ALASKA PERMANENT FUND CORPORATION

AUDIT COMMITTEE MEETING

May 16, 2018
10:30 a.m.

Location of Meeting:
Alaska Mental Health Trust Authority
3745 Community Park Loop
Anchorage, Alaska

SUMMARY MINUTES

Trustees Present:	Marty Rutherford, Chair Craig Richards Bill Moran Carl Brady
Staff Present:	Angela Rodell, CEO Valerie Mertz, CFO Danielle Graham Nellie Metcalfe
Other participants:	Melissa Beedle KPMG Beth Stuart, KPMG

PROCEEDINGS

CALL TO ORDER
CHAIR RUTHERFORD called the meeting to order and asked for a roll call.

ROLL CALL
A quorum was formed with TRUSTEES RICHARDS and RUTHERFORD present, and TRUSTEES MORAN and BRADY appearing via conference call.

CEO RODELL introduced Danielle Graham as the new board liaison and executive assistant. She started work at the Permanent Fund Corporation a week ago, coming to us from payroll services at the Division of Personnel and Labor Relations.

CHAIR RUTHERFORD welcomed Ms. Graham and moved to the approval of the agenda.

APPROVAL OF AGENDA

MOTION: TRUSTEE RICHARDS made a motion to approve the agenda, seconded by TRUSTEE RUTHERFORD.

The MOTION was APPROVED.

APPROVAL OF MINUTES (September 7, 2017)

MOTION: TRUSTEE RICHARDS moved to approve the minutes of September 7, 2017, seconded by TRUSTEE RUTHERFORD.

The MOTION was APPROVED.

SCHEDULED APPEARANCES AND PUBLIC PARTICIPATION

There were no scheduled appearances or public participation.

CHAIR RUTHERFORD moved to the Audit Preview, and introduced Beth Stuart from KPMG.

FY18 AUDIT PREVIEW AND RISK ASSESSMENT REVIEW

MS. STUART began with a brief presentation that explained the audit plan for the upcoming June 30, 2018, year-end audit. She stated that the engagement team is identical to last year, and she will serve as the lead audit engagement partner. She added that this will be her ninth year serving as the lead audit engagement partner on the account; and it is time to think about partner rotation. She continued that the company has a ten-year policy that is not required by law, but KMPG believes it is a best practice to have audit partner rotation from time to time. The firm policy is that the lead audit partner is allowed for ten years, then another partner steps in for at least two years before the engagement partner can serve again. She stated that Melissa Beedle, who is based in Juneau and has worked for the KPMG Anchorage office for nearly 15 years, will continue to serve as the audit senior manager. She continued that Nick Katsanos, the valuation specialist, is based in New York City and spends his entire year working with audit engagements, on alternative investment, valuation, and audit procedures, and is an important part of the engagement team. She added that there is always a second partner on the account who does a cold review of the financial statements prior to issuance, Mike Hayhurst in this case, who was the managing partner of the Anchorage office of KPMG, and has served as the engagement partner for the State of Alaska Treasury and Retirement Systems audit for a few years. He is currently based as the managing partner in the Boise office. She stated that, from a risk assessment perspective, summarized are the areas identified as having the most significant risk to the audit. The first item is presumed risk for all audits and is not specific to the Permanent Fund. It does not give any kind of view on management's likelihood of overriding controls. She continued that the audits are designed to identify material fraud that exists from the override of internal controls, which is consistent with each year and across all audits. She stated that there are also two specific risks related to the Permanent Fund and the makeup of the investment portfolio: One related to the valuation of alternative investment, nonpublic investments, securities and investment form types; the other, within that group, the real estate investments. She added that both are more complex investment structures and have a higher degree of subjectivity. Specific procedures are designed to address the risk, particularly the valuation risk of real estate and the other nonpublic investments.

TRUSTEE RICHARDS asked if the valuation of investments are done, or is it an audit of the Permanent Fund's valuation.

MS. STUART replied that the Permanent Fund's valuation is audited.

TRUSTEE RICHARDS asked who did the valuations.

MS. STUART answered that a variety of entities do. For the nonpublic, primarily, the investment manager is providing a valuation. Management of the Permanent Fund is reviewing that valuation for reasonableness, and then third-party appraisers are auditing as it relates to real estate; management is reviewing that for reasonableness, and then the evaluation is audited.

