

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**May 31, 2006**

The Audit Committee met in open public session at 9:01 a.m. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present:           Treasurer Michael Murphy, Chair  
Charlie Kaminski  
George Masten  
Sandra Matheson  
Bob Nakahara (via teleconference)  
Dave Scott

Others Present:                           Joe Dear, Executive Director  
Theresa Whitmarsh, Deputy Director for Operations  
Liz Mendizabal, Public Affairs Director  
Jim Lee, Information Systems Manager  
Shawna Killman, Internal Auditor  
Beth Vandehey, Risk and Compliance Director  
Rita Wineinger, Administrative Assistant  
Paul Silver, Assistant Attorney General  
Steve Wendling, State Auditor's Office  
Steve Weil, Seitel Leeds & Associates  
Kellye Testy, Seattle University School of Law  
Dana Gold, Seattle University School of Law

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Murphy called the meeting to order at 9:01 a.m.

**ADOPTION OF MINUTES – FEBRUARY 7, 2006**

**Mr. Masten moved to approve the February 7, 2005, Audit Committee meeting minutes. Mr. Scott seconded and the motion carried unanimously.**

**STATE AUDITOR'S ENTRANCE CONFERENCE**

Mr. Steve Wendling, State Auditor's Office, presented the WSIB's entrance conference for Fiscal Year 2006. The audit will cover the period beginning July 1, 2005, and ending June 30, 2006. The audit was planned using a risk-based audit approach in these general areas: accountability for public resources; compliance with state laws and regulations and agency policies; financial statements; and federal compliance. The audit will cover the following areas: contracts, wire transfers, investment reconciliation, records retention, business continuity, portfolio administration, investment management fees, cash receipting and receivables, human resources – separation process, and

partnership distributions. In the area of financial statements, the State Auditor will place reliance on the CPA Firm audit that will occur later in the year. The audit reports will include: Accountability Reports, Independent Auditor's CAFR Opinion, and Single Audit Report.

[Mr. Kaminski arrived at 9:04 a.m.]  
Chair Murphy identified the members present.

Ms. Matheson asked when the audit would be completed. Mr. Wendling indicated that the accountability portion of the audit would be done in October/November and the financial statement review may run into December.

## **INTERNAL AUDITOR REPORT**

### **Information Services Network Security Review Results**

Chair Murphy called the Audit Committee into executive session at 9:06 a.m. to review and discuss information concerning potential information technology vulnerabilities identified, the public discussion of which would result in loss to the funds managed by the WSIB. He indicated that the executive session was expected to last about 20 minutes, at which time the Audit Committee would reconvene in open session.

[The Audit Committee reconvened in open session at 10:18 a.m.]  
[The Audit Committee recessed at 10:18 a.m. and reconvened in open session at 10:31 a.m.]

### **Fiscal Year 2006-2007 Audit Plan**

Ms. Killman presented areas she has selected for audit review in the coming year. She plans to audit Investment Performance Reporting, Cash Overlay Management Program, and Active Emerging Markets Managers during the Fiscal Year 2006-2007.

Chair Murphy asked how Ms. Killman selected the topics for audit, as there are items that have not been reviewed in recent years. Ms. Killman responded, indicating that a risk assessment of Investment Management, Investment Operations, External Parties, and Business Operations was conducted. Because there are many areas that have not been audited recently and only three audits will be completed this year, she took into account other qualitative factors in making her selections, to include the level of Board involvement, previous reviews, external audit plans, and lower risk items.

Chair Murphy commented that it appears many items have not been reviewed for several years and asked if additional resources are necessary to assist the Internal Auditor. Mr. Dear indicated that staff has developed a budget proposal to address the need for an additional FTE for internal audit in the upcoming 2007-2009 budget. The budget will be presented at the June Board meeting.

**Chair Murphy moved that Audit Committee recommend the Board approve an additional FTE for the Internal Audit function in the 2007 - 2009 budget. Mr. Scott seconded and the motion passed unanimously.**

Mr. Masten asked why Internal Audit would be looking at the Cash Overlay Program given that it will be starting July 1, 2006. Mr. Dear commented that when you have a proactive internal audit program like ours, it allows for identification of issues early on that can be mitigated prior to causing problems in the future.

**Ms. Matheson moved that the Audit Committee accept the Fiscal Year 2006-2007 Audit Plan and forward it to the Board for approval. Mr. Scott seconded and the motion passed unanimously.**

### **Audit Recommendations Status Report**

There are four outstanding audit recommendation items since last quarter. The expected completion date for the summarization of partnership agreement terms under Private Equity Audit 2004-01 recommendation was moved back to November 30, 2006. The expected completion dates for two items regarding implementation of the Contact Management System have been adjusted due to external factors. Staff has selected a contact management system and implementation is underway with an expected completion date of August 1, 2006. The remaining recommendation associated with implementing independent compliance policies outside of the Fixed Income area for Savings Pool investments is still on track for completion by June 30, 2006.

