MINUTES OF THE NINETY-THIRD MEETING OF THE AUDIT AND FINANCE COMMITTEE HELD ON JUNE 26, 2006

Pursuant to notice dated June 14. 2006 and a revised notice and agenda dated June 22, 2006, a copy of which is annexed hereto, the ninety-third (93rd) meeting of the Audit and Finance Committee of the NEW YORK STATE ENERGY RESEARCH AND DEVELOPMENT AUTHORITY ("Authority") was convened at 12:30 p.m. on Monday, June 26, 2006, in the Authority's 10th floor conference room at 485 Seventh Avenue, New York, New York, and by video conference in the Authority's board room at 17 Columbia Circle, Albany, New York, and by video conference in the Authority's board room at 617 Main Street, Suite 105, Buffalo, New York. The following members of the Committee were present:

Vincent A. Delorio, Esq., *ex officio* George Akel, Jr. (by video conference from Albany) Jay L. Gottlieb

Committee members Catell and Marusak were not able to attend.

Also in attendance were Authority Members Parker Mathusa, Frank McCullough, and Dr. Elizabeth Thorndike. In addition, Peter R. Smith, President and Chief Executive Office; Robert G. Callender, Vice President for Programs; Wendy M. Shave, Vice President for Administration and Secretary to the Board; Jeffrey J. Pitkin, Treasurer; Roger D. Avent, Esq., General Counsel; Sara L. LeCain, Esq., Assistant Counsel and Acting Secretary to the Audit and Finance Committee; Mark Mitchell, Director of Internal Audit; John Schiavone and Kristin Anderson from Lumsden & McCormick, LLP; John V. Connorton, Jr., Esq. from Hawkins Delafield & Wood, LLP; and various other members of the staff of the Authority were present.

Since Mr. Catell, Chair of the Audit and Finance Committee, was unable to attend, Mr. Gottlieb, Vice-Chair, acted in his stead. Mr. Gottlieb noted the presence of a quorum and indicated that the first item on the agenda concerned the approval of the minutes of the ninety-second meeting of the Committee held on April 3, 2006.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote, the minutes of the ninety-second meeting of the Committee held on April 3, 2006, were approved.

Mr. Gottlieb indicated that the next item to be considered was the Annual Investment Report ("Investment Report") of the Authority and the Investment Guidelines, Operative Policy and Instructions (June 2006) ("Investment Guidelines"). Mr. Pitkin explained that the Investment Guidelines set forth the policies and procedures for the investing, monitoring and reporting of the Authority's investments and that the Members are required to review and approve the policy annually pursuant to Public Authorities Law Section 2925.

On March 29, 2006, the Office of the State Comptroller ("OSC") issued revised regulations concerning investments by public authorities. In response to these revisions, Authority staff is recommending a few changes to the Authority's Investment Guidelines, including clarifying the Authority's investment objectives; providing for the Member's delegation of investment management responsibilities and for the setting of standards of conduct for those responsible for managing the Authority's investments; modifying the types of investments authorized by redefining eliminating Federal Government Obligations to include only those securities where the payment of principal and interest is unconditionally guaranteed by the federal government; providing more detailed policies on diversifying investments and limiting the length of each type of investment; and effecting other editorial and clarifying changes noted in the materials sent to the Committee members.

The Investment Report, which is also required to be approved annually by Public Authorities Law Section 2925, summarizes the Authority's investments and results of its investment activities. The Investment Report indicates that the Authority's overall investments increased from \$307.6 million to \$326.5 million, principally due to funds received for specific energy efficiency programs administered by the Authority which were not yet expended. It also indicates that the composition of the Authority's investments changed slightly from the prior year, with a reduction in the concentration of investments maintained in federal government obligations and a corresponding increase in the concentration of investments in certificates of deposit. This change was primarily made to segregate various new sources of funds for programs administered by the Authority without having to establish separate banking accounts.

The Authority purchases its investments with maturities that match its anticipated cash flow needs. The investment portfolio has been structured predominately with staggered maturities to accommodate short-term cash flow needs and also to provide for more stable investment results by reducing the affects of fluctuations in short-term interest rates. The weighted average term of investments was about 28 months (2.3 years), a slight decrease from the prior year average term

of about 35 months (2.9 years). The Authority's strategy of holding investments with staggered maturities has benefitted it well; it limits the Authority's exposure to fluctuations in short-term interest rates, which are often volatile, which also provided it with generally higher overall rates of return.

