

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
November 27, 2007

The Audit Committee met in open public session at 1:01 p.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

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

Others Present: Joe Dear, Executive Director
 Theresa Whitmarsh, Chief Operating Officer
 Liz Mendizabal, Public Affairs Director
 Steve Verschoor, Investment Accounting Controller
 Shawna Killman, Internal Auditor
 Kate Sandboe, Corporate Governance Officer
 Rita Wineinger, Administrative Assistant

Paul Silver, Assistant Attorney General
Ray Holmdahl, Peterson Sullivan PLLC
Mark Raker, Peterson Sullivan PLLC

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

Ms. Matheson chaired the meeting and called it to order at 1:01 p.m.

ADOPTION OF THE SEPTEMBER 28, 2007, MINUTES

Mr. Masten moved to approve the September 28, 2007, Audit Committee meeting minutes. Chair Matheson seconded the motion and the motion carried unanimously.

FINANCIAL REPORTING PROCESS AND UPDATE OF 2006 RECOMMENDATIONS

Update of 2006 Recommendations

Ms. Whitmarsh and Mr. Verschoor presented follow-up information on items related to spreadsheet automation and private markets valuations from the internal control review conducted by outside auditing firm Peterson Sullivan PLLC, last year. Significant progress has been made on both sets of recommendations and staff will update the Committee as work continues. In response to Chair Matheson, Mr. Verschoor explained that staff is continuing the process of working with our investment accounting system vendor, Financial Control Systems (FCS), to further automate spreadsheets used in

the preparation of the financial statements. This has helped reduce the reliance on spreadsheets, but has not completely eliminated their use. Staff continues to evaluate spreadsheets that would benefit most from automation and is working with FCS to develop them. Additional review controls have been put in place around those spreadsheets still used in the preparation of the financial statements.

[Mr. Nakahara arrived at 1:05 p.m.]

Ms. Whitmarsh explained that an Alternative Asset Valuation policy was drafted utilizing the requirements listed in the Practice Aid for Auditors – Alternative Investments. This policy is under review by investment staff for additional clarification and refinement.

Ms. Whitmarsh further explained that Compliance staff has developed Valuation Policy Manuals for both Real Estate and Private Equity that organize the relevant valuation documents from every partnership. Once compiled, Compliance staff noted exceptions which Investment Accounting and the Investment Officers are investigating further. The compliance review found a very high level of compliance with approved valuation methods. These manuals will be updated annually by staff to ensure compliance and provide auditable evidence to auditors.

Financial Reporting Process

Mr. Verschoor presented an overview of processes used to develop the annual financial statements as requested at the September 28, 2007, Audit Committee meeting. In response to Mr. Kaminski's question, Mr. Verschoor indicated there are roughly 500-1,000 transactions posted each month. Mr. Masten asked if the monthly reconciliations are automated.

Mr. Verschoor indicated that the monthly reconciliation process is automated and staff investigates any exceptions that are raised. Mr. Nakahara asked staff to have Peterson Sullivan review the financial report preparation process/diagram provided for accuracy.

FISCAL YEAR 2007 INDEPENDENT AUDITORS' REPORT

Mr. Holmdahl and Mr. Raker presented the Independent Auditors' Reports, along with their respective financial statements prepared by WSIB management. The auditor concluded in each case the financial statements were presented fairly, in all material respects. Mr. Raker indicated the audit of the Fiscal Year 2007 financial statements involved statements for each category of funds under management by the WSIB. He explained that, as part of audit standards, auditors accumulate adjustments during the audit process; however, there were none as a result of this audit. Mr. Holmdahl explained that, although auditors work on a day-to-day basis with management, it is understood that ultimately they report to the Audit Committee of the Board.

Mr. Masten asked at what threshold any small accumulated adjustments would become material. Mr. Holmdahl responded that the threshold is determined by a dollar amount for each fund; for example, in an organization with \$50 million in assets, the materiality threshold may be \$500,000.

Mr. Raker stated that Peterson Sullivan PLLC issued a management letter recommendation to the Board regarding improvements to certain investment risk disclosures. Those disclosures include the categorization of investments by maturity, and various credit quality ratings. The recommendation is that the preparation process should be reviewed by someone other than the preparer.

Mr. Raker indicated the auditor also reviewed two recommendations noted in their 2006 internal controls review. The tracking system for alternative investments was reviewed and found to provide a more robust audit trail. The documentation of general partner valuation techniques was adequate. When reviewing spreadsheet controls, they found the policies have not yet been finalized, but were able to see the financial reporting process improvements implemented by staff. Mr. Raker indicated that staff should include a process for version control and changes to formulas in the spreadsheets still being used, and these should be documented and reviewed. Policies will be reviewed during the next audit.

Mr. Masten moved to approve the Fiscal Year 2007 Independent Auditors' Reports. Chair Matheson seconded the motion and the motion carried unanimously.

INTERNAL AUDITOR REPORT

Audit Plan Update

Ms. Killman presented an update of the status on the current Fiscal Year 2007-2008 Internal Audit plan to include audit areas, time budget, and July – November 2007 activities. Ms. Killman also introduced Michelle Weiberg, who recently joined the Internal Auditor staff on November 1, 2007.

The 2007-2008 audit areas are: daily funds transaction processing, daily cash trades, Financial Control Systems, deferred compensation managers, and petty cash. An unannounced petty cash count was conducted and the funds were accounted for appropriately. The daily funds audit is underway.

Ms. Killman explained that Internal Audit activities include internal auditing, management consulting/board meetings, special reviews/contract management, internal audit administration/planning, audit liaison, and professional development.

