

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
January 31, 2007

The Audit Committee met in open public session at 9:05 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
 Sandy Matheson
 Bob Nakahara
 Dave Scott

Others Present: Joe Dear, Executive Director
 Theresa Whitmarsh, Chief Operating Officer
 Diana Will, Senior Investment Officer – Asset Allocation
 Steve Verschoor, Investment Accounting Controller
 Alicia Markoff, Portfolio Administrator
 Shawna Killman, Internal Auditor
 Kate Sandboe, Corporate Governance Officer
 Rita Wineinger, Administrative Assistant

Paul Silver, Assistant Attorney General
Patricia Kecht, State Auditor’s Office
Ray Holmdahl, Peterson Sullivan

[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 9:05 a.m.

ADOPTION OF THE NOVEMBER 1, 2006, MINUTES

Mr. Scott moved to approve the November 1, 2006, Audit Committee meeting minutes. Ms. Matheson seconded the motion.

Mr. Dear indicated that Mr. Kaminski requested changes to the minutes to add Mr. Kaminski’s question and staff’s answer regarding the names of the executive management team members.

The above motion to approve the minutes, as corrected, carried unanimously.

FISCAL YEAR 2006 STATE AUDIT REPORT

Ms. Kecht, State Auditor’s Office (SAO), provided the SAO exit conference memo from the Fiscal Year 2006 audit of the WSIB. The audit was conducted for the period beginning July 1, 2005 and ending June 30, 2006 and covered accountability for public resources /

compliance with state laws and regulations; financial statements; and federal compliance. The auditor did not examine every portion of the Board's financial activities during the audit. The areas examined were those representing the highest risk of noncompliance, misappropriation or misuse of public resources. There were no recommendations reported to the Board in the prior audit, and no findings or management letter items were noted in this audit.

FISCAL YEAR 2006 FINANCIAL STATEMENT AUDIT

WSIB Independent Auditor Report

Shawna Killman, Internal Auditor, introduced Steve Verschoor, Investment Accounting Controller, and Ray Holmdahl of Peterson Sullivan, to provide the results of the independent audit of the Board's Fiscal Year 2006 financial statements. Mr. Verschoor referred Committee members to the financial statements located in the Annual Report. Mr. Nakahara asked if the WSIB annual budget was part of the Peterson Sullivan audit. Mr. Verschoor indicated it was not part of the audit.

Chair Murphy asked for clarification from Peterson Sullivan regarding the reference made in the Independent Auditor Report for the Retirement Funds to investments where fair values have been estimated by management in the absence of readily determinable fair values. Mr. Verschoor explained that because there are not readily determinable market values, the information is obtained from the managers. Mr. Holmdahl explained that one of the recommendations from Peterson Sullivan is for management to review the recently released American Institute of Certified Public Accountants practice aid for auditors "Alternative Investments – Audit Considerations" to consider and ensure control procedures at the WSIB comply with those required in the Practice Aid. Chair Murphy asked what procedural recommendations Peterson Sullivan could give management to feel comfortable with the values provided by the managers. Mr. Holmdahl explained that the Audit Guide speaks to procedures such as outlining standard procedures for alternative investments, documentation of the underlying investments, and ensuring fund managers are contacted on a regular basis. Mr. Nakahara asked if most of the fund managers are audited as well, and if so, should that give the Committee a sense of comfort. Mr. Holmdahl indicated that approximately 80% of general partners in the industry are audited and our attention should be focused on the 20% that are not. Mr. Verschoor indicated that all of the WSIB's general partners are audited. Chair Murphy asked if the underlying companies were audited as well. After some discussion, Mr. Holmdahl indicated that he would hope the general partners would be looking into that level of detail as well.

Mr. Kaminski asked if there was a difference in the internal rate of return to a fund if an investment is held at cost until such time as it is liquidated versus an investment that is carried at cost initially and then is gradually marked up until it is disposed of. Ms. Will, Senior Investment Officer for Asset Allocation responded, indicating that there is no difference in the internal rate of return.