MS. MERTZ added that all of the private investments are required to have an annual audit. The valuation would be audited as part of their audit; and then it passes through the financials, which are then audited.

MS. STUART stated that those audits typically are as of the 12/31 valuation date and added; that was a focus of the procedures. She continued that part of the audit strategy will involve the service organization like New York Mellon, as the investment custodian. They have an internal control report issued over their internal processes. Also reviewed are the Permanent Fund's internal controls that are necessary to integrate with the service organization's processes to get to accurate financial reporting within the Permanent Fund's report. She then went over the timeline on the audit plan.

CHAIR RUTHERFORD asked if any of the trustees had any questions or comments. There being none, she moved on to the next step.

MS. STUART stated that one of the things in the audit plan is to gain an understanding of the Audit Committee's perspectives on fraud or of any fraudulent financial reporting or any concerns that have happened during the year. She continued that if anything like that came up to the Audit Committee, she requested to be informed of that and to help design the audit plan.

CHAIR RUTHERFORD and TRUSTEE RICHARDS both replied that they had no concerns about fraud or fraudulent financial reporting or other concerns.

CHAIR RUTHERFORD stated that the agenda has a peer-review type of discussion for best practices for an audit committee scheduled for later.

MS. STUART stated that if things do come up over the course of the audit, her practice would be to work through management to reach out directly to the Audit Committee chair. She added that she would like to confirm that that is the right approach if there is anything that requires any immediate discussion or concern.

TRUSTEE RICHARDS stated that one of the questions that he will have when going through the new audit presentation is to talk about any areas of concerns historically and how they were addressed.

CEO RODELL stated that it is important for the Chair of the Audit Committee to have a standalone relationship with Ms. Stuart as the audit manager, and to not have herself or

Ms. Mertz as part of the discussion. She added, that maintains the integrity of the audit by being able to do that, and part of the Audit Committee is to establish that dialogue between the auditor and the committee chair.

MS. STUART emphasized that it is important and underscores that the audit firm works for the Audit Committee. The contract may be signed by management, but the responsibility is directly to the Audit Committee, not management. She asked if there are any other concerns or areas that may be particularly risky in the audit that have not been identified.

CEO RODELL stated that staff relies on what the Bank of New York is doing, what is being done internally as much as could be done with staff data integrity. She asked if they are also getting representations because that is what is being relied on for valuations and things like that in the financial statements.

MS. STUART replied that one way is a confirmation directly with them, as well as their internal control report. She stated that the biggest risk of data-breach-type cyber issues is keeping personal information safe. The Permanent Fund has a different really big risk, and from a pure financial statement perspective, it is easier to audit around because there are third-party custodians. She moved on and discussed the status as a firm with PCOB, the regulator, the Public Company Accounting/Oversight Board, the division of the SEC that regulates public accounting firms. She stated that, in February of 2017, a current employee of the PCOB had shared a list of upcoming inspections with some members of the KPMG senior leadership. These were important because that is how the PCOB evaluates their work. This information was shared with an employee of KPMG, who shared it internally. Some of those members were in the audit leadership group and did not say that this information should not be had. In the investigation it came out that information was used to try and help engagement teams do better in the inspection process. When this came to light, the CEO immediately fired seven partners, including the head of the audit department and the head of the inspections department. She continued that an internal investigation was started that went through last fall and all the results were shared with the SEC. The Department of Justice has pressed charges against the individuals involved, both the former KPMG partners and employees, as well as the former PCOB employees. The process is working its way through the court system. She added that there has been no indication that charges will be pressed against the firm because it was not a systemic issue. The firm’s response was decisive and swift to terminate the people involved. She stated that a civil penalty is expected and accrued for. It will be a big number, and there is insurance. It will hit the press when it does come out. She continued that internal restructuring has been made, and we have a new head of audit, a new head of inspections, and we have made employee changes. She moved on and stated that every three years every audit firm has a peer review done, and it was done by PWC. A response was issued that we passed except for a tone-at-the-top issue that if the head of the Audit Department was willing to use this information he should not have. She added that the response to that was a letter that described the changes that were made, and the AICPA accepted and issued a letter saying that the peer review and response was accepted, and has considered it closed.

