

**STATE OF WASHINGTON
STATE INVESTMENT BOARD**

Audit Committee Meeting
Minutes

February 2, 2004

The Audit Committee met in open public session at 2:02 P.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: John Charles, Chair
 Debbie Brookman
 Charlie Kaminski
 George Masten
 Bob Nakahara
 Dave Scott

Other Board Members Present: Mike Murphy

Others Present: Joe Dear, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Theresa Whitmarsh, Deputy Director for Operations
 Beth Vandehey, Internal Auditor
 Kristi Walters, Administrative Assistant

Paul Silver, Office of the Attorney General
Steve Wendling, Office of the State Auditor
Rodney Reynolds, Office of the State Auditor

[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 2:02 P.M., and identified Committee members present.

ADOPTION OF MINUTES – DECEMBER 3, 2003

Mr. Masten moved to approve the December 3, 2003, Audit Committee meeting minutes. Mr. Charles seconded and the motion passed unanimously.

FISCAL YEAR 2003 STATE AUDIT REPORT

Mr. Wendling reported that the WSIB had its twelfth consecutive clean audit in fiscal year 2003. The description of the audit scope was available in the Committee packet. Mr. Wendling said that there were no problems, and that controls and monitoring are excellent which is a credit to both staff and the Board. In response to a question from Mr. Murphy, Mr. Wendling replied that there were no management level issues.

[Mr. Scott was in attendance at 2:05 P.M.]

Mr. Masten moved that the Audit Committee forward the Fiscal Year 2003 State Audit Report to the Board for acceptance. Ms. Brookman seconded and the motion passed unanimously.

INTERNAL AUDITOR REPORT

Audit Recommendations Status Report

Ms. Vandehey reported that two audit recommendations had been completed since December. The follow-up work with general partners stemming from Internal Audit 2004-01 Private Equity was completed, and Financial Control Systems (FCS) had completed its short-term business recovery plan in response to Internal Audit 2004-02. Both recommendations were completed on time. Staff responses to the remaining items were included in the Committee materials.

Internal Audit 2004-03, WSIB Performance Reporting

Ms. Vandehey presented the internal audit of Performance Reporting at the WSIB. Ms. Vandehey said that the audit objectives were to review controls and risks in preparing reports, and to determine if the data is accurately presented and supported. Ms. Vandehey said that the performance reporting function was moved internally from an outside consultant in 1998. The goal was to improve timeliness and customization of the reports and this goal was achieved. Ms. Vandehey said that when the performance reporting function was moved internally it created an appearance of lack of independence, as is always the case when investment managers calculate their own investment performance. The lack of independence could put the investment staff in an awkward reporting position if the integrity of the data was questioned. To decrease the independence issue, the investment staff has always obtained the majority of the performance data from external sources such as State Street Bank.

Ms. Vandehey described the inflows of external data and the internal calculations performed by an investment officer to produce returns, durations, and custom benchmarks. Ms. Vandehey

recommends that management analyze the placement of the performance reporting function in the organizational structure to minimize the appearance of lack of independence or add additional internal controls. Ms. Vandehey also recommends staff continue to work toward automated calculations to reduce the potential for errors.

Ms. Vandehey detailed the internally created performance reports and their purpose. The number of reports produced by staff has increased 58 percent since 2000 and are all created using Microsoft Excel. The performance reporting process is labor intensive and distracts the investment officer from higher value activities. Ms. Vandehey recommends combining or eliminating reports and researching the possibility of automating the formatting of the performance reports.

Ms. Vandehey described the three different calculations used in reporting the Commingled Trust Fund return to different users. While each calculation is different, they are all appropriate and applied correctly. Ms. Vandehey said that the differences might cause confusion and potential inconsistencies in reporting. Ms. Vandehey recommends that management consider using one return calculation. A discussion ensued relating to the purpose of the various calculations, the need for consistency with Generally Accepted Accounting Practices (GAAP), dialogue needed with the Office of Financial Management, and effects on reporting.

Mr. Murphy asked how money is priced moving into and out of the Total Allocation Portfolio as part of the defined contribution (DC) plan options. Mr. Charles described that movement only occurs on the first of each month and staff designates the price at that time. If a participant requests to move money mid-month, that action would not take place until the first day of the following month. Mr. Bruebaker commented that self-directed DC options other than TAP are daily valued. Mr. Charles stated that these are for the Plans 3, not the Deferred Compensation Program.

Overall, Ms. Vandehey said that performance returns are accurate and the investment officer does a good job. To reduce the appearance of lack of independence and to reduce errors, the majority of performance data and benchmarks are obtained from external sources, other units perform independent reviews of formal performance reporting to the Board, the investment officer who performs performance reporting has no direct investment management, and procedures are well documented and back-up staff have been trained.

Ms. Vandehey said that management is working on consolidating management reporting as part of its strategic plan to centralize the function and free up staff. Management is working to improve the integrity of reporting through organizational restructuring and automation. Ms. Vandehey said that she will consult with management as reporting and structures change to ensure success.

Mr. Nakahara asked if management had revisited external preparation of the reports. Ms. Vandehey said that timeliness of reporting is the concern. Mr. Bruebaker said that there are costs involved in removing the function from the investment division. Staff loses a feel for the numbers if they are not looking at the detail each day.

Mr. Charles said that he feels use of one return calculation is a wonderful recommendation because this can be confusing to members. Mr. Bruebaker stated that worst-case scenario is to end up with

two calculations, which would be more compliant with GAAP. Mr. Murphy said that CAFR reconciliations are an important consideration.

Mr. Masten moved that the Audit Committee accept Internal Audit 2004-03, WSIB Performance Reporting, and forward it to the Board for approval. Mr. Scott seconded and the motion passed unanimously.

