

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Audit Committee Meeting
Minutes

December 3, 2003

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: John Charles, Chair
 Glenn Gorton
 Charlie Kaminski
 George Masten
 Bob Nakahara
 Dave Scott

Committee Members Absent: Debbie Brookman

Others Present: Joe Dear
 Gary Bruebaker
 Theresa Whitmarsh
 Beth Vandehey
 Alicia Markoff
 Steve Verschoor
 Kristi Walters

Paul Silver, Office of the Attorney General

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

Chair Charles called the meeting to order at 9:01 A.M., and identified Committee members present.

ADOPTION OF MINUTES – SEPTEMBER 25, 2003

Mr. Masten moved to approve the September 25, 2003, Audit Committee meeting minutes. Mr. Scott seconded and the motion passed unanimously.

INTERNAL AUDITOR REPORT

Ms. Vandehey introduced herself to the Committee and described the Audit Committee Reference Guide distributed to each member. The Guide contains the current year's audit plan; the Audit Committee and Internal Auditor Charters; information on audit planning, risk assessment, risk and control review; and audit standards and newsletters issued by the Institute of Internal Auditors.

Audit Recommendations Status Report

Ms. Vandehey briefed the Committee on the Audit Recommendations Status Report which is presented every quarter. She reported that there are five outstanding audit recommendations, and that Ms. Markoff would report on the outstanding real estate consultant audit recommendation.

Ms. Markoff, Portfolio Administrator, introduced Courtland Partners' final reconciliation report to the Committee. She explained that, during an audit of the WSIB's real estate consultant (Courtland), Ms. Vandehey had recommended that Courtland perform a reconciliation between the WSIB and general partners' records to ensure the accuracy of the records. Courtland performed the reconciliation from information received from the general partners and downloads from the WSIB's investment accounting system. Ms. Markoff researched all differences noted in the reconciliation since Courtland did not hold all the source documentation. Ms. Markoff determined that reasonable explanations existed for the discrepancies, to include issues with timing and classification recording, and differing accounting methods.

In response to a question from Mr. Nakahara, Ms. Markoff said that partnership accounting records follow Generally Accepted Accounting Principles. Ms. Vandehey stated that the WSIB accounting and recording is also appropriate as WSIB maintains the cash record of the contributions and distributions as they actually occur.

Ms. Markoff noted the dollar amount difference originally reported by Courtland compared to the reduced difference following staff research. Ms. Markoff said that the majority of the remaining difference involves two of the WSIB's oldest real estate relationships, Union Square and PAC/SIB.

Ms. Markoff reported that the differences have not impacted valuation and no cash is missing. Ms. Markoff also reported that procedures were put into place for Courtland to verify partnership instructions and advise the WSIB how to record the transaction. Monthly reconciliations are now performed against both the investment accounting system and the custodian bank. This procedure provides a timelier avenue to identify and correct any differences. Ms. Markoff said that Courtland will continue to work with the general partners to identify the remaining differences along with staff who will determine any necessary correction of records. Ms. Markoff requested that the Committee close this audit item.

Mr. Kaminski asked if performance was affected by reclassifications and to what extent. Ms. Vandehey responded that any net affect to performance was to the portfolio as a whole and was less than a basis point. Mr. Verschoor, Investment Accounting Controller, explained that cost is

impacted but not market value, which is what performance is based upon. Mr. Nakahara asked if any closed partnerships' differences were included and, if not, whether they should be examined. Ms. Markoff replied that no closed partnerships were examined and that it was not of value to do so.

In response to a question from Mr. Masten, Ms. Vandehey said that the differences between the records came as a surprise, but were found after the WSIB transitioned to a new real estate consultant that used different procedures than the prior consultant. Ms. Vandehey added that the records of all active real estate relationships were examined back to inception. Ms. Vandehey said that the newly established monthly reconciliations by both Courtland and the Investment Accounting unit will assist staff to identify and correct differences in a timely fashion.

Mr. Masten moved that the Audit Committee accept the final reconciliation report from Courtland Partners and close the real estate consultant outstanding audit recommendation. Mr. Gorton seconded and the motion passed unanimously.

Internal Audit 2004-02, Financial Control Systems, Inc.

Ms. Vandehey introduced the audit of Financial Control Systems, Inc. (FCS), the WSIB's accounting vendor. Ms. Vandehey said that FCS has provided portfolio verification and investment accounting and reporting services to the WSIB since 1997. The WSIB is FCS's largest client, followed by Pennsylvania, Minnesota, and Maryland. FCS serves as the WSIB's "book of record," accounts for all investments, provides portfolio accounting and reporting data, performs month-end reconciliations, provides independent verifications of various investment activities, and creates a separation of the custodial and investment accounting functions as required by accounting standards.

Ms. Vandehey stated that her audit objectives were to identify efficiencies to eliminate reliance on manual practices and strengthen controls; examine the structure of the FCS database; and to review procedures, security, and business recovery processes. Ms. Vandehey reported that she reviewed FCS transactions from 1997 forward in this audit. Ms. Vandehey also audited FCS in 1998; no recommendations were made at that time.

Ms. Vandehey said that several processes performed manually by WSIB staff had been automated in the FCS system within the past year, including the monthly commingled trust fund unitization and pricing. Ms. Vandehey said that this function used to be a major monthly process for WSIB staff.

In response to a question from Mr. Charles, Ms. Vandehey described the daily unitization process. She explained that the automated daily unitization process is performed on the WSIB managed funds (the Savings Pool, Bond Fund, and the Horizon Funds) at the fund level (i.e., TRS 3, PERS 3, etc.), which is then used by the record keepers that track the units at the participant level.