Ms. Killman reported July–November 2007 activities included the following: Internal Auditor recruitment, petty cash count, daily funds audit, external audit liaison, custody structure management letter, audit issues database, May 2008 APPFA conference planning, ERM team consultant, professional development, management consulting, participation in an internal auditor panel at Saint Martin's University, as well as the Chief Audit Executive Group.

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendation Status Report. Since the last quarterly status report in September 2007, staff continues the work on the remaining two recommendations and the scheduled completion dates remain unchanged. Mr. Nakahara asked if management is comfortable with an expected completion date of December 31, 2007, for the second audit recommendation involving performance reporting that was ranked as a Level 1 (immediate action required). Ms. Whitmarsh indicated this was the original expected completion date and management is comfortable with the expected completion date; she also indicated significant progress has been made toward completion.

PROXY VOTING

2007 Proxy Season Voting Status Update

Ms. Sandboe presented a report on WSIB's voting record for the first 10 months of the 2007 proxy voting season.

Through October 15, 2007, the WSIB voted a total of 3,686 proxies. Proxy votes were cast on a total of 24,410 individual proxy proposals dealing primarily with election of directors, ratification of auditor, compensation plans, and shareholder proposals.

In a further breakdown of our proxy votes, the WSIB withheld votes from approximately 4,014 of the 18,159 director votes, which represents 22 percent of the total votes on this issue. Consistent with the WSIB proxy voting guidelines, the WSIB voted against 191 of 1,027 proposed executive compensation packages this year. The WSIB policy states that executive compensation should be directly lined with performance and for that reason, the WSIB voted "against" approximately 19 percent of the time. This year the WSIB also voted in favor of 41 proposals to allow shareholders an advisory vote on executive compensation plans. In response to a question from Chair Matheson, Ms. Sandboe explained withholding a vote is essentially a no vote.

Mr. Kaminski asked how research is conducted for those votes that were withheld. Ms. Sandboe explained that Glass Lewis & Co. provides a voting recommendation on every ballot that is voted and that those recommendations are in compliance with WSIB policy.

2008 Proxy Voting Season Issues

Mr. Cameron, President of Glass Lewis & Co., discussed the upcoming 2008 proxy voting season and highlighted what are expected to be the prominent issues of shareholder concern. Mr. Cameron anticipates that there will be a continued emphasis on controlling executive compensation and election of directors by a majority vote during the next proxy season. Previously, institutional investors expressed concern regarding plurality voting for directors. In the intervening time, majority voting has become more common than not in the S&P 500. Mr. Cameron believes that this distinct change is, in part, due to funds like the WSIB casting votes in favor of majority votes. Executive director compensation was another area in which the Board has concerns. In the last two years, there has been little progress related to CEO compensation; however, corporate boards are spending more time on this topic.

Mr. Cameron further explained that during the 2008 proxy season, the Service Employees International Union and the AFL-CIO will raise a very interesting proposal that would require companies to give a summary of the company's compensation plan including what the management team will receive if benchmarks are hit, and let shareholders vote on it--the "Say on Pay" initiative. This is common practice in the United Kingdom and in Australia, where CEOs are paid roughly one half to one third of what CEOs in the United States are paid. Mr. Cameron responded to a question from Chair Matheson, explaining more multi-year incentives for CEOs are anticipated.

Mr. Cameron indicated another 2008 proxy season issue is shareholder access to the ballot. In 2003, there was a proposal which would have allowed shareholders to put director nominees on the ballot. In response to a question from Mr. Dear, Mr. Cameron explained that there is an undeniable trend in two arenas, the rise of activist investors and the macro approach. In the macro approach, which is performance of the market as a whole, governance changes are one of the few weapons

available. He further stated that executive compensation accounted for 10 percent of the revenue of the S&P 500.

AUDIT COMMITTEE ROLE – WSIB 1.00.130 AUDIT COMMITTEE CHARTER

Ms. Matheson explained that at the previous Audit Committee meeting on September 28, 2007, Internal Audit presented an education session called *The Audit Committee: Purpose, Process, Professionalism*. The session provided a summary of the oversight responsibilities of audit committees, in general, and leading practices related to their current role.

Following the meeting, some Audit Committee members requested a review of the current WSIB Audit Committee Charter. Ms. Killman presented an overview of activities of the Audit Committee to assist it with oversight in the following areas/systems: risk management, internal controls, internal audit, external audits, compliance monitoring, financial reporting, and proxy voting. Mr. Kaminski raised a question regarding how the Internal Auditor communicates issues to the Committee privately. Chair Matheson explained that the Internal Auditor raises any concerns with the Committee Chair during their quarterly pre-meeting briefings conducted between the auditor and the Committee Chair, or more immediately if necessary. The Chair then determines whether or not the issue needs to be addressed by the entire Committee. Mr. Masten indicated that a Committee member can also raise issues to the Chair and then determine if the discussion should occur publicly or privately, in accordance with the open meeting requirements.

AUDIT COMMITTEE CALENDAR OF TOPICS

Chair Matheson indicated during the September 28, 2007, Audit Committee meeting, the Committee requested a report on its routine annual activities in a calendar for 2008 format. The Committee discussed improvements to future agendas to include clearly mapping agenda items to oversight activities noted in the Charter. Ms. Killman and staff responsible for agenda preparation will work together to provide a proposed agenda format to the Chair for approval based on those improvements at the next meeting.

OTHER ITEMS

There was no further business to come before the Committee and the meeting adjourned at 2:31 p.m.