the Kansas Investment Fund. If accrued net income exceeded the preferred return (the average 91-day Treasury Bill rate), Reimer and Koger received 13 percent of the income exceeding the Treasury Bill rate. All accrued interest is counted when computing the income incentive fee. However, if accrued interest had not been paid for a year, the amount of uncollected interest would be deducted before payment of the fee. Interest that is capitalized, (added to the principal amount of the loan) is also counted as income whether or not the capitalized amount is eventually paid. Income incentive fees were to be paid within 30 days after the end of each quarter.

Adding Unpaid Interest to the Principal of Tallgrass' Loans Allowed Reimer and Koger to Earn Higher Management Fees

Between June 1988 and May 1990, more than \$1 million in unpaid interest was added to the principal amount of the loans to Tallgrass. By so doing, Reimer and Koger was able to increase both the base management fees and (at least temporarily) the income incentive fees it received.

Base management fees were increased whenever an addition was made to the total funds being managed by Reimer and Koger in the Kansas Investment Fund. Adding Tallgrass' unpaid interest to the loan balance had this effect, because the total amount of funds under management was increased.

Income incentive fees were increased whenever the accrued income of the Kansas Investment Fund exceeded the average 91-day Treasury Bill rate. By adding Tallgrass' unpaid interest to its loan at the end of a quarter, Reimer and Koger was able to recognize the accrued income for purposes of its income incentive fee computation. Under the contract, unpaid accrued interest could be included as income until the interest payments were a year overdue.

Base management fees and income incentive fees were paid for the Kansas Investment Fund, not for individual investments made by Reimer and Koger. Therefore, income incentive fees would be paid only if the performance of the entire fund exceeded the preferred return rate set by the Retirement System.

Because base management fees and income incentive fees were based on the entire Kansas Investment Fund, it was not possible to accurately determine the amount of fees associated with any single investment. However, during its meeting on March 21, 1991, the Joint Committee on KPERS Investment Practices requested estimates of fees paid to Reimer and Koger for managing the Tallgrass investment, among others in the Kansas Investment Fund.

In response to the Joint Committee's request, Retirement System officials did a rough estimate of fees paid for management of the Tallgrass investment. By prorating fees according to the annual average cost value of investments, the Retirement System staff estimated a total of almost \$360,000 in fees associated with the Tallgrass investment—about \$214,000 in base management fees and about \$146,000 in income incentive fees.

The Retirement System's estimate of fees was presented to the Joint Committee on March 27, 1991. One day later, Reimer and Koger completed a more precise estimate of fees for the same specific investments, and sent it to Retirement System officials. By prorating fees on a quarterly basis instead of an annual basis, Reimer and Koger estimated it had received about \$324,000 for the Tallgrass investment—about \$207,000 in base management fees and about \$117,000 in income incentive fees.

The Reimer and Koger estimate appears to be more accurate than the estimate done by Retirement System officials, because it was done on a quarterly basis and recognized the timing differences between the two types of fees. However, both methods allocated income incentive fees based on cost value of the investment rather than on actual or accrued income generated by the investment in Tallgrass Technologies.

When we estimated income incentive fees based on the accrued income solely from the Tallgrass investment, we determined that about \$84,000 in fees would have been paid to Reimer and Koger. (This figure may be slightly overstated, because the Retirement System did not have information about some of Reimer and Koger's reimbursable expenses.) By adding the \$85,000 in income incentive fees to the \$207,000 estimate of base management fees, our total estimate of fees paid for the Tallgrass investment is about \$292,000.

APPENDIX A

The Evolution of Kansas Public Employees Retirement System's Direct Placement Investment Policies

Since 1975, the Kansas Public Employees Retirement System's investment policies have evolved from effectively prohibiting direct placement investments to strongly encouraging them. At the same time, the nature of permissible direct placement investments changed; companies eligible for direct placement investments went from established companies in sound financial condition to startup and other venture capital-type enterprises.

In addition to specific requirements for direct placement investments, the Board of Trustees' statement of investment policies also contained the standard for investment applicable to all Retirement System investments. This standard, commonly known as the "prudent man rule," is mandated by K.S.A. 74-4921(4)(a) and is set out on page 6 of the report. The prudent man rule has been the standard of investment for Retirement System investments for the entire period under consideration in this audit.

The Retirement System's direct placement investment policies for the years reviewed can be divided into four periods:

1. 1975 and Before: The Board of Trustees instituted its first formal Statement of Investment Policy. Direct placements were not allowed unless they were made through a broker with the recommendation of the Chase Manhattan Bank.
2. 1976--1983: The Board began allowing direct placements, but only in established companies that were in sound financial condition. No direct placement investments were allowed in new or expanding businesses.
3. 1984--1990: The Board authorized direct placement investments in new or expanding businesses.
4. 1991 To Date: The Board replaced its direct placement fund managers. In addition, it placed a moratorium on new direct placement investments and required that additional investments in currently-held direct placements be approved.