Mr. Holmdahl also stated that from an overall audit perspective, Peterson Sullivan has worked with management on a day to day basis, but realizes that the ultimate reporting

responsibility is to the Board. The independent auditors examined each fund which resulted in a clean audit for the WSIB.

Mr. Scott moved to approve the Independent Auditor Report. Ms. Matheson seconded the motion and the motion carried unanimously.

Internal Control Review and Recommendations

During the audit of the 2006 financial statements, Peterson Sullivan also conducted an in depth review of the WSIB's internal controls over financial reporting. This was the first step to determine what the WSIB would need to do if it chose to become a voluntary complier with Sarbanes-Oxley Act (SOX) Section 404.

Ms. Whitmarsh, Chief Operating Officer, indicated that at the September Audit Committee meeting she recommended and received approval from the Committee to give an additional work assignment to Peterson Sullivan in relation to internal controls. The letter provided by Peterson Sullivan indicates their recommendations regarding the WSIB's internal controls. It is important to note that this is short of a full SOX internal control review and is intended to make some sort of cost benefit analysis of whether the WSIB should pursue a full SOX internal control review. This letter addressed the two areas that could be improved in regard to internal controls. The first recommendation is related to the alternative investment valuation issue. The second involves spreadsheet controls. In addition, Peterson Sullivan provided a summary of what it would take to become SOX Section 404 compliant.

Chair Murphy asked what management's response is to these recommendations.

Ms. Whitmarsh indicated that management is in full agreement with the two recommendations and included in the handouts is an External Audit Quarterly Status Report outlining the recommendations and management's response. Ms. Whitmarsh will develop a project plan to address the two recommendations and present that, with expected completion dates, at the next Audit Committee meeting.

The Committee discussed the four steps outlined by Peterson Sullivan to become a voluntary complier with SOX 404. Ms. Whitmarsh stated that this independent review is the first step in conducting the evaluation of whether or not it is of benefit to pursue becoming a voluntary complier. The areas Peterson Sullivan have identified as needing improvement will be evaluated in the next two years in conjunction with the accounting system review, as the FCS contract will be re-bid, and the data warehouse project.

Ms. Whitmarsh indicated she believes it would be premature to begin further documenting the internal controls, as these will change over the next couple of years. Mr. Holmdahl indicated that the Public Company Accounting Oversight Board (PCAOB), who regulates implementation and compliance with SOX 404, will be simplifying the requirements and costs associated with compliance with SOX 404. He further stated that the WSIB has a strong tone at the top and he recommends waiting for the new requirements to be set before implementing change to become a voluntary complier. Ms. Matheson stated that the WSIB should do what is cost effective, but make sure the internal controls are as good as they can be to protect assets. Mr. Kaminski requested a copy of the overview of the new standard.

Mr. Holmdahl indicated he would scan the article and send it to Ms. Whitmarsh for distribution.

Ms. Whitmarsh clarified that the way the letter from Peterson Sullivan is structured, if taken, the four steps listed would move toward SOX 404 implementation. Staff will provide a high level overview and analysis of those four steps at the next Audit Committee meeting. The Committee requested that the four steps listed in the Peterson Sullivan letter be added to the External Audit Status Report with updates provided periodically to the Committee. Ms. Whitmarsh indicated staff will develop a work plan and present recommendations at the next Audit Committee. Chair Murphy also requested that the WSIB Information Systems staff contact the Office of State Treasurer Information Systems staff to discuss best practices for selecting and implementing a new accounting system.

Ms. Matheson moved to approve the Internal Control Review Report. Mr. Scott seconded the motion and the motion carried unanimously.

[The Committee took a recess at 10:19 a.m. and reconvened in open session at 10:27 a.m.]

INTERNAL AUDITOR REPORT

Audit Committee Charter 1.00.130 and Internal Audit Charter 1.00.190 Revision

Ms. Killman proposed revisions to the Audit Committee Charter 1.00.130, and the Internal Audit Charter 1.00.190. Additions to the Audit Committee Charter include the duties of reviewing the WSIB financial statement audit results, significant adjustments, suggestions for improvement of the financial reporting process, and status of legal matters that may effect the financial statements. The Internal Audit Charter update reflects the delegated responsibility of managing contracts for the firms hired to perform audit-related services to Internal Audit, making it consistent with the Audit Committee Charter.

