



THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

November 8, 2012

Mr. Reynolds Williams
Willcox, Buyck & Williams, P.A.
PO Box 1909
Florence, SC 29503

Dear Chairman Williams:

At the Investment Commission's Audit Committee meeting on November 2, 2012, Investment Commission staff presented a document titled "Internal Audit and Compliance: Alternative Investment Valuation Monitoring Procedures." In that document and during its presentation, Investment Commission staff appears to have improperly used accounting literature to justify the investment valuations to be used in SCRS' financial statements as of June 30, 2012. (The investment valuations to be used for about 69% of the SCRS' assets are the valuations provided as of June 30, 2012, by each third-party investment manager.)

On page 3 of that document and in its presentation, Investment Commission staff used the following excerpt from a FASB accounting pronouncement to justify the use in SCRS' FY 2012 financial statements of the investment valuations as of June 30, 2012, as provided by the third-party managers:

Accounting Standards Codification (ASC) 820-10-35-59:

"a reporting entity is permitted, as a **'practical expedient'**, to estimate the fair value of an investment within the scope of paragraphs 821-10-15-15-4 through 15-5 using net asset value (NAV) per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the NAV per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date."

On the same page, staff said that "further accounting guidance on this topic" may be obtained from "the AICPA's guidance in Technical Inquiry Service (TIS) Section 2220 'Long Term Investments' Sections 19-27."

As a preliminary matter, we are not sure that third-party fund managers provide NAVs to the Investment Commission. We have seen only reports from third-party managers that provide gross

ending values stated in dollars, not net asset values per share. However, even if the third-party managers provide NAVs, the use of such NAVs by the Investment Commission for GAAP purposes comes with strings attached. Please note that the cited passage says that a reporting entity (presumably SCRS) may estimate the fair value of their investments by using the NAV provided by the third-party fund manager ONLY IF “the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles in Topic 946 as of the reporting entity’s measurement date.” Therefore, the Investment Commission has some work to do before it can use a third-party manager’s NAV to estimate the fair value of SCRS’ investments.

Using TIS Section 2220, *Long-Term Investments*, that was cited by Investment Commission staff, it appears that the Investment Commission has not done the work required to be in a position to say that “the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles in Topic 946 as of the reporting entity’s measurement date.”

Paragraph 20 of TIS Section 2220 answers the question of how a reporting entity may conclude that the NAV has been calculated consistent with the principles in Topic 946. These answers raise several important issues that question the Investment Commission’s use of the NAVs provided by third-party fund managers.

First, the answer places the burden and responsibility of making sure that the valuations are correct on SCRS by reiterating that “[a] reporting entity’s management is responsible for the valuation assertions in its financial statements.” In this case, it appears that the Investment Commission (and the Retirement Division) has improperly delegated the responsibility for the valuations to third-party fund managers who have a financial incentive to overstate the investment valuations.

Second, the answer “requires a reporting entity to independently evaluate the fair value measurement process utilized by the investee fund manager to calculate the NAV.” There is no evidence that the Investment Commission has performed this type of independent evaluation of each fund manager’s valuation process. In fact, according to the 2012 report from Deloitte and Touche, the Investment Commission has no “initial/on-going due diligence and financial reporting controls to support the valuations of the External Managers.” (See p. 12 of Deloitte’s 2012 report.) Additionally, the 2012 Deloitte report appears to confirm that the Investment Commission performs no due diligence on investment valuations when Deloitte stated, “[T]he Commission is looking to expand the scope of the External Manager Due Diligence program to include the valuation . . . practices of the External Managers.” (See p. 5 of Deloitte’s 2012 report.) But even if the Investment Commission had included valuation procedures in its due diligence procedures, it would be unable to perform those valuation procedures because Deloitte reported, “[T]he Commission indicated that it does not have the staff or resources to address the operational due diligence areas noted within the [Due Diligence] Guidelines.” (See p. 9 of Deloitte’s 2012 report.)

As part of the reporting entity’s independent evaluation of each third-party fund manager’s fair value measurement process, the reporting entity must “determin[e] that the investee fund manager has an effective process and related internal controls in place to estimate the fair value of its investments that are included in the calculation of NAV. The reporting entity’s controls used to evaluate the process of the investee fund manager may include the following:

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- Initial due diligence . . .
- Ongoing due diligence . . .
- Financial reporting controls”

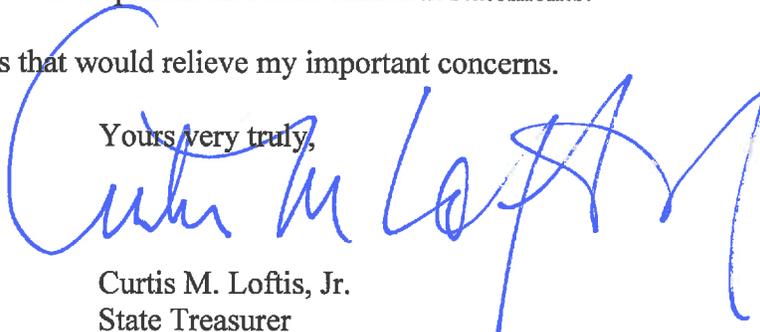
Based on our knowledge of the Investment Commission from the Deloitte reports and other sources and our communication with the Retirement Division (now PEBA) no one in State government is performing these types of procedures in order to independently evaluate the valuations provided by the third-party fund managers.

In addition, Investment Commission internal audit staff has confirmed that Deloitte’s findings regarding the Investment Commission’s valuation practices are accurate. In an August 18, 2012 memo the Investment Commission’s Audit and Compliance Officer said that Deloitte confirmed that the Investment Commission’s policies and procedures regarding investment valuations “do not effectively mitigate the risks to the organization.” The Audit and Compliance Officer also made recommendations that indicate that the Investment Commission does not understand and monitor the valuation methods of its third-party investment managers and that the Investment Commission can not currently challenge those third-party valuations.

In conclusion, I have raised many valid concerns about SCRS’ FY 2012 financial statements, especially regarding the investment valuations. No one has sufficiently answered my concerns by providing a complete list of procedures performed and controls in place within the Investment Commission (and the Retirement Division) to independently validate and be able to challenge the investment valuations provided by conflicted third-party fund managers. In fact, all of the evidence indicates that sufficient procedures have not been performed and sufficient controls do not exist imposing a scope restriction on the auditor’s opinion on SCRS financial statements.

I welcome a complete analysis that would relieve my important concerns.

Yours very truly,

A large, stylized handwritten signature in blue ink, which appears to read "Curtis M. Loftis, Jr.".

Curtis M. Loftis, Jr.
State Treasurer

CMLjr/afw

cc: Members of the Commission
The Honorable Richard Eckstrom
Mr. Art Bjontegard
Mr. Ted Pitts
Mr. Hershel Harper
Mr. Bill Blume