Date

Summary of Investment Policies

1975

Direct placement investments were not generally allowed in the Board of Trustees' first formal statement of investment policy. According to the January 1975 Statement by the Board of Trustees, direct placement investments were not to be made and if they were, it would only be through a broker with the recommendation of the Chase Manhattan Bank. With the adoption of its first unified Statement of Investment Policy in March 1975, the Board issued guidelines for investment managers. Those guidelines generally gave the investment managers broad latitude in managing the investments of the System and spelled out responsibilities such as investing idle cash, providing reports to the Retirement System, and the like. Those guidelines did not mention direct placement investments.

1976 **The Board of Trustees began allowing direct placement investments, but only in companies that were in sound financial condition.** The Board first authorized direct placement investments in 1976. In February of that year, the Board of Trustees directed that a portion of the total Retirement Fund be set aside for investment "in debt securities of companies impacting the Kansas economy." These securities could be either publicly traded or private placements. This portfolio, called the Kansas Debt Fund, was managed by Reimer and Koger Associates. The requirements and restrictions placed on such investments were set out in "Guidelines for Fixed Income Securities in Kansas." According to those guidelines, no single investment was to be for less than \$500,000 nor more than \$4 million and the total value of this fund was never to exceed 10 percent of the total funds of the Retirement System.

Investments selected for the Kansas Debt Fund were to provide a rate of return that was equal to or better than comparable investments available elsewhere and had to be in companies that were financially strong with good earnings records. To ensure that the companies invested in were financially strong, the Board placed a number of specific requirements on those investments. For example, companies had to have securities rated A or higher by Moody or Standard and Poor's or meet several listed criteria. The listed criteria included such things as a requirement that the companies' pretax earnings had to exceed annual interest payments by four times, the companies could not have debt exceeding 50 percent of total capitalization, and the companies had to show through financial statements that they could adequately service principal payments on the debt.

1977 **In March 1977, the Board of Trustees allocated another portion of the total Retirement Fund for investments in the common stock of companies that had an economic impact on the economy of Kansas.** This portion of the Retirement Fund's investments was called the Kansas Equity Fund which, along with the Kansas Debt Fund, was managed by Reimer and Koger. In addition, the Board replaced the "Guidelines for Fixed Income Securities in Kansas" with an investment policy specific to Reimer and Koger. This policy included specified limits on direct placement investments, such as the requirements that common stock holdings in any one company could not be greater than 10 percent of the common stock assets under Reimer and Koger's management, common stock holdings in any one company could not be greater than five percent of the total number of shares outstanding for that company nor more than 10 percent of the shares publicly traded, and no single fixed income investment was to be greater than \$4 million. In addition to this specific investment policy, Reimer and Koger was still governed by the general guidelines for investment managers first adopted by the Board of Trustees in 1975.

1984 **The Board of Trustees amended its Statement of Investment Policy to allow direct placement investments in new or expanding businesses.** With the August 1984 Statement of Investment Policy, the Board of Trustees merged the Kansas Debt and Kansas Equity funds into a single portfolio called the Kansas Investment Fund. This updated policy statement also contained a broader expression of the types of direct placement investments in which Reimer and Koger could participate. Namely, Reimer and Koger could invest in such things as private placement

and publicly traded debt or equity, government-backed issues, and--for the first time--debt or equity participation in new or expanding businesses.

1985 In March 1985, the Board deleted from the Statement of Investment Policy the language that limited investment to only those companies that were “relatively substantial, seasoned, and in sound financial condition.” It appears that the stricken language could have been construed as inconsistent with language allowing investments in new or expanding businesses.

1987 In its July 1987 Statement of Investment Policy, the Board established a second direct placement investment fund, the Western Kansas Investment Fund. Peters, Gamm, and West, Inc. (later Peters, Gamm, West, and Vincent, Inc.) was named to manage this fund. The new fund had the same stated purpose, restrictions, and requirements as the Reimer and Koger-managed Kansas Investment Fund, but as the name implies, it was intended to cover a different geographic area.