CHAIR RUTHERFORD stated that KPMG responded quickly and appropriately. It was interesting that partners involved in that particular area would be so willing to participate. She calls a break.

(Break.)

CHAIR RUTHERFORD called the meeting back to order and moved to the year-to-date financial statements.

FY18 YEAR-TO-DATE FINANCIAL STATEMENT REVIEW

MS. MERTZ began by walking through the financial results for the first three quarters of fiscal '18. She stated that the first page showed the balance sheet and the income statement, which is highly summarized for simplicity. The top page showed the net assets as of March 31st at $64.6 billion, which is a $4.8 billion increase since the beginning of the year; an amazing performance. She continued that there was some volatility, particularly in the public markets, that caused that value to bounce around in the last quarter. She continued that the net asset balance is affected by valuation movement in the investment and is also impacted by in-flows into the fund from interest, dividends, gains, and the mineral royalty deposits that affect the balance. She added that there is also an allocation of the unrealized gains held in the portfolio that are allocated between principal and earnings reserves. As of March 31, there were $40.1 billion in deposits and an allocation of unrealized gains of about $7 billion. The principal is sitting at about $47 billion in total; which is the corpus.

CEO RODELL stated that the audit findings will be presented at the Audit Committee meeting in September.

CHAIR RUTHERFORD asked if the committee needed some guidance on the issue prior to that.

CEO RODELL stated that there were two choices: One is to change it now for fiscal year '18; or because SB 26 takes effect FY19, to work on this over the course of the year and start it in FY19.

CHAIR RUTHERFORD asked what needed to occur to help understand this. She stated that it seems there is a need for some discussion within the internal corporation and KPMG, with some feedback about this so that an informed decision can be made, but also, in this discussion, to see how SB 26 will affect us.

TRUSTEE RICHARDS stated that a practical question if there is a stressed situation with the ERA balance, to know what the rules are around what is done with unrealized gain in the corpus.

MS. STUART stated that financial statements are being issued as they have been with the disclosure that says SB 26, effective July 1st, will be evaluating the impact of that on the classification of fund balance.

TRUSTEE RICHARDS asked for this to be pursued so that discussion can be had at the September meeting.

MS. STUART replied that there is a direct contact with a partner in the Department of Professional Practice, which is the think-tank office in New York. His name is Jeff Parker who has served on the GASB board and has an understanding of the Permanent Fund from the '09 attorney general's opinion. He was involved in helping interpret the accounting that came out of that AG opinion, and is always available.

MS. MERTZ moved on to the second component of fund balance, the committed portion of the fund balance and earnings reserve. These are amounts that are set aside during the course of the year for payments for the dividend, inflation-proofing, and for transfer to the Alaska Capital Income Fund. She stated that the zero on the dividend line is reflective of the fact that the fiscal '18 dividend transfer had already taken place, so nothing needs to be set aside for that. She continued that it is already reflected on the detailed income statement. There is a zero showing for inflation-proofing because there was no appropriation for that purpose in the fiscal '18 budget. She added that $33 million was set aside for transfer of realized earnings related to the Amerada Hess principal that, by statute, gets transferred to the Alaska Capital Income Fund. She stated that the final component of fund balance is basically everything that is left over. This is the amount that is available for future appropriation. She continued that this has two components: The net realized earnings line, which is the cumulative earnings of the fund since inception, with an amount of $15 billion. Then the allocation of the unrealized gains relating to that balance. She moved to the income statement section which showed the components of statutory net income. She explained that it started with statutory net income and then added back any unrealized gains that have been experienced in the portfolio during the year. She moved on and explained the charts that gave a visual comparison of the past few years. She wrapped up the financial review and moved on to updates on staffing and the finance team.