Mr. Scott moved to accept the proposed revisions to the Audit Committee Charter 1.00.130 and the Internal Audit Charter 1.00.190 and forward it to the Board for approval. Ms. Matheson seconded the motion.

Mr. Nakahara stated that he asked Peterson Sullivan to review the Audit Committee Charter and Mr. Holmdahl agreed to perform the review, although this review would not delay adoption of the proposed changes. Mr. Kaminski proposed striking the word “financial” in the first sentence of the Audit Committee Charter. Ms. Matheson proposed instead of removing the word “financial,” add “and related.”

Mr. Scott moved to amend the previous motion to add the words “and related” to the first sentence of the Audit Committee Charter 1.00.130. Ms. Matheson seconded the motion and the amended motion carried unanimously.

Internal Audit Report – Cash Overlay Program Management

Ms. Killman presented the Internal Audit Report 2007-01, Cash Overlay Program Management. The objectives of this audit were to determine whether the overlay manager, Russell Implementation Services Inc. (Russell), has internal governance, ethics, compliance, and risk management programs in place and operating; determine if the overlay manager is meeting the scope of services required under the contract; and to determine whether the overlay manager has adequate internal controls in place to ensure an accurate accounting of the WSIB financial data and transactions is maintained.

The overall assessment of the cash overlay program management is good. Russell has adequate internal controls in place to ensure WSIB financial data is accurate, an internal governance program in place and operating, and is in compliance with the WSIB contract agreement. However, the following recommendations and associated management action plans to take advantage of resources currently available to monitor the contract more efficiently were noted during the audit:

1. Recommendation: The WSIB currently uses the Charles River Compliance System to independently monitor its external investment managers' compliance with established contract guidelines. As this may be an efficient way to monitor the Russell contract guidelines, Ms. Killman recommends the WSIB Compliance staff determine whether contract guidelines included in the WSIB Contract for Cash Overlay Program Management can be monitored through the use of the automated compliance system furnished by the Custody Bank. This is a Level 2 recommendation.
Management's Action Plan: The contract for the Cash Overlay Program has been reviewed by the compliance team and the guidelines are being automated in the Charles River System as of January 31, 2007.
2. Recommendation: During the audit, all documentation had to be requested in advance, produced and redacted by the manager, and then provided to the auditor. The nature and timing of testing had to be adjusted to accommodate this process. Ms. Killman recommends WSIB staff work with legal counsel to review contract language regarding audits. This is a Level 3 recommendation.

Chair Murphy asked why this was a Level 3 recommendation instead of a Level 2. Ms. Killman indicated that it is because she was able to obtain the documentation, it was just more cumbersome. Chair Murphy asked Ms. Killman to change this recommendation to a Level 2 prior to taking it to the Board.

Management's Action Plan: Management will work with legal counsel to review the standard language inserted into contracts regarding the WSIB's access to documentation for the purposes of conducting audits.

3. Recommendation: Given the confidentiality restrictions noted in recommendation 2, Ms. Killman recommends WSIB staff consider reviewing the SAS 70 audit reports of its external investment managers. This is a Level 2 recommendation.
Management's Action Plan: Management will work with the contracts administrator and the compliance officer to determine if there is value in conducting reviews of external managers'

SAS 70 audits during the procurement process and/or as part of ongoing manager compliance monitoring.

Mr. Scott moved to accept the Cash Overlay Program Management Audit Report 2007-01, and forward it to the Board for approval. Ms. Matheson seconded the motion and the motion carried unanimously.

2006 – 2007 Internal Audit Plan Update

Ms. Killman presented an update to the 2006 – 2007 Internal Audit Plan. The plan was changed to accommodate internal audit's contract management duties related to the financial audit and the SOX internal control review, performance of consulting services designed to improve operations, additional resource requirements to complete the cash overlay audit, and taking the 2007 Audit Committee meeting schedule into account. The investment performance reporting audit was postponed and the audit of the active emerging markets managers has been dropped from the schedule. However, the next annual audit plan will be completed in May 2007, so a new risk assessment will be performed and audits ranked at that time.