1990 The Board of Trustees set out a new section, “Direct Placement Portfolio Guidelines” in the March 1990 Statement of Investment Policy. These new guidelines governed both the Kansas Investment Fund, managed by Reimer and Koger, and the Western Kansas Investment Fund, managed by Peters, Gamm, and West. While such things as investment objectives, portfolio valuation, and permissible investments were the same for both funds, somewhat different guidelines were set out for the different funds and managers. For example, the minimum investment size for both funds was \$500,000, but maximum allowed investments differed for the two funds. Initial investments made by Reimer and Koger were limited to \$10 million with total investments in one company not to exceed \$15 million, while initial investments made by Peters, Gamm, and West were limited to \$5 million with total investments in one company not to exceed \$8 million.

Both managers also were required to have institutional co-investors, but again the requirements were somewhat different for each. Reimer and Koger was required to have institutional co-investors for all initial and add-on investments in portfolio companies, with the co-investors providing at least 25 percent of the amount. Peters, Gamm, and West was required to have institutional co-investors only for initial and add-on investments of more than \$5 million, with the co-investors providing at least 25 percent of the amount in excess of \$5 million. For both firms, the co-investors’ claims on portfolio company assets were not to be senior to claims of the Fund and the funding for the co-investors was to be provided from sources other than the Retirement System.

Finally, both managers were allowed to invest up to 25 percent of their respective funds in out-of-State direct placements and/or venture capital funds which invest nationally. This provision appears to run counter to the long-standing policy (again restated in the Board’s “Investment Definition” for direct placements) which stated that the focus of the direct placement funds was to be on investments in companies that provide favorable economic benefits to Kansas.

The March 1990 Statement of Investment Policy also contained the requirement that both managers produce their own internal direct placement

investment guidelines and provide those guidelines to the Retirement System staff. Those internal guidelines were adopted in the August 1990 Statement of Investment Policy. Generally, the firms' internal guidelines mirrored the existing requirements set out in the Board's Statement of Investment Policy. However, in a few cases, the firms placed more rigid restrictions on their investment practices. For example, Reimer and Koger stated that portfolio companies "must have a minimum potential revenue of \$10 million." Also, both firms indicated that their direct placement investments should have some sort of mechanisms for exit.

The only significant change made by the Board to its Statement of Investment Policy in August 1990 was a new requirement on Reimer and Koger. Before Reimer and Koger could make an add-on investment with a portfolio company it had classified as "troubled," it had to first obtain the assistance of an industry consultant to analyze the investment opportunity before committing the additional capital. Peters, Gamm, and West had a similar restriction on add-on investments in the March 1990 Statement of Investment Policy.

1991

The Board of Trustees replaced its direct placement fund managers and placed a moratorium on new direct placement investments. In its meeting of May 24, 1991, the Board of Trustees relieved both Reimer and Koger and Peters, Gamm, and West from their duties as managers of the Retirement System's direct placement funds. The Board also placed a moratorium on further direct placements, pending a review of such investments. In addition, the Board obtained the services of an oversight advisor to review any add-on investments in direct placement fund companies proposed by the Board's newly hired managers for direct placements, Pacholder Associates and Chemical Bank of New York.

APPENDIX B

History of the Retirement System's Investment in Tallgrass

The purpose of this appendix is to document the principal amounts of money committed to the investment in Tallgrass Technologies on specific dates. Included in the history are the major investment transactions such as the purchase, sale, repayment, or conversion of the company's debt. In several instances, money was loaned to Tallgrass in the form of a grid note. When grid notes were issued, the investment manger advanced money in several installments over time upon Tallgrass' request. For the sake of simplicity, the entire amount loaned under these types of notes was recorded as though all money was advanced to Tallgrass on the date of the note. Also, this appendix does not take into account accounting adjustments made periodically to increase the book value of investments purchased at less than face value. Therefore, the cumulative amount invested will not agree exactly with the total value of the investment in the Retirement System's accounting records on any given date.

History of Investment in Tallgrass Technologies Inc.