AUDIT COMMITTEE NEW MEMBER ONBOARDING

MS. MERTZ stated that Andrew Cloward has been added as a team member to the trade operations group supporting the internal trading. She continued that he is an Alaskan with a degree from UAF in business administration, finance, and he had been working on mortgage loans in Orlando. He was happy to have an opportunity to come back to Alaska. She moved on to the summer college intern, Zach Hebert, from Juneau, who is going to be a junior at Washington State University studying accounting and finance. She moved on to the table of contents that she brought before the committee in September for a reference guide to help walk through what an audit committee does. She stated that the reference guide was divided into sections: The first section is the Audit Committee charter; then the minutes from the prior two meetings to allow new members to understand what the issues and discussions are about; then, the meeting schedule for the current and next year; then, a series of sample reports that support the Audit Committee's role in governing their portion of the operations; following that are several documents related to the external; and at the back is KPMG's Audit Committee Institute Guide. She stated that the charter outlines the operating procedures for the committee and also defines three roles of the Audit Committee in the governance of the corporation; supporting each of those roles are some duties and responsibilities that the board decided are important for the Audit Committee to fulfill. She moved to operating procedures. The charter states that the board will have an Audit Committee which will consist of at least three members of the board. It will meet twice annually, and minutes of those meetings are required. It also requires the self-assessment to be performed annually. She moved to the roles of the Audit Committee and stated that there are three defined in the charter. The first is to monitor the integrity of the financial reporting process and the system of controls that are in place for that reporting. The duties and responsibilities defines are to review the audited financial statements prior to distribution; second is to support the role of the financial reporting process. Together with the auditors and management, the committee needs to consider the integrity of the reporting process. Third is the committee is required to discuss significant changes to accounting principles, and annually review any legal matters that could impact the financial statements or compliance with laws and regulations that are in place. She moved on to the cash transfer report, which is the standard report in the quarterly board packets. It is a great way to see the movements of cash and the other assets of the portfolio. She went through and summarized the report and moved to the current investment management fee report. This breaks out what is being paid in each asset class through net-of-fee arrangements. These are fees that are paid by the manager, netting the management fee expense out of the income of the investment.

TRUSTEE RICHARDS asked why public equity was showing up in performance but is not showing in terms of a cost.

MS. MERTZ replied that when it is recognized as a fee it is recorded as a fee in the financial statements. She explained that visibility is not available for all of the managers.

TRUSTEE RICHARDS stated that there is always a lot of dialogue in justifying whether or not more staff for the fund makes sense. He continued that, in general, the total fee charges are with the public equity and we want to be able to understand that the management fees are truly paid.

MS. MERTZ stated that information is tracked, and the net-of-fees are broken out by asset class. She suggested changing the report to break out the funded by appropriation to show asset class, which will give a better picture of what everything is costing. She added that she will look at some ideas on that and bring that back to the committee. She continued that following fees there is the monthly performance report. These are Callan's calculations of the fund returns, as well as the corresponding benchmarks. This report is e-mailed out to all the trustees when it is finalized each month. It is also published on the website, and included in the board packet, the quarter-end reports. She stated that following the monthly performance report there is the daily dashboard; which is emailed to staff and trustees. She continued that the front page has asset allocation information, some performance information, and is a quick way to see what is going on with the portfolio each day.

CEO RODELL asked if that included Mental Health Trust moneys.

MS. MERTZ replied that it does, and the following pages are asset allocation, comparing them to the target allocations per policy. Last in this reporting section is the daily performance report that is produced by Bank of New York Mellon and emailed out every morning. She stated that those are the sample reports, and if there is an area of interest that more information is needed, that will be provided.

TRUSTEE RICHARDS stated that the daily flash report is very useful because it is a level of information that can be consumed in a day and is not overwhelming.

MS. MERTZ moved to the final two roles that are defined in the charter for the committee and are related to the external audit. Those are to review the performance and the independence of the external auditor. She stated that it is the Audit Committee's task to gauge how they are doing and to make sure that they are independent in order to conduct an audit. The third role is to provide an avenue of communication, which has been discussed. She continued that there is a list of things that the charter lays out to support the committee in fulfilling two roles: One is to review the external audit plan; second is to consider the auditor's judgments about the quality and appropriateness of the accounting principles that are applied; third is to discuss with management and auditors the quality of the underlying estimates that are used in the financials. She added that the committee is also tasked with discussing with the auditors the clarity of the financial disclosure practices. It is also the committee that would review the performance and independence of the external auditors; recommend an appointment of a new auditor; discharge an existing auditor. She stated that the last one related to audit is to make sure that the committee understands all significant relationships that the auditors have with APFC.

MS. STUART stated that they have a global database, where she, as lead partner, has the responsibility to ensure that under Alaska Permanent Fund Corporation she listed all of the investments required to maintain independence. She continued that in order to perform any service for any company that is listed within the family tree, she has to approve that service ahead of time.