Policy Revision 1.00.190 – Internal Audit Charter

Ms. Vandehey introduced the proposed internal audit charter, which is a complete revision from the previous policy. It reflects best practices used by internal auditors and aligns with the Audit Committee Charter adopted last August. Ms. Vandehey described that the policy outlines the internal audit scope, authority and independence, access, and system of risk management and internal controls. Ms. Vandehey said that the policy expands responsibilities to better reflect her function. Mr. Masten asked why a redline policy revision had not been included. Mr. Dear responded that nothing from the previous policy had been removed but, rather, it is just more extensive and designed to parallel the Audit Charter. In response to a question from Mr. Nakahara, Ms. Vandehey said that there is no mandate for the WSIB to have the charter and comply with requirements of the Sarbanes-Oxley Act. In response to a question from Mr. Kaminski, Mr. Dear described the state whistleblower program managed by the Office of the State Auditor and the annual requirement for agencies to inform staff of its procedures. Mr. Dear stated that the Audit Committee would be informed if the agency were made aware of any whistleblower complaint under investigation. Ms. Brookman said that she had read the previous policy and that this new one looked fine.

Ms. Brookman moved that the Audit Committee accept policy revision 1.00.190, Internal Audit Charter, and forward it to the Board for approval. Mr. Charles seconded.

Mr. Charles said that he and Ms. Vandehey met and discussed the policy revision, which is an extensive re-write. Mr. Charles said that it would be helpful to have an annotated document available to the Committee prior to the Board meeting. Mr. Scott said that he would support the motion although he would like to see more flexibility.

The above motion passed unanimously.

NONVOTING BOARD MEMBER SELECTION CRITERIA

Mr. Charles introduced the nonvoting Board member selection criteria item. Mr. Dear said that three categories were added to the gap analysis and nonvoting members' information had been filled in. Mr. Dear shared that Mr. Kaminski also suggested the addition of professional certifications to the gap analysis.

Mr. Charles said that a relatively new area to the WSIB is defined contribution programs and it would be helpful to add that experience to the gap analysis.

Mr. Kaminski said that it would also be useful to add experience in asset classes that the Board is not currently utilizing, such as hedge funds. Mr. Nakahara felt that the analysis lacked coverage in risk management, internal controls, audit process, monitoring compliance and financial reporting, which is important to support the Audit Committee. Mr. Charles directed staff to add an expertise area dealing with general audit experience. Mr. Kaminski said that it would be helpful to have legal review of the gap analysis. Mr. Scott expressed a concern that the right expertise may not exist within Committees. Mr. Masten asked to have the appropriate consultants added to the Asset Allocation area.

Mr. Charles said that the next step is to discuss the nominating process. He reported that at least one individual had submitted a nomination to staff. A discussion about having an upfront notification for persons interested in nonvoting Board positions.

Mr. Masten said that he felt the Board had not been successful in creating a “pipeline” of persons interested in serving on the Board to use when vacancies were experienced. He asked that the Committee seek out a few more candidates for the pipeline. Mr. Charles expressed a desire that the Board have a more open process. Ms. Brookman said that she felt the nomination procedure adopted in 1993 was appropriate and suggested that the process for recruiting and appointing nonvoting members be added to the agency’s website.

Mr. Charles said that the Committee would report its progress to the Board, ask for nominations to get people in the pipeline, and said that the Committee would review materials at their next meeting to move ahead. Mr. Masten asked staff to update Appendix G to reflect the current Board membership.

OTHER ITEMS

Mr. Charles brought forward a concern resulting from a recent *60 Minutes* episode, addressing public trust funds investing in companies doing business in nations that are sponsoring terrorism. Mr. Dear distributed a transcript of the broadcast, a summary of the issue, and a fact sheet on WSIB holdings. The *60 Minutes* report alleges three specific companies were doing business with governments of terrorist supporting nations. Mr. Dear said that plan participants are very concerned and want to know what is being done.

Mr. Dear said clear guidance on what should or should not be in the Board’s portfolio is needed, including a finding by a competent authority that U.S. law was violated. He said there might be a need to amend investment policies at that time.

Mr. Masten suggested that the Board send a letter to federal entities requesting more information. Mr. Murphy said that a response might not be received in a timely fashion. Mr. Murphy said that the Board had been faced with divestiture issues in the past, but he felt this concern is in a different category. Mr. Murphy said that if companies we are doing business with are doing business with rogue nations, the WSIB ought not to do business with them.

Mr. Masten said that he wants to see the Board communicate with the President, senators and representatives to get them to step up before the Board discusses divesting. Mr. Nakahara noted that

the report indicates there is a possibility of up to 400 companies that fall into this category and asked where the WSIB would draw the line. Mr. Charles reiterated the importance of the issue and the need to verify accuracy of the report, and then, secondly, to express concern to national leadership. Mr. Murphy suggested sending something to the Securities and Exchange Commission, as they would be the proper regulatory authority to pursue action. Mr. Dear said staff would draft a letter for consideration at the February Board meeting, which would be sent to Committee members in advance of the meeting for review. Mr. Murphy said that he would like letters to be sent right away if the Board provides direction. Mr. Masten said that he wanted to get inquiries out there rather than to wait for a federal response. Mr. Dear summarized that staff would draft a letter to national authorities for review at the February Board meeting, consider other steps that are active and produce action, and attempt to determine facts from the *60 Minutes* broadcast.

Mr. Kaminski asked Mr. Silver if all outstanding findings from the 2002 conflict of interest review had been satisfied. Mr. Silver responded that there were no findings, but merely questions raised. Mr. Silver reported that the Office of the State Auditor is requesting a copy of his report and he will ensure that all clarifications are added so that the record is complete.

There being no further business to come before the Committee, the meeting adjourned at 4:03 P.M.