		Cumulative Amounts Invested		
<u>Date</u>		<u>Stock</u>	<u>Loans</u>	<u>Total</u>
4-23-86	Reimer & Koger made an initial investment in Tallgrass consisting of 45,000 shares of stock purchased from the company's founders for \$179,106, and a 9 percent convertible debenture with a face amount of \$4,950,000, which was purchased for \$4,851,000.	\$179,106 45,000 shares	\$4,851,000	\$5,030,106
2-13-87	Reimer & Koger loaned an additional \$270,000 to Tallgrass in the form of a 9.5 percent convertible note.	\$179,106 45,000 shares	\$5,121,000	\$5,300,106
4-03-87	Reimer & Koger issued a new loan to Tallgrass in the form of a 9 percent convertible debenture with a face amount of \$6.3 million and a cost of \$6,174,000. That debenture was used to pay off the existing \$4,851,000 and \$270,000 in loans, plus \$117,341 in interest due on those two loans. In addition, this loan provided \$935,659 in new funding for Tallgrass.	\$179,106 45,000 shares	\$6,174,000	\$6,353,106
7-20-87	Reimer & Koger made available \$1.5 million in new funding to Tallgrass in the form of a 12 percent demand grid note. That money was issued to the company in seven installments during July and August of 1987.	\$179,106 45,000 shares	\$7,674,000	\$7,853,106
9-15-87	Reimer & Koger made \$350,000 in new funding available to Tallgrass in the form of a 12 percent demand grid note.	\$179,106 45,000 shares	\$8,024,000	\$8,203,106
10-19-87	Reimer & Koger loaned Tallgrass an additional \$100,000 in the form of a 12 percent promissory note.	\$179,106 45,000 shares	\$8,124,000	\$8,303,106
11-19-87	Tallgrass paid back the \$1.5 million, 12 percent demand grid note issued on 7-20-87.	\$179,106 45,000 shares	\$6,624,000	\$6,803,106
11-19-87	Reimer & Koger issued a new 12 percent demand grid note to Tallgrass in the amount of \$1,353,367. The proceeds from this loan were used to pay off the \$350,000 note issued 9-15-87 and the \$100,000 promissory note issued 10-19-87 plus \$3,367 in interest owed on those two loans, and to provide \$450,000 in immediate new funding with the ability to draw an additional \$450,000. Between November 1987 and April 1988, Tallgrass drew down \$420,000 of the remaining \$450,000 authorized.	\$179,106 45,000 shares	\$7,497,367	\$7,676,473

<u>Date</u>		<u>Stock</u>	<u>Loans</u>	<u>Total</u>
12-03-87	Gateway Mid-America partnership bought a portion of previous loans Reimer & Koger had made to Tallgrass for a total of \$105,000.	\$179,106 45,000 shares	\$7,392,367	\$7,571,473
4-07-88	Reimer & Koger loaned Tallgrass an additional \$297,308 in the form of a 12 percent demand note .	\$179,106 45,000 shares	\$7,689,675	\$7,868,781
4-07-88	Reimer & Koger purchased 3,470,475 shares of common stock from a minority shareholder for \$1,021,151. (\$.295 per share)	\$1,200,257 3,515,475 shares	\$7,689,675	\$8,889,932
4-07-88	Reimer & Koger purchased the right to buy 275,400 shares of common stock at \$4 per share for \$900	\$1,201,157 3,515,475 shares	\$7,689,675	\$8,890,832
5-27-88	Reimer & Koger made an additional \$1.5 million available to Tallgrass in the form of a 12 percent grid note. Tallgrass requested the money in several installments between 5-27-88 and 7-29-88.	\$1,201,157 3,515,475 shares	\$9,189,675	\$10,390,832
6-03-88	Reimer & Koger purchased 1,979,282 shares of common stock from a minority shareholder for \$582,899. (\$.295 per share)	\$1,784,056 5,494,757 shares	\$9,189,675	\$10,973,731
6-22-88	Reimer & Koger purchased 106,190 shares of common stock from a minority shareholder for \$31,273. (\$.295 per share)	\$1,815,329 5,600,947 shares	\$9,189,675	\$11,005,004
6-30-88	Reimer & Koger converted debt instruments into 14,606,843 shares of common stock at approximately \$.54 per share for a total of \$7,932,695.	\$9,748,024 20,207,790 shares	\$1,500,000	\$11,248,024
	Breakdown:			
	Converted 4-03-87 debenture	\$6,198,930		
	plus capitalized interest of	\$133,875		
	Converted 11-19-87 Note	\$1,218,367		
	plus capitalized interest of	\$76,386		
	Converted 4-07-88 Note	\$297,308		
	plus capitalized interest of	<u>\$7,829</u>		
	Total	\$7,932,695		
8-12-88	Reimer & Koger issued a new 12 percent grid note in the amount of \$2,521,722 to Tallgrass. This new loan was used to liquidate the 5-27-88 note for \$1.5 million plus \$21,722 in interest due on that note, and make available \$1 million in new funding. \$200,000 of the new funding was provided immediately, and the remainder was provided in three installments during August and September 1988.	\$9,748,024 20,207,790 shares	\$2,521,722	\$12,269,746
9-29-88	Reimer & Koger purchased 51,075 shares of common stock from a minority shareholder for \$15,042 or \$.295 per share.	\$9,763,066 20,258,865 shares	\$2,521,722	\$12,284,788