The Investment Report shows that while the total original cost of the Authority's investments was \$326.5 million and the value of investments on an amortized-cost basis (reflecting amortization of fixed-rate securities which are purchased at a discount and mature at par value) was \$339.7 million, the market value of investments on March 31, 2006, was \$335.3 million, or about \$4.4 million less than their amortized-cost value. As overall interest rates go up, the market value of fixed-rate investments goes down, so the result of overall general increases in interest rates has caused the current value of certain of the Authority's investments to decline. Since the Authority almost always holds investments to maturity, this difference is expected to be short-term in nature and is not expected to impact the ultimate return on the Authority's investments.

As a result of the generally higher market interest rates and slightly higher average balances available for investment, interest earnings for the fiscal year ended March 31, 2006 increased by \$1.6 million to about \$10.2 million and the rate of return on the Authority's investments was about 4.0%, an increase from the 2.7% return in the prior year.

As approved by the Members annually since 1994, the Authority participates in the New York State Excelsior Linked Deposit Program and has deposited funds with various banks under the program. These deposits earn interest rates of 2% to 3% less than the bank's normal rate for comparable certificates of deposit so that the bank will grant comparably reduced interest rate loans for eligible projects, which the Members limited to energy-related businesses or projects. The Authority had approximately \$1.3 million in investments under this program during the fiscal year, but no investments were held as of March 31, 2006 due to maturing loans.

The Investment Report also summarizes a list of fees and charges related to investments. For the fiscal year ended March 31, 2006, these fees and changes included payments of approximately \$193,000 to the New York State Department of Taxation and Finance, the Authority's fiscal agent, and payments of \$6,000 to the trustee for the West Valley State Service Contract Revenue bonds.

In addition, the Investment Report includes a report from the independent auditors Lumsden & McCormick LLC. In response to requirements under the OSC's revised regulations, the format of the auditor's report has changed from a "negative assurance" report (indicating nothing came to their attention to indicate that the Authority was not in compliance with the Comptroller's Investment Guidelines for Public Authorities) to a "positive assurance" report (indicating that the Authority did comply with the OSC's Investment Guidelines for Public Authorities and relevant sections of the Public Authorities Law).

Mr. Gottlieb stated that a resolution considering approval of the Annual Investment Report and Investment Guidelines would be considered after the Committee members met in executive session with the independent auditors.

Mr. Gottlieb stated that the next discussion item concerned the Authority's financial statements. Mr. Pitkin explained that the Committee members are requested to recommend adoption of a resolution approving the Authority's annual audited financial statements for the fiscal year ended March 31, 2006. The independent auditors will issue an unqualified opinion on the financial statements.

Mr. Pitkin explained that the financial statements include two restatements of the comparative results from the fiscal year ended March 31, 2005. These two restatements contained no new information, but simply present the information in a different manner. The first restatement was previously discussed with the Committee members at the April 2006 meeting and corrects the recording of program funds advanced to the Authority in 2004. Initially the funds were recorded as deferred revenue, but staff and the independent auditors subsequently determined that this treatment did not conform with applicable governmental accounting standards. Such standards require funds to be recorded as revenue upon receipt unless there are pre-established eligibility requirements which are unmet. Since there were no unmet eligibility requirements associated with these funds, staff consulted with the independent auditors and determined that it was appropriate to restate the prior year's results to reduce deferred revenue by about \$4.6 million. to increase third-party reimbursement revenue by about \$2.1 million, and to increase net assets restricted for program uses by about \$2.5 million.

The second restatement concerns a correction for the recording of investments. In 1999, governmental accounting standards were revised to require the recording of investments at book value or market value. Over time, as the Authority diversified the length of its investments.

changes in market interest rates caused more significant differences between book value and market value. In 2003 and 2004, decreases in market interest rates caused the market value of investments to be nearly \$5 million higher than their book value. In 2005, increases in market interest rates caused the portfolio's market value to be \$3.7 million less than its book value and \$4.4 million below book value as of March 31, 2006. Although differences between market value and the investments' costs are still believed to be short-term in nature, after consulting with the independent auditors, staff determined that it would be appropriate to adopt the requirements of listing investments at market value in order to be in line with the most current accounting practices. The adoption of the current standards resulted in the restatement and reduction of the prior year's recorded value of investments by about \$3.7 million.

Mr. Gottlieb emphasized that these two restatements contained no new information, but simply reported the information as required by government accounting rules.

