

**WASHINGTON STATE INVESTMENT BOARD**  
**Audit Committee Meeting Minutes**  
**May 15, 2007**

The Audit Committee met in open public session at 1:00 p.m. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present:           Sandy Matheson, Chair  
  Charlie Kaminski  
  George Masten  
  Bob Nakahara  
  Mason Petit  
  Dave Scott

Others Present:                           Joe Dear, Executive Director  
  Theresa Whitmarsh, Chief Operating Officer  
  Steve Verschoor, Investment Accounting Controller  
  Beth Vandehey, Risk and Compliance Director  
  Shawna Killman, Internal Auditor  
  Rita Wineinger, Administrative Assistant

Paul Silver, Assistant Attorney General  
Heidi Algieri, State Auditor's Office

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

Chair Matheson called the meeting to order at 1:00 p.m.

**ADOPTION OF THE JANUARY 31, 2007, MINUTES**

**Mr. Masten moved to approve the January 31, 2007, Audit Committee meeting minutes. Mr. Petit seconded the motion and the motion carried unanimously.**

**STATE AUDITOR'S OFFICE 2007 ENTRANCE CONFERENCE**

Ms. Algieri presented the WSIB's entrance conference for the Fiscal Year 2007 State Auditor's Office (SAO) audit. The audit will cover the period beginning July 1, 2006, and ending June 30, 2007. The audit was planned using a risk-based audit approach in these general areas: accountability for public resources; compliance with state laws, regulations, and agency policies; financial statements; and federal compliance. The audit will include the following areas: business continuity, contracts, conflict of interest, disbursements, the Innovation Portfolio, investment holdings, investment management fees, internal control for all investment funds, and the pension funding stabilization account. In the area of financial statements, the State Auditor will place reliance on the independent CPA firm audit of the WSIB statements that will occur later in the year. The SAO audit reports include: Accountability Reports, Independent Auditor's Comprehensive Annual Financial Report (CAFR) Opinion, and a Single Audit Report.

Mr. Masten asked if the audit of investment management fees would only involve ensuring that the WSIB paid the right amount to managers. Ms. Algieri said that was correct.

## **INTERNAL AUDITOR REPORT**

### **State Auditor's Office Public Records Request Performance Audit**

Ms. Killman reported that the WSIB is one of ten state agencies selected by the SAO for a performance audit of its public records request policies and procedures. The objectives of the SAO performance audit will address how effective the WSIB is at providing public records in a prompt and cooperative manner; and how effective the WSIB is at complying with state law and incorporating model rules that increase their ability to satisfy public records requests in a prompt and cooperative manner. SAO will provide the final report in July 2007, and staff will share the results at the next Audit Committee meeting.

### **Fiscal Year 2007–2008 Internal Audit Plan**

Ms. Killman presented a summary of the activities of Internal Audit during Fiscal Year 2006 – 2007, as well as areas she has selected for audit review in the coming year. Three of the four audits planned for 2006-2007 have been completed. The fourth audit was not completed due to competing priorities of the Internal Auditor. Other activities conducted by the Internal Auditor in 2006-2007 included attending training, providing training to the Audit Committee, coordination with the SAO and WSIB staff for the Fiscal Year 2006 accountability audit, Fiscal Year 2007 audit planning, acting as the contract manager for external audits, conducting a Financial Control Systems (FCS) security access review, and acting as a consultant to management and the Enterprise Risk Management team.

Mr. Nakahara raised concern about the Internal Auditor being referred to as a consultant and prefers the term “subject matter expert.” Ms. Killman indicated the standards for an Internal Auditor include consulting services, as long as the requirement to maintain independence is achieved, and agreed that the term “subject matter expert” implies independence.

Ms. Killman explained that there are four broad audit areas within the WSIB: investment management, investment operations, external parties, and business operations. Internal Audit met with each unit manager to complete scoring worksheets to assess areas of risk. From this risk assessment, the following areas have been selected for the Fiscal Year 2007-2008 Audit: daily funds transaction processing, daily cash trades – tickets, confirmations, trade processing, financial control systems, deferred compensation managers, and petty cash. Ms. Killman also plans to hire and train a new auditor in the coming year.

Mr. Nakahara asked what the petty cash balance is and who serves as the custodian.

Ms. Killman indicated Celina Verme, Finance & Administrative Services Manager, is the custodian and the balance is \$200.

Mr. Kaminski asked if consideration has been given to auditing the Board's activities. Mr. Dear indicated that a number of the Board's activities are reviewed by internal audit, the State Auditor's Office, and the compliance area. Mr. Masten raised concern regarding the Internal Auditor, who reports to the Board, conducting an audit of the Board. Ms. Killman indicated that it isn't uncommon for an independent auditor to conduct a fiduciary audit of boards; and offered to obtain

additional information and provide to the Committee if interested. Chair Matheson indicated that would be helpful, and informative for them to hear about.