Ms. Vandehey described other functions automated within FCS involving the permanent funds and private equity monthly cash reconciliation. Ms. Vandehey reported that automation has eliminated reliance on manually-created spreadsheets and strengthened controls.

Ms. Vandehey recommended that WSIB use the FCS system to automate the following processes: 1) private equity and real estate unfunded commitments; 2) daily valued funds prices/interest factors from State Street Global Advisors, Barclays Global Investments, and BlackRock; 3) real estate monthly cash reconciliation; and, 4) performance worksheets currently maintained by investment officers within the Asset Allocation and Fixed Income units.

Ms. Vandehey said that she tested the FCS database system using audit software and transactions back to the inception of the WSIB contract, and examined the new client interface software package. Ms. Vandehey reported that the systems do a wonderful job and she has faith in them. Ms. Vandehey recommended that FCS document their programming code, because the company is small in size and limited FCS staff work within the code. Ms. Vandehey relayed that FCS was open to the suggestion.

Ms. Vandehey examined FCS's business recovery process and recommended that FCS document a short-term business recovery process (within 24 hours of outage) due to the WSIB's reliance on the system for daily valued funds processing. FCS has a long-term (24 hours or more) business recovery procedure in place. Ms. Vandehey stated that she had already received a draft short-term business recovery plan from FCS and they expect to finalize it by year end.

Ms. Vandehey said that management responses to the audit suggestions were included in her report and that staff will work with FCS to automate manual processes. FCS expects to have the programming code documentation ready by the fourth quarter of 2004. Ms. Vandehey added that the recommendations will be tracked and reported to the Committee on a quarterly basis.

Ms. Vandehey concluded her report, stating that FCS provides strong financial control and reliable data.

Committee members asked several questions about cost, FCS staffing, reliance on the FCS system, and back-up processes. Ms. Whitmarsh confirmed that the FCS contract allows for unlimited creation of management reports within existing fees. Ms. Whitmarsh said that use of the FCS system for reporting will provide more accurate information and free-up investment officer staff time.

Mr. Masten moved that the Committee accept Internal Audit 2004-02 Financial Control Systems, Inc. and forward it to the Board. Mr. Scott seconded and the motion passed unanimously.

NON-VOTING BOARD MEMBER NOMINATION PROCESS

Committee members received a sample letter and procedures adopted in 1993 related to the nomination process for non-voting Board members. Mr. Charles advised the Committee that he recommends a process change which would provide more structure and allow the Board to look more globally at its needs for the longer term. Mr. Charles said that he wants a more strategic

process in place so that positions are not filled solely on the basis of what expertise the departing member contributed to the Board.

Mr. Charles reported that Mr. Kaminski's term is up for renewal as of December 31, 2003, and that he has expressed a desire to continue with the Board. Mr. Dear added that Mr. Magnuson's term was also set to expire and he too wished to continue as a non-voting member. Mr. Masten commented that non-voting Board members remain until the Board takes action. Mr. Charles responded that a more strategic process could be developed since there is no emergent need to take immediate action. Mr. Charles reported that some interest in serving on the Board had been received. Mr. Charles expressed that he would like to involve the entire Board in re-developing the nomination process, rather than limiting it to the Audit Committee.

Mr. Charles stated that there are a total of five non-voting Board member positions. A discussion ensued relating to the history of the Board Committee structure and how it has evolved, and the make-up of industry expertise among the current non-voting Board members. Mr. Dear suggested that private equity expertise could be increased.

Mr. Charles said that it would be a good idea to have a candidate in mind if a member were to leave unexpectedly. Mr. Masten suggested breaking down the asset areas to see if it can be segmented or if broad expertise would be more appropriate. Mr. Charles asked staff to put together a suggested structure for the Committee's review.

Mr. Masten mentioned the statute relating to non-voting Board members. Mr. Silver said the statute gives broad guidance in that non-voting Board members must have investment expertise, but also gives specific advice that Board members are trustees; therefore, non-voting Board members are not.

Mr. Charles requested that staff provide input on what investment areas could use additional Board member expertise, so the Committee could discuss the process with the Board. Mr. Nakahara suggested that staff poll voting members to get their input on what they feel is missing as far as skill sets. Mr. Masten asked that non-voting members also be polled. Mr. Dear summarized that the Audit Committee is requesting staff to prepare a memo which addresses non-voting Board members' roles and any limitations that may exist; a possible scheme for areas of expertise, exploring both generalist and specialist roles; and include input from all Board members on what they feel is needed. Mr. Charles stated that he wanted to have a discussion with the Board on this issue. Mr. Dear said that he believed he could have sufficient information compiled in time for the January Board meeting. Mr. Charles asked that staff move ahead with the plan.

REVISED COMMITTEE MEETING SCHEDULE FOR 2004

Mr. Charles explained that a revised Committee meeting schedule was developed so that meetings could continue on a quarterly basis, but be timed after the end of a reporting quarter. Mr. Dear added that the revised schedule attempted to tie in other Committee meeting dates to assist members who travel.

Mr. Masten moved that the Audit Committee accept the proposed 2004 meeting schedule. Mr. Gorton seconded.

Mr. Kaminski asked if the schedule was sufficient to conduct business, noting the number of agenda items tentatively scheduled for the summer meeting. Mr. Dear responded that the schedule was developed and tied to timing of audit reports, but other items could potentially be rearranged if necessary.

The Committee agreed to meet at 9:00 A.M. on each of the scheduled meeting dates.

The above motion passed unanimously.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 10:09 A.M.