Mr. Pitkin then continued by explaining that there is a change in the information reported on the Authority's financial statements. During fiscal year 2005-06, the Authority adopted Governmental Accounting Standards Board Statement ("GASB") No. 40, Deposit and Investment Risk Disclosures, which required additional information to be included in Note (3) of the Notes to Basic Financial Statements.

The independent auditors reported no instances of noncompliance or material weaknesses. The independent auditors also reported on certain matters required to be communicated to the Committee under relevant auditing standards.

Lastly, the materials for the meeting include a letter from the independent auditors containing observations or suggestions for improvement identified during the audit, commonly referred to as a management letter. Authority management's responses to the suggestions and observations contained in the management letter are summarized in a memorandum following the management letter.

One of the independent auditors' observations concerned the threshold for capitalization of fixed assets. The Authority's current accounting policy requires equipment purchased with a cost in excess of \$500 to be capitalized and depreciated, rather than to be recorded as a current period expense. The independent auditors note that this threshold could be raised to provide some administrative efficiencies and to be more appropriate given the overall size of the Authority.

After reviewing the fixed asset policies used by New York State and several public authorities, staff recommends raising the threshold from \$500 to \$2,500. Staff believes that \$2,500 provides for a reasonable threshold for the Authority's financial reporting and will provide for some administrative efficiencies. Following approval by the Committee, staff will seek approval from the OSC to change the Authority's accounting policy, as required by his revised regulations.

Another observation concerned a recommendation to change the methodology used to record accrued liabilities for program costs incurred but not yet billed to the Authority. The Authority's practice has been to base the accrual on an analysis of program invoices received after year end for the prior two fiscal years. The auditors suggest that using a longer period of historical results will reduce the effects of timing differences or anomalies in any one year. Staff concurs and will now use a 5 year average to calculate the accrual.

The auditors also reported on the work the Authority is doing to implement GASB Statement 45, which impacts the accounting for post-employment health insurance benefits. As previously reported to the Committee, the Authority has retained an actuary to perform the required calculations. Staff expect the calculations to be completed by the end of next month, and that they can be factored into the Authority's Budget for fiscal year 2007-2008.

Lastly, the report confirms that the Authority satisfactorily addressed a comment contained in the prior year's management letter to clean up vendor files in the accounting system.

Mr. Pitkin then introduced Peter Mahar, Controller and Assistant Treasurer, who discussed the financial statements in detail.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 313

RESOLVED, that pursuant to Section 105 of the Public Officers Law, the Members of the Audit and Finance Committee of the New York State Energy Research and Development Authority shall convene in executive session for the purpose of reviewing the financial condition of the Authority.

The Committee members then met in executive session with the independent auditors.

Mr. Gottlieb reconvened the meeting in open session. Mr. Gottlieb announced that no formal action was taken during the executive session. Mr. Gottlieb stated that the Committee members had a complete and thorough discussion with the independent auditors, that the independent auditors stated that Authority staff was responsive to their requests for information, and that the Committee members received comfort that the Authority's handling of its large volume of contracts was being done in a responsible manner.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 314

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit A), approving and adopting the 2005-2006 Annual Investment Report including but not limited to the Investment Guidelines. Operative Policy and Instructions (June 2006), substantially in the form submitted to the Committee (attached as Exhibit B).

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 315

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit C), approving the Authority's Financial Statements as of March 31, 2006 (attached as Exhibit D).

Mr. Gottlieb then said that the next agenda item concerned the appointment of independent auditors for fiscal year 2006-07. Mr. Pitkin explained that the Committee members are requested to recommend adoption of a resolution appointing Lumsden & McCormick, LLP ("Lumsden") as the independent auditors of the Authority for the fiscal year ending March 31, 2007. The proposed fee for the audit will be \$39,580, and is consistent with the provisions of the cost-of-living increase clause set forth in the underlying contract.

In 2003, the Authority competitively selected Lumsden through a mini-bid of firms prequalified by the New York State Office of General Services to provide auditing services. The

original contract, awarded in 2003, provided options to renew the contract annually for three more years. This would be the third of the one-year extensions. Staff has been fully satisfied with Lumsden's audit services and recommends their reappointment as auditors for the fiscal year ending March 31, 2007.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 316

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit E), appointing Lumsden & McCormick LLP as the Authority's independent auditors for fiscal year 2006-07.