Chair Murphy noted that expected completion dates have changed. He encouraged staff to set realistic completion dates in the future and said that he does not expect further slippage in completion dates.

### **FISCAL YEAR 2006 FINANCIAL STATEMENT AUDIT**

#### **Approval of Scope of Work**

Ms. Killman explained that there are two items to bring forward for review and discussion. As part of its key drivers for success, the WSIB will hire an independent auditor to conduct an audit of the financial statements for the fiscal year 2006. According to the Audit Committee Charter, the Audit Committee is to approve the scope of services performed by external auditors. The contractor shall perform such work as is required to accomplish the following general objectives: (1) Conduct an audit of the statements of net assets of the WSIB as of June 30, 2006, and the related statements of changes in net assets, including footnote disclosures and supplementary information for the year ended. (2) Express an opinion on the WSIB financial statements at the conclusion of the audit. (3) Conduct the audit in accordance with auditing standards generally accepted in the United States of America. (4) Allow staff from the State Auditor's Office (SAO) access to appropriate working papers for the purposes of placing reliance on the contractor's opinion as it relates to the State of Washington Comprehensive Annual Financial Report (CAFR).

The contractor will express an opinion based upon their audit and staff will have access to their working papers so that the SAO can use those for their audit. The audit will be completed by November 30, 2006.

**Mr. Scott moved that the Audit Committee approve the Fiscal Year 2006 Financial Statement Audit Scope of Work and forward it to the Board for approval. Mr. Masten seconded and the motion passed unanimously.**

**Independence Statement Review and Appointment of External Auditor (Peterson Sullivan)**

Ms. Killman explained that management would like to engage Peterson Sullivan PLLC to perform the independent audit of the Board's fiscal year 2006 financial statements. She also presented the independence statement of Peterson Sullivan, indicating their independence from the WSIB.

**Mr. Scott moved that the Audit Committee approve the appointment of Peterson Sullivan and forward it to the Board for approval. Mr. Masten seconded.**

Mr. Nakahara asked how Peterson Sullivan was selected to conduct this audit. Ms. Killman explained that an RFP went out for a two year contract ending at the end of this calendar year.

**The motion passed unanimously**

[Ms. Matheson departed at 10:46 a.m.]

**CONFLICT OF INTEREST POLICY 2.00.100**

Paul Silver, Assistant Attorney General, reported the annual review of compliance with the gift, travel, and financial statement reporting requirements of the Ethics in Public Service Act and the Conflict of Interest Policy 2.00.100 for Board members and staff. Board members and staff of the Board continue to demonstrate both an awareness and understanding of the Board's Conflict of Interest Policy and the State Ethics in Public Service Law. Full compliance was found with no exception.

**Mr. Masten moved that the Audit Committee forward the Conflict of Interest Report to the Board. Mr. Scott seconded and the motion passed unanimously.**

**BOARD POLICY COMPLIANCE REVIEW**

Ms. Vandehey, Risk and Compliance Director, conducted a Board policy compliance review as required by the Board governance policy. A list of Charters and Policies reviewed was presented to the Committee.

The review included identifying readily verifiable provisions within governance policies, attendance at 2005 Board and Committee meetings, review of 2005 Board and Committee minutes, review of additional supporting documents maintained by staff, and identification of areas of compliance and non-compliance. While the WSIB has a high rate of compliance, the following areas were identified where compliance could be strengthened: (1) Documentation of investment philosophy. (2) Board approval of basic organizational structure changes, annual strategic plans, a broad human resource policy, and a communications policy. (3) Improved Administrative Committee oversight of Conflict

of Interest Policy revisions, Board self-evaluation, legal actions, approval of strategic or business plans, monitoring compliance with the operating budget, and monitoring Board governance and human resource policies. (4) Improved Audit Committee oversight of delegation to the internal auditor the management of contracts for any certified public accountants doing audit type reviews, exercising final approval of the appointment, retention or discharge of auditors/consultants doing audit type work, and receiving compliance reports from staff.

Overall there is a very high degree of compliance with WSIB governance policies. Staff will recommend modifications of Board charters and policies at the June 2006 Board meeting.

Chair Murphy indicated that he would like the Committee to review the human resource policies as well. Mr. Dear explained that the human resource policies are based on State law and are also delegated to the executive director for approval, rather than the Board. Mr. Murphy discussed how his Treasury policies are adopted to give clarity to the statute, based on his organizational structure and further indicated that it is appropriate for those similar policies to be reviewed by the Committee and the Board.