**Mr. Petit moved to accept the Fiscal Year 2007–2008 Internal Audit Plan.  
Mr. Masten seconded the motion and the motion carried unanimously.**

### **Audit Report 2007-02, Investment Performance Reporting**

Ms. Killman presented Internal Audit Report 2007-02, Investment Performance Reporting. This area was last audited in January 2004, which prompted recommendations that resulted in the report preparation process assignment being moved to Public Affairs from Investments, automation of custom benchmark calculations, and template improvements to customize the report.

The objectives of this audit were to review, document, and assess the controls surrounding the preparation of the performance data, graphs, and written market analysis; and to determine whether the information included in the performance reports is accurately presented and adequately supported.

Ms. Killman indicated the performance reports are supported and materially accurate, however, she identified the following recommendations that would strengthen the controls around the reporting process:

1. Recommendation: To reduce the risk of errors made during the report preparation process, management should continue to work toward automating the process as much as possible. This is a Level 2 recommendation.  
Management's Action Plan: Management has two initiatives underway that will improve automation of report compilation and preparation. The custody conversion to JPMorgan Chase and the data warehouse will automate many report processes. Management has made automation a major focus for both initiatives.
2. Recommendation: To ensure performance reports are presented accurately, a more thorough review process should be designed, implemented, and monitored. Roles and responsibilities in the review process should be clarified, as errors were noted in performance reports after going through the review process. There are also reports that are currently not subject to an established independent review process. This is a Level 1 recommendation.  
Management's Action Plan: Management plans to develop a more robust review process with clearly defined review guidelines, procedures, and clear responsibilities. The review process will be tested every quarter for the next year, and then annually thereafter.

Mr. Petit asked how large the errors identified were. Ms. Killman indicated it was not the size of the error that was of concern, but that there were numerous errors. Mr. Masten inquired if the errors found were material. Ms. Killman explained that there were not material errors, but more housekeeping errors which could affect the reputation of the Board, as the report is distributed to stakeholders. Mr. Dear indicated that any Level 1 recommendation receives immediate response from management. The data warehouse project and the transition to a new custodian bank will provide opportunities to improve the system and reduce the opportunity for errors in the future; however, more rigorous reviews will be conducted in the meantime. Ms. Killman also commented

that the staff responsible for the report is working closely with the transition teams on both the custodian transition and the data warehouse projects to ensure requirements of the performance reports are included in the design. Mr. Nakahara asked if the errors noted in the report affect the external stakeholders. Mr. Dear explained that most errors were immaterial with the exception of one, which was reported to the Department of Retirement Systems immediately.

3. **Recommendation:** Outstanding tax reclaim receivables should be periodically reviewed by staff to ensure funds due to the Board are received in a timely manner. With the upcoming custodian bank transition, it will also be important to research the old receivables prior to the transfer of responsibilities to the new bank contractor. This is a Level 3 recommendation.  
**Management's Action Plan:** Management plans to have staff review all outstanding tax reclaims with State Street Bank, write-off past due reclaims deemed uncollectible, and aggressively pursue collection of open reclaims. Going forward, staff will have JPMorgan Chase develop a special report on outstanding items and the estimated collection periods, and will continue to monitor on a regular basis.

Mr. Petit asked if it is possible to collect all outstanding tax reclaims. Ms. Killman indicated that staff is working with the bank to determine how collectible they are.

**Mr. Masten moved to accept Internal Audit Report 2007-02, Investment Performance Reporting, and forward it to the Board for approval. Mr. Petit seconded the motion and the motion carried unanimously.**

#### **Audit Recommendations Status Report**

Ms. Killman presented the Audit Recommendation Status Report. Since the last quarterly status report in January 2007, three recommendations relating to the Cash Overlay Management Audit were added to the tracking list and resolution work began.

The Committee discussed the first recommendation, noting that compliance staff is awaiting assistance from State Street Bank to ensure all compliance tests are working correctly.

Ms. Whitmarsh explained that staff will continue to work with State Street Bank; however, the issue will be resolved with the transition to the new custodian bank. In response to Mr. Kaminski's inquiry regarding boiler plate language within contracts, Mr. Silver explained that efforts have been undertaken to streamline and agree upon standard templates. This effort has proven to be impossible due to resistance within the industry. Staff is working toward standard language for each WSIB contract to ensure we are proposing the same language consistently.