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendation Status Report. As of this quarter, no outstanding internal audit recommendations remain. Since the last quarterly Audit Recommendations Status Report in November 2006, the WSIB Private Equity investment staff has completed capturing partnership terms electronically within the new contacts management database. The Cash Overlay Program Management recommendations will be added to monitor management's response and resolution.

Chair Murphy asked for clarification regarding how the status information was obtained. Ms. Killman indicated it was obtained through informal conversation with staff and that there is not typically follow-up testing conducted.

PROXY VOTING

Private Equity Executive Compensation Policies

Ms. Sandboe, Corporate Governance Officer, reported on Private Equity Compensation Policies, as requested at the November 1, 2006 Audit Committee meeting. Staff spoke with Perry Golkin, at KKR, and Jim Williams, at Texas Pacific Group (TPG), about their firms' policies. Both stressed that pay-for-performance is a critical element in their executive compensation packages.

When KKR hires a CEO, he or she is given an equity compensation package with very specific performance goals. Mr. Golkin said pay-for-performance is exactly that, that there will be times when executives make a lot of money, but only when they make a lot of money for KKR and its partners. Mr. Golkin also stressed that KKR is not hesitant to fire people or take corrective action if someone is not meeting their performance goals. He said executives they hire are expected to work hard and perform.

Mr. Williams, who chairs the compensation committee at TPG, also said that pay-for-performance is a strong theme/element in their executive compensation packages. He said compensation is thin on perks and retirement because it is very performance-focused. The key elements in TPG's executive

compensation are: alignment of the executive team and shareholders; very equity and ownership-focused, they want executives to be owner/operators; CEOs are expected to invest in the company the same way the private equity firms do; there is greater emphasis on long-term equity growth than near-term cash compensation; performance is emphasized over tenure or security. TPG's base compensation is at or below the median of the market place, but incentives are at or above the market place. Equity compensation is weighted very heavily – probably in the 90th percentile of the market.

Chair Murphy asked Ms. Sandboe why only two Private Equity partners were contacted. Ms. Sandboe indicated that these two partners represent a large portion of the WSIB portfolio and would be representative of the larger group. Mr. Dear indicated that he felt the two partners that were contacted would provide a feel for the similarities and differences in compensation practices. Chair Murphy expressed his disappointment that only two partners were contacted. Ms. Matheson indicated that it may be helpful to look at the different motivations regarding executive compensation practices for public companies as opposed to private companies. Mr. Nakahara also wanted information from Private Equity partners about their practices regarding post-employment benefits and severance packages. The Committee directed that Ms. Sandboe contact two more companies regarding CEO compensation, as well as compare private equity compensation and public equity compensation.

DAILY VALUED FUNDS ANNUAL REPORT

Ms. Markoff, Portfolio Administrator, provided the daily valued funds (DVF) annual report. She reported that there have been no errors above or below the tolerance level that impacted any of the five DVF's (Savings Pool, Bond Fund, and Short, Mid, & Long Horizon Funds) closing unit prices. There were no instances where the funds were unable to complete calculating the day's unit price, the managers' or bond prices were unable to be obtained, or delays in closing that were specific to WSIB. Based on the policy, this report will be brought to the Audit Committee again next year. However, the Board will continue to be notified timely of any error that impacts the unit price by more than the tolerance level, \$0.01/unit.

OTHER ITEMS

Mr. Kaminski asked when the annual budget review has been scheduled for the Audit Committee. Mr. Dear indicated that staff would present the fiscal year budget to the Administrative Committee in June. The Committee requested a review of the budget to date at the next Audit Committee meeting.

[Ms. Matheson departed at 11:12 a.m.]

Chair Murphy noted that he has a conflict on the next scheduled Audit Committee meeting date and that staff would work with the members to reschedule.

There was no further business to come before the Committee and the meeting adjourned 11:16 a.m.