CHAIR RUTHERFORD asked about the standard of the review to make that determination.

MS. STUART replied that she reviewed the draft of the engagement letter that they would be providing that governs KPMG's scope of work. In general, audit services do not impair auditor independence because they have to be independent.

MS. MERTZ moved on to some more information regarding the audit component event of all of this with a variety of documents related to the external audit. She stated that first is the engagement letter, which is the contract with KPMG that outlines the scope of services, deliverables, and all the normal things expected to be seen in a contract. Following the engagement letter are the reports that were issued as a result of the FY17 audit. Then, following the full audit report there is the management representation letter. She included a schedule of unadjusted audit differences because it has been a topic of conversation at the audit review meeting for the last few years. She stated that there is no lag in the financial reporting and GAAP requires reporting fair value as of the end of the period. She clarified that the lag is only for performance reporting.

MS. STUART stated that there is a lag, but the accounting rules do not allow for that. She explained that this is capturing the difference between what has to happen to have the books closed and what should happen in the world of perfect accounting.

MS. MERTZ stated that finally in this section there is provided contact information for both Beth and Melissa. It is important to keep communication between the committee and the external auditor open, and she encouraged it.

TRUSTEE RICHARDS asked if there have been any auditing issues that were a big deal; a red flag.

MS. STUART replied not with the Permanent Fund. The issue is the reporting lag; the reporting numbers are getting bigger, and the level of estimation within the financial statements is growing every year as the move toward private markets increases.

CHAIR RUTHERFORD asked what the resolution is when that becomes significant.

MS. STUART replied that the resolution would ultimately be to record an adjustment.

CHAIR RUTHERFORD stated that this is a guide that was developed at KPMG. She asked if that is because they actually do training for audit committees.

MS. STUART replied yes, there is a group within the firm called the Audit Committee Institute. Audit committee training and audit committee member conferences are done. There are also committee member roundtables in a handful of cities around the country with small groups. There are also quarterly webcasts designed for audit committee members. There are a lot of resources available, and we spend a lot of time with audit committees.

CHAIR RUTHERFORD asked if the webcasts are free and if the committee could be notified of what is coming up over the course of the next six months.

MS. STUART answered yes, that she will keep her eyes on it. A lot of the material focuses on SEC registrants, and the last few focused on the level of accounting change on the corporate side. She explained that considered best practice with audit committees is to have an executive session without management present. The reason for that is to give an opportunity to speak freely without management present. Most audit committees have an executive session at every audit committee meeting as a matter of routine.

CHAIR RUTHERFORD replied that is something to consider. She asked for anything else. There being none, the committee moved into the self-assessment.

AUDIT COMMITTEE SELF-ASSESSMENT

CHAIR RUTHERFORD asked if this was done real-time last year.

MS. MERTZ stated that it was during the regular meeting. In the past, it was done any way the Chair wanted.

CHAIR RUTHERFORD asked if there was a specific timing associated with this.

MS. MERTZ replied that the requirement in the charter is to do it annually.

CEO RODELL suggested doing this in May, prior to the start of the audit, because there are charter-specific questions, general questions that can lead to raising an issue that is helpful for the external auditor to know. She stated that this was done last year because a new audit charter was being adopted.

CHAIR RUTHERFORD suggested giving themselves a couple of weeks, and asked Ms. Mertz to send a reminder that it is due by a specific date.

MS. STUART mentioned that one of the responsibilities as part of the charter is to evaluate the auditor. She stated that there is a third-party organization, the Center for Audit Quality, that is unaffiliated with any of the firms, and has published a document to help audit committees do that evaluation.

MS. MERTZ stated that she had that and would forward it.

TRUSTEE RICHARDS thanked all for a good meeting.

CHAIR RUTHERFORD agreed and stated that there are other matters and future items. We have talked about how to deal with the issue of unrealized gains as reflected in the financial statements. That will be an item that is on the September agenda.

CEO RODELL stated that a confidential presentation on the audit of the Mental Health Trust will be sent next week.

CHAIR RUTHERFORD thanked staff for putting this together.

MS. MERTZ stated that any feedback for next time would be greatly appreciated.

CHAIR RUTHERFORD adjourned the meeting.

(Alaska Permanent Fund Audit Committee meeting adjourned at 12:46 p.m.)