Mr. Gottlieb indicated that the next agenda item was the Annual Bond Sales Report and he called upon Mr. Pitkin to discuss this item. In accordance with Public Authorities Law Section 2800 and the Authority's Financial Services Firms Guidelines, the Committee Members are asked to adopt a resolution approving the Annual Bond Sales Report ("Report"). The Report summarizes the results of bond transactions for the fiscal year ended March 31, 2006. The report indicates that during the 2005-06 fiscal year, the Authority completed four refundings totaling approximately \$328 million and completed one interest rate conversion for \$50 million. The report includes additional information added to the requirements of this report under the Public Authorities Accountability Act of 2005, including a detailed list of costs of issuance and the means of repayment for each bond transaction completed, as well as a schedule of bonds outstanding. The schedule of bonds outstanding reports required information on the Authority's bonds outstanding as of March 31, 2006, which totaled about \$3.7 billion.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 317

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit F), adopting and approving for submission pursuant to Section 2800 of the Public Authorities Law, the Authority's Annual Bond Sales Report for the fiscal year April 1, 2005 through March 31, 2006, and the information contained therein, as presented at this meeting.

Mr. Gottlieb indicated that the next item on the agenda was a report from Peter Smith, Pre-sident of the Authority, on the Authority's compensation schedule. Mr. Smith stated that the Public Authorities Accountability Act of 2005 modified the information to be included in the annual report filed under Section 2800 of the Public Authorities Law. The Annual Report is now to include a compensation schedule reporting the name, title, salary, and total compensation for all employees in decision making or managerial positions with salaries in excess of \$100,000. The schedule was included in the meeting materials.

Whereafter, upon motion duly made and seconded, and by unanimous voice vote of the Committee members present, the following resolution was adopted.

Resolution No. 318

RESOLVED, that the Audit and Finance Committee recommends that the Members of the Authority adopt a resolution in substantially the same form as the resolution submitted to the Committee (attached as Exhibit G), adopting and approving the Authority's compensation schedule to be submitted pursuant to Section 2800 of the Public Authorities Law.

Mr. Gottlieb then asked Mr. Pitkin to brief the Committee on the status of a review by the Office of the OSC of the Authority. Mr. Pitkin reported that the OSC issued an audit report dated June 5, 2006 as a follow-up to the audit report issued in November 2004 of the Authority's internal controls over financial operations. The report confirms that the Authority has fully implemented four of the five recommendations contained in the November 2004 report. The one remaining recommendation, to formally develop, document, and test a disaster recovery plan has been partially implemented and soon will be fully implemented. While computer backup procedures are in place, a formal plan for resumption of computer systems at another site following a partial or total loss of computer services is still being developed. The Authority has retained a consultant to perform a gap analysis, expected to be completed by the end of the

summer, with a formal documentation process, planning, and testing expected to be completed in early 2007.

As previously reported to the Committee, the OSC is currently conducting an audit of the implementation of Executive Order No. 111 pertaining to the setting of energy efficiency standards and New York State agencies purchasing of energy efficient products. Staff is currently working with the OSC to determine the scope of the audit.

Mr. Gottlieb stated that the next item on the agenda was a report by Mr. Pitkin concerning auction rate securities. Mr. Pitkin stated that in 2004, the Committee was advised that the United States Securities and Exchange Commission ("SEC") was investigating auction rate bond procedures used by broker-dealers. The investigation was not directed at Authority bonds, but was directed at the national auction rate market. At several utilities' requests, the Authority continued to issue auction rate bonds. Relevant disclosure language supplied by the underwriters and broker-dealers was included in the Authority's Official Statements.

On May 31, 2006, the SEC announced that it had reached a \$13 million settlement agreement with 15 broker-dealer firms, including some who are serving as broker-dealers on Authority bonds. The SEC found that the firms had engaged in a series of practices that, among other, favored certain investors over others, favored issuers over investors, and involved manipulation of clearing rates. Under the settlement agreement, each of the 15 broker-dealers was assessed a civil penalty and censured, was ordered to cease and desist from future violations, and is required to take certain major remedial actions on a timetable prescribed by the SEC.

By the end of August 2006, each broker-dealer is required to make available at all times a description of its then current material auction practices and procedures to (1) all customers and broker-dealers who are participating through such Broker-dealer in an auction of auction rate securities on the portion of its website that is accessible to such customers and broker-dealers and is related to such auction, and (2) the general public on another portion of its website accessible to the general public.

