

DELAWARE STATE EMPLOYEES' RETIREMENT SYSTEM
AUDIT COMMITTEE MEETING
AUGUST 24, 2005
WILMINGTON, DELAWARE

ATTENDEES:

Audit Committee

Robert Allen
William Markell
Joel Poorman

Pension Office

David C. Craik
Kim Vincent
Alice L. Simon
Kathy Kunkle

State Auditor's Office

Tom Wagner
Ron Draper
Candy Casto

KPMG

Fran Murphy
Evelyn Zerenner

The primary purpose of the meeting was to review the draft of the Comprehensive Annual Financial Report for 2005 and the proposed "management comments" from the 2005 financial audit.

1. KPMG Audit

The audit contract was delayed from January to July because of the indemnification clause. While this did not delay completing the audit on time, it is indicative of the impact of Sarbanes Oxley on public accounting firms.

KPMG presented a letter to the Audit Committee on various items which are required to be disclosed per Sarbanes Oxley to public companies. Although the Fund is not a "public company", the provisions of Sarbanes Oxley are considered "best practices" and, therefore, are followed by KPMG on all audits. Notable comments are [1] the auditor is not responsible to detect non material events of fraud or error; [2] the audit does not include examining the effectiveness of internal controls nor provide assurance on internal control; [3] managements assumptions on key items affecting the financial statements were reasonable; and [4] there were no significant audit adjustments or disagreements with management.

This year, Tom Wagner will not co-sign the report as in prior years. However, the State Auditors will continue their practice of performing a quality control review of the work papers of the external auditors. This review will be completed before the Annual Report is published.

KPMG reviewed a draft of the "management letter". There were ten items:

- Information from County/Municipalities, University of Delaware and Diamond State Port Authority is not complete and does not permit the accuracy of their contributions to be verified. Basically the Pension Office cannot confirm that all employees of the entity are included in the contributions submitted.

- There is no reconciliation of contribution information between People Soft reports, Mercantile information, and the Fund's in-house schedules.
- Mercantile's monthly information appears to be correct but when rolling up the information [i.e., to arrive at year-to-date and quarterly data] errors occur which means the roll up must be done manually. Mercantile's shift to SunGard and was one of the primary concerns discussed when the Audit Committee met with Mercantile on May 17, 2005. At that time, the Audit Committee was assured the problems would be resolved by June 30. In view of the KPMG comment, Alice Simon was asked to follow up with Mercantile outlining KPMG's and the Committee's concerns and have a specific plan with deadlines and responsibilities developed.
- Reconciliation of Mercantile accounts and the investment managers needs to be performed on a more timely basis.
- Control of system changes, access to source code, and program documentation all need greater attention. Implementation of the STAT Change Control tool will help plus need better restriction/segregation of duties.
- IT department users have elevated system administrator-like privileges. This permits circumvention of established controls -- e.g. changing current and historical transactions without an audit trail.
- Passwords need to be updated.
- Daily maintenance of systems is done in a "shared administrator" account which does not permit establishing accountability for changes to the databases.
- Passwords are not complex and do not meet Delaware NT Security Policy of 9/30/2003 requirements.
- No record is maintained that pension data are backed up daily and rotated off-site.

KPMG indicated they were still reviewing items and there may be changes to the Management Letter. When the letter is finally issued, it will contain Pension Office comments/response.

2. Annual Report

The draft of the Annual Financial Report was reviewed. However, the Auditor's Letter and the Actuary Report were not included in this draft. KPMG advised that their "letter" will be a clean opinion. The Actuary report was received by the Pension Office the day before our meeting and was distributed for review. Any comments are to be made to Alice Simon before the end of August. The letter, dated August 23, states the Fund is adequately and appropriately financed and that reasonable actuarial methods and assumptions have been used.

The Committee had various comments for clarification and completeness of the draft which were shared with the Pension Office staff for consideration. Also attention was paid to the financial statement footnote on derivatives with several suggestions made.

Cc: Audit Committee Members
Philip S. Reese
David C. Craik
Alice L. Simon