Mr. Kaminski asked how often the operating budget was presented to the Board. Mr. Dear indicated that the Board approves the budget biennially and towards the end of the biennium the Board is presented with status reports. Mr. Kaminski requested quarterly reports on the status of the budget. A discussion ensued regarding the frequency the budget should be reported. Chair Murphy agreed that the budget should come forward on a semi-annual basis and include both appropriated and non-appropriated funds. Mr. Dear said that budget reports could be taken to the Administrative Committee on a semi-annual basis.

Ms. Vandehey concluded her presentation explaining that the compliance review function helps demonstrate that the Board's internal governance structure is strong, improves policy oversight, refines overlaps in policies and processes, and improves the Board governance process. Chair Murphy indicated that Ms. Vandehey would present to the Audit Committee twice per year on compliance issues.

## **BOARD GOVERNANCE**

Chair Murphy introduced Kellye Testy, Dean of the School of Law at Seattle University. Chair Murphy indicated that Dean Testy was asked to speak to the Committee regarding the topic of board governance at the July retreat. She introduced Dana Gold, Director of the Center on Corporations, Law & Society.

Chair Murphy explained that the Board was exploring the possibility of having Seattle University School of Law present the topic of Board Governance at the Board retreat in July. The purpose of this agenda item is to determine if the program is a good fit for the WSIB Board. Mr. Kaminski indicated that he attended the Seattle University's Directors Training Academy and indicated that the work being done with a broad spectrum of participants including corporations seems to lead to a number of best practices that were shared during the session he attended. He asked if there are things that can be learned from the work Dean Testy is doing with board governance best practices. She responded that, in keeping with values based education, the curriculum for the corporate

governance session focuses on best practices for any kind of governing board. Many of those best practices are ones that are not mandated by law, but good practices. The training academy is one of broad applicability.

Dean Testy said that she collaborated with Professors Eric Chiappinelli, Russell Powell, and Dana Gold to develop a session best suited for the WSIB. They recommend an overview to cover governance, fiduciary duties, the relationship between boards and executive directors, the role of the board in strategy, and why good governance is a mechanism for fulfillment of fiduciary duties. In addition, the overview will address best practices for board governance to include due diligence, Board communication (internal and external), Board relations with management and stakeholders, and why good governance is an important factor for evaluating institutional health. After the overview, a facilitated discussion with the Board would be conducted that would try to help the Board come up with a governance framework for moving forward.

The Committee discussed the issue of continued facilitation by the Seattle University staff throughout the remainder of the retreat. Dean Testy indicated that it may be helpful to have the initial discussion to find a framework and best practice model for moving forward through the rest of the retreat, as this approach provides a foundation for other topics the board may want to work through. The Committee determined that the Seattle University staff should join the retreat informally on Wednesday evening, and conduct their governance session on Thursday morning.

### **SARBANES OXLEY FOR VOLUNTARY COMPLIERS**

Ms. Whitmarsh explained that last spring Ms. Vandehey conducted an education session on Sarbanes Oxley (SOX) for the Audit Committee and the committee expressed an interest in better understanding the provisions of SOX that staff would like to implement and why the WSIB would want to become a voluntary complier with SOX. Staff has completed its initial analysis of what provisions of SOX are most beneficial and relevant to voluntary compliers and has a proposal for moving forward, with a focus on Section 404, which is the provision related to controls over financial reporting.

There are three main provisions of SOX of interest to the WSIB: Section 201 – 204, relating to auditor independence; Section 302, dealing with management's attestation to the financials; and Section 404, which is designed to improve the controls around financial reporting.

Ms. Whitmarsh reviewed each of these provisions, noting where the WSIB is well positioned to be a voluntary complier and laid out a plan for improving compliance.

Mr. Nakahara asked who at the WSIB, is the equivalent of a CFO to certify the financials as required under SOX. Ms. Whitmarsh indicated that it could fall to her position or that of the comptroller. Mr. Nakahara asked if Ms. Whitmarsh fit the profile of a CFO, to which Ms. Whitmarsh replied she did not and we currently do not have one person or position that fits the profile. She indicated staff would work with a consultant to determine how that certification should take place.

**Mr. Masten moved that the Audit Committee forward the plan to voluntarily comply with Sarbanes Oxley Section 404 to the Board. Mr. Scott seconded and the motion passed unanimously.**

### **INTERNAL AUDITOR EVALUATION**

Chair Murphy called the Audit Committee into executive session at 11:45 a.m. to review and discuss the performance of a public employee. The executive session was expected to last about 15 minutes, at which time the Audit Committee would reconvene in open session.

[The Audit Committee reconvened in open session at 11:54 a.m.]

### **OTHER ITEMS**

There was no further business to come before the Committee and the meeting adjourned 11:54 a.m.