#### **Internal Audit Position Recruitment and Audit Charter Revisions**

Ms. Killman indicated that recruitment to fill the new internal audit position that was approved during the budget process is underway, and revisions to the Audit Committee Charter 1.00.130 and the Internal Audit Charter 1.00.190 are proposed to add clarity and reflect that the internal audit function will now have a manager position.

Mr. Masten raised a concern regarding the appointing authority for the new internal audit position. He indicated the change to the Charter did not indicate clearly that the Executive Director approves the final candidate.

**Mr. Masten moved to forward the Audit Committee Charter 1.00.130 and Internal Audit Charter 1.00.190 revisions to the Board without recommendation. Mr. Petit seconded the motion and the motion carried unanimously.**

## **FISCAL YEAR 2007 FINANCIAL STATEMENT AUDIT**

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

Ms. Killman explained that 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 2007. 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 as of June 30, 2007, and the related statements of changes in net assets, including footnote disclosures and supplementary information for the year ended, prepared by the WSIB; (2) Express an opinion on each set of financial statements prepared by the WSIB, at the conclusion of the audit; (3) Conduct the audit in accordance with auditing standards generally accepted in the United States; and, (4) Allow SAO staff access to appropriate working papers for the purposes of placing reliance on the contractor's opinion as it relates to the CAFR.

**Mr. Masten moved to approve the scope of work for an audit of the Fiscal Year 2007 financial statements prepared by the WSIB. Mr. Petit seconded the motion and the motion carried 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 2007 financial statements. She also presented the independence statement of Peterson Sullivan, indicating their independence from the WSIB.

In response to a Committee member's questions, Ms. Killman and Mr. Dear explained that this would be the second audit that Peterson Sullivan PLLC has performed for the WSIB, if appointed, and the estimated engagement fee is \$50,000.

**Mr. Masten moved to appoint Peterson Sullivan PLLC to perform the Fiscal Year 2007 audit of the financial statements prepared by the WSIB. Mr. Petit seconded the motion and the motion carried unanimously.**

[The Committee took a recess at 1:56 p.m. and reconvened in open session at 2:04 p.m.]

## **PETERSON SULLIVAN INTERNAL CONTROLS REVIEW**

### **Alternative Investments – Valuation Issues**

Ms. Whitmarsh provided an overview of the work conducted by Peterson Sullivan PLLC last year regarding internal controls over financial reporting, as well as the requirements of voluntarily complying with the provisions of Sarbanes Oxley – Section 404 (SOX). She explained that Peterson Sullivan PLLC provided two recommendations to improve internal controls and described what would be necessary to become a voluntary complier with SOX.

Mr. Verschoor reported on the valuation issues with alternative investments, which were noted as a high risk area related to internal control over financial reporting by the outside auditing firm of Peterson Sullivan PLLC. Staff reviewed the newly released Practice Aid for Auditors – Alternative Investments – Audit Considerations by the American Institute of Certified Public Accountants (AICPA) and determined the WSIB will need to design and implement additional internal control procedures in order to provide auditable evidence that complies with the Practice Aid.

Although the Practice Aid discussed many areas of alternative investments, listed below are important areas that need to be considered by the WSIB as development of additional policies and procedures progresses. Management needs to:

1. Ascertain reasonable valuation methods are being used.
2. Have sufficient understanding of the nature of the underlying investments, portfolio strategies, and methods of assumptions used to value the investments reported in the financial statements.
3. Be responsible for the valuations as presented in the financial statements.
4. Establish auditable evidence that it has reviewed and accepts the financial statement valuations.
5. Implement a process of internal controls to ensure the investment valuations reported in the WSIB financial statements are in accordance with its stated accounting policies.
6. Provide appropriate confirmations related to alternative investments to the auditors.

Mr. Verschoor discussed the current processes and the enhancements that are planned. Currently, staff of the Private Equity unit sit on advisory committees for most of the WSIB's private equity partnerships, where valuations are discussed. However, the main source of investment valuations that the WSIB relies on is the audited annual financial statements, which partnerships make available to the WSIB. The partnerships are required by Generally Accepted Accounting Principles (GAAP) accounting standards to price their portfolios at fair market value and are audited to GAAP standards. The major accounting firms are developing additional expertise in the valuation area in order to comply with the Practice Aid. Real Estate staff also has active participation and oversight of the real estate partners, where valuation is reviewed regularly.

The enhancements include crafting a valuation policy, which will describe the WSIB's understanding of the Practice Aid and its selected approach in implementation. The process to be developed to comply with the policy will include creating a review and tracking system to ensure the WSIB has received and reviewed the audited financial statements of our partnerships where the valuation assertions are made, understands the methodologies used by the partnerships, and agrees the methodologies conform to WSIB policy. The compliance unit will create a process to randomly review certain partnerships' valuations each year so we gain our own independent view.