Mr. Pitkin concluded this discussion by stating that by the end of November 2006, each broker-dealer is required to provide all current and future holders of auction rate securities, first time purchasers of such securities, and issuers of such securities with a written description of their material auction practices and procedures, and (ii) the Chief Executive Officer or General

Counsel of each Broker-dealer are required to certify in writing to the SEC that the respective Broker-dealers have implemented policies and procedures designed to detect noncompliance with securities laws and rules in the auction rate securities area.

Mr. Gottlieb stated that the next agenda item was a report on the principles of governance. Mr. Pitkin reported that on May 17, 2006, the New York State Commission on Public Authority Reform, chaired by Ira Millstein, issued its final report. The Commission's recommendations would have to be implemented through legislation, which has been introduced in the Assembly. Copies of the final report and draft legislation are available for any Committee members who wish to receive them.

At the April 2006 meeting, the Committee members were informed that the Public Authorities Accountability Act of 2005 ("Act") requires all public authority board members to receive New York State approved training on their legal, fiduciary, financial, and ethical responsibilities. This training is to be completed by March 2007 for existing members and new board members are to complete training within one year of their appointment. New York State approved training is offered by the City University of New York ("CUNY") School of Professional Studies, structured as full-day sessions covering: board oversight and responsibilities; audit and audit committee responsibilities; budgeting for public authorities; overseeing tax-exempt debt issuance; and understanding authority financial statements.

As requested by the Members, staff is working to try to establish a customized, tailored training program. Staff has consulted with CUNY and a public accounting firm with experience in providing board training and is working on an agenda.

In response to an inquiry by Mr. Gottlieb, Mr. Pitkin indicated that staff will be working to have the approved training provided via video or the internet.

Mr. Gottlieb then stated that next on the agenda was a report from Mark Mitchell. Director of Internal Control. Mr. Mitchell explained that in keeping with the audit plan, an audit of the Authority's Projects Database System was completed. Although the audit did identify several opportunities to make improvements to the operating design of the Projects' Database System and to improve the monitoring of certain operating practices, the audit did not detect any significant control deficiencies.

The opportunities to make improvements, which are described in the status report provided in the meeting materials, resulted in several recommendations. The first identified recommendation was to restrict access so that program staff may no longer make address changes in the system on their own; this should help assure that any payment made to a contractor goes to the intended party. This recommendation was implemented before the completion of the audit report. The next recommendation was to improve the monitoring of those who are authorized to make address changes; this should increase the ability to detect any inappropriate or improper changes made to a contractor's address. The third recommendation was to improve the monitoring of changes in encumbrances; this should increase the ability to detect whether a change in an encumbrance has been properly authorized. The last recommendation, to improve the process for notifying the MIS unit of personnel changes, should make it easier for MIS to assure that only authorized employees have active user identifications.

With respect to the risk assessment process, the Authority has established an initial assessment of its commonly recognized risks. Mr. Mitchell said he has compared the results of the risk assessment against the audit plan that was presented at April 2006 meeting and believes that the audit plan will appropriately address some of the higher risks identified through the risk assessment process and the audit plan does not need to be modified.

As a result of reviewing the risk assessment and the underlying documentation, Mr. Mitchell said that he came to several conclusions about the Authority's operations. Namely, he concluded that the Authority has a governance structure and operating environment that are good and that seem to be operating effectively at all levels – the Members, the management team, and the staff level. The risk assessment should enhance Authority management's ability to analyze some of the identified risks and form a basis for determining how they should be managed.

Next, Mr. Mitchell reported on monitoring of contractor overhead rates. This audit has been postponed for now and will be rescheduled for later in the fiscal year. Mr. Mitchell found that it is premature to conduct an audit of contractor indirect rates as new measures have just been put in place. Postponing the review to a later time will allow the Authority to have some initial experience with the measures and to make any necessary adjustments before they are reviewed by Internal Audit.

With respect to this year's audit plan, the first phase, the preliminary survey, of the audit of the Assisted Multifamily Program ("AMP") is underway. The purpose of the AMP audit is to

determine whether the AMP's procedures and controls are being followed and provide adequate safeguards. The preliminary survey, Mr. Mitchell said, will allow him to gain the insight, information and perspective about AMP to design and budget a meaningful audit program. The budget and the audit program will be reviewed with the officers just before beginning the fieldwork.

Mr. Gottlieb asked if there were any other matters the Committee members wished to discuss. There being none, upon motion duly made and seconded, and by unanimous voice vote, the meeting was adjourned.

Respectfully submitted,

Sara L. LeCain

Acting Secretary to the Committee