<u>Date</u>		<u>Stock</u>	<u>Loans</u>	<u>Total</u>
12-22-88	Reimer & Koger issued to Tallgrass a new \$3,325,904 grid note at 13.5 percent. The proceeds from this loan were used to pay off the 8-12-88 grid note of \$2,521,722 plus \$104,182 in interest on that note and make \$700,000 in new funding available to Tallgrass. \$200,000 of the new money was advanced to Tallgrass immediately, and the remainder was requested by Tallgrass in five separate installments during the period January through March 1989.	\$9,763,066 20,258,865 shares	\$3,325,904	\$13,088,970
12-30-88 to 3-30-90	Between these dates, a total of \$609,139 in accrued interest was added to the balance of grid note issued 12-22-88.	\$9,763,066 20,258,865 shares	\$3,935,043	\$13,698,109
3-16-90	Reimer & Koger provided Tallgrass with a new 14 percent grid note in the amount of \$300,000 to provide additional funding for the company. Tallgrass requested those funds in three installments between 3-16 and 4-27-90.	\$9,763,066 20,258,865 shares	\$4,235,043	\$13,998,109

APPENDIX C

Agency Response

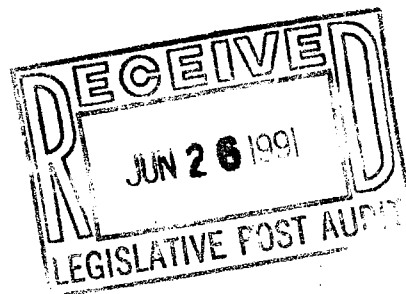
On June 21, 1991, we provided a copy of the draft audit report to Kansas Public Employees Retirement System. Its response is included in this Appendix.



Kansas Public Employees Retirement System

MARSHALL CROWTHER, Executive Secretary

JUNE 26, 1991



Mr. Meredith Williams
Legislative Post Auditor
Legislative Division of Post Audit
1200 Merchants Bank Tower
8th & Jackson
Topeka, Kansas 66612-1212

Dear Mr. Williams:

This letter is in response to your request for comments regarding draft copies of performance audit reports as were received in this office June 21, 1991.

We have no comments regarding the Tallgrass performance audit report. Comments regarding the Investment Practices audit report are as follows:

To ensure that all claims submitted by investment managers for compensation and expense reimbursements are accurate and allowable, the Retirement System should:

- a. ensure that its established procedures for monitoring investment manager compensation payments and expense reimbursements are followed.

KPERS response: The Retirement System staff does have an established set of procedures that are routinely followed regarding the verification and payment of all discretionary manager fees who individually are required by executed Board contracts to remit invoices to the KPERS office prior to receipt of payment. Established internal procedures include the verification of market value information reported by the Manager to the portfolio values maintained by the Custodian Banks, recomputation of fee invoice amounts, and isolation and resolution of computational differences of \$200 per invoice or more.

- b. document the steps taken by Retirement System staff to verify the accuracy of fee billings and expense claims.

KPERS response: Staff utilizes standard tic and initialing procedures to indicate verification of portfolio market values and recomputed fee amounts, and approval for payment, evidenced on all manager fee invoices. No other documentation is completed by staff to document these procedures or the variance amounts computed.

To support additional documentation of reconciliation and verification efforts would require human resources in excess of the relative cost

associated with established tolerable variance level of generally \$800 per discretionary manager, per fiscal year or less.

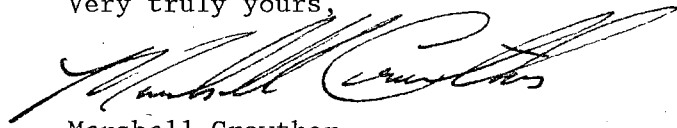
- c. Systematically require investment managers to provide any additional information needed to support compensation billings and expense claims.

KPERS response: In the limited instances where executed Board of Trustee contracts do not require prior approval by KPERS staff for fees charged the Retirement System, KPERS has not always been in possession of sufficient documentation need to verify fees. Executed Board contracts are being reviewed to determine where this fee arrangement is permissible, and staff will initiate formal requests for information from discretionary managers to fulfill this recommendation.

Upon engagement of direct placement portfolio managers, Pacholder Associates and Chemical Bank, KPERS staff initiated procedures to insure receipt of such documentation at the time request for reimbursement of expenses is forwarded to this office.

For the remaining discretionary manager where expenses and other miscellaneous payments can be allowed, O'Connor Realty Advisors Inc., KPERS staff is initiating procedures to ensure receipt of documentation when request for reimbursement of expenses or advice of capitalization is received for processing.

Very truly yours,



Marshall Crowther
Executive Secretary

MC:LAB

cc: Walter Cobler, Chairman
Jack Hawn
Louise Brock