[Mr. Scott arrived at 2:11 p.m.]

The compliance unit will also work with investment staff to establish a process that documents they understand the nature of the underlying investments, the portfolio strategy of the alternative investment, and the method and significant assumptions used by the fund manager to value the

underlying investments. In discussions with investment staff, it is obvious they do monitor these aspects of the active partnerships, but an audit trail has not been established. The Investment Accounting unit will review its internal controls over the process to ensure that its alternative investments are recorded at amounts in accordance with its stated accounting policies.

The Committee discussed the current practice and the proposed process improvements. Mr. Nakahara asked if WSIB has the level of proficiency to review the valuations, and whether the external auditing firm had assessed WSIB staff's technical abilities to perform the valuation review. Ms. Whitmarsh indicated that Peterson Sullivan had not opined on staff's technical abilities; however, the methodologies are not complex and she is confident staff can review valuations to ensure they are being calculated correctly. Ms. Whitmarsh further commented that Peterson Sullivan PLLC had reviewed the proposed approach and believed it to be a sufficient resolution.

### **Spreadsheet Controls**

Mr. Verschoor reported on the issue of reliance on electronic spreadsheets in the preparation of the financial statements, noted by Peterson Sullivan PLLC. The auditing firm suggested the WSIB consider its current controls over spreadsheets and design procedures to ensure there are adequate controls in place over access, changes, reconciliation, and review.

Mr. Verschoor explained staff reviewed the recommendations and is in the process of working with WSIB's investment accounting firm, Financial Control Systems, to further automate several of the spreadsheets used in the preparation of the financial statements. This will reduce the reliance on spreadsheets in the development of the financial statements, but not eliminate it completely. Staff will perform an inventory of the remaining spreadsheets to determine which ones could be further automated. For the spreadsheets not automated, staff will develop and document internal controls and procedures.

### **Sarbanes Oxley Section 404**

Ms. Whitmarsh reported on the requirements of voluntarily complying with the provisions of Sarbanes Oxley – Section 404 (SOX), as directed by the Audit Committee at their January meeting. She explained that Peterson Sullivan PLLC reviewed the WSIB's internal controls as they relate to voluntarily complying with the provisions of Sarbanes Oxley – Section 404 (SOX) and reported to the Committee in January 2007, indicating that the WSIB's current internal controls are strong. She explained that staff has reviewed the requirements and is also of the opinion that the WSIB has excellent internal controls over financial reporting and would not gain significant benefit at this time from further documentation or from a formal third party review to express an opinion on the control environment. The WSIB continually reviews the control environment as business process improvements are made and will be working closely with the new custodian bank, JPMorgan Chase, to further enhance controls through the transition to their more automated systems.

If it is decided in the future that a more formal review of our controls and procedures should be conducted, staff would recommend hiring a SOX-proficient consultant to determine any improvements that could be made.

Chair Matheson asked if there were any components of SOX – Section 404 that made sense to implement at this time. Mr. Verschoor explained that some of the recommendations in SOX have

already been implemented. Mr. Dear indicated that implementing all of the recommendations does not seem to be a value added effort. Mr. Nakahara voiced his agreement with management that there is no cost benefit to fully implementing all SOX – Section 404 components. Mr. Scott noted that the goal of the WSIB should be to have adequate internal controls, rather than to be SOX-compliant.

#### **CONFLICT OF INTEREST POLICY 2.00.100 COMPLIANCE REVIEW**

Mr. Silver presented 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.

#### **BOARD POLICY COMPLIANCE REVIEW**

Ms. Vandehey presented the Board policy compliance review for the 2006 calendar year. Since the last report to the Audit Committee in June 2006, there was significant improvement in compliance with WSIB Board policies and charters. The WSIB has improved oversight responsibilities at the Board and Committee levels by adopting additional governance policies including human resource and communication policies, approving the strategic plan, and managing the Board self-evaluation process. Quiet periods and operating budget monitoring are two policy areas that need to be strengthened for 2007. Ms. Vandehey also said future reviews will be conducted on a bi-annual basis.

Mr. Scott asked to know the outcome of the reported non-compliance with the quiet period. Mr. Dear indicated that the requirements of the quiet period were brought to the Board Member's attention. In this case, it did not compromise the request for proposal process; however, if it had, the process would have had to be restarted.

#### **INTERNAL AUDITOR EVALUATION**

Chair Matheson called the Audit Committee into executive session at 2:40 p.m. to review and discuss the performance of a public employee.

[The Audit Committee reconvened in open session at 2:50 p.m.]

#### **OTHER ITEMS**

There was no further business to come before the Committee and the meeting adjourned 2:51 p.m.