

**STATE OF WASHINGTON  
STATE INVESTMENT BOARD**

Audit Committee Meeting  
Minutes

May 10, 2005

The Audit Committee met in open public session at 9:04 A.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present:            Treasurer Michael Murphy, Chair  
  Debbie Brookman  
  Charlie Kaminski  
  Sandra Matheson  
  Bob Nakahara

Committee Members Absent:            George Masten  
  Dave Scott

Others Present:                                Joe Dear, Executive Director  
  Gary Bruebaker, Chief Investment Officer  
  Theresa Whitmarsh, Deputy Director for Operations  
  Liz Mendizabal, Public Affairs Director  
  Beth Vandehey, Internal Auditor  
  Alicia Markoff, Portfolio Administrator  
  Christina Blue, Administrative Assistant  
  Paul Silver, Assistant Attorney General

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

Chair Murphy called the meeting to order at 9:04 A.M., and identified Committee members present.

**ADOPTION OF MINUTES – MARCH 17, 2005**

**Ms. Brookman moved to approve the March 17, 2005, Audit Committee meeting minutes. Ms. Matheson seconded and the motion passed unanimously.**

**STATE AUDITOR'S EXIT/ENTRANCE CONFERENCE**

Mr. Steve Wendling and Ms. Kim Hurley, State Auditor's Office, presented the WSIB's State Auditor's Office Exit Conference for Fiscal Year 2003-2004 and the Entrance Conference for Fiscal

Year 2004-2005. The Board received its 13<sup>th</sup> consecutive clean audit. This audit covered the following areas: investment reconciliation, confirmation, and market valuation testing; commingled trust fund allocations; legal and authorized investments; AFRS to FCS reconciliation; securities lending; current year trading activity; fixed income securities; conflict of interest; and the basic financial statements included in the state's CAFR. The audit for this fiscal year will review the risk of theft and fraud as well as the perspective of public sensitivity, accountability, and safeguarding of assets. In addition, the POMS system, payroll, vendor payments and payments for travel, meals, and conferences will be reviewed in 2004-2005. The same staff will conduct this year's audit, which is expected to be completed by October with a final review of the CAFR in December.

## **INTERNAL AUDITOR REPORT**

### **Fiscal Year 2005-2006 Audit Plan**

Ms. Vandehey presented her Fiscal Year 2005-2006 Audit Plan in accordance with the Audit Committee charter. Ms. Vandehey's presentation showed an overview of the prior year's results. Three of the four audits have been completed and the final one is expected to be reported on in August. Other work and management projects reviewed and completed by Ms. Vandehey include a Private Equity Auditing Best Practices whitepaper she had written. Mr. Kaminski requested a copy of the white paper and Chair Murphy requested that the white paper be shared with the entire Audit Committee. Ms. Vandehey's presentation included the role of internal audit, a summary of Quality Assurance activities in relationship to the IIA standards for the year, and the plan for the next fiscal year. Ms. Vandehey stated that she breaks the audit universe into four areas: investment management, investment operations, external parties, and normal state business operations. The 2005-2006 fiscal year's audits will be Custodian Bank, last audited in 2002, Fixed Income, last audited in 2001, Private Equity Consultant, last audited in 2001, and Information Technology (IT) will receive an external security review by May 2006. Chair Murphy asked whether the recommendation for the IT audit is a cost issue. Mr. Dear responded that it was covered in the budget and that DIS could perform the audit. Ms. Vandehey further stated the overall objectives for these audits are to ensure compliance, determine accuracy of information, ensure the assets are safeguarded, and identify risks that could affect the agency efficiency. Ms. Vandehey concluded her presentation with a budget of time spent on audit activities versus other projects. Mr. Nakahara asked how Ms. Vandehey assesses ethics and strong values. Ms. Vandehey stated that the agency's Code of Conduct and Board policies are strong, which is always used as a base to compare the agency's activities and she also works with staff on ethical questions when they arise.

**Ms. Brookman moved that the Audit Committee accept the Fiscal Year 2005-2006 Audit Plan and forward it to the Board for further approval at the May 19, 2005, Board meeting. Ms. Matheson seconded and the motion passed unanimously.**

### **Audit Recommendations Status Report**

Ms. Vandehey presented an update to the Audit Recommendations Status Report, which is reported quarterly. There have been no changes since last quarter and staff is still on track to complete the outstanding items by June 30, 2005, or December 30, 2005.

## **INTERNAL AUDIT CHARTER POLICY 1.00.190 REVISION**

Ms. Vandehey presented the changes to the Internal Audit Charter policy 1.00.190, removing the reference to the governmental auditing standards as recommended by the external Quality Assurance Team since the agency does not receive federal funding.

Ms. Brookman asked if the Audit Committee would notice the change. Ms. Vandehey responded that the change would not affect the work she does since she follows the IIA standards which are similar to the governmental auditing standards.

**Ms. Brookman moved that the Audit Committee accept the Internal Audit Charter Policy 1.00.190 revision and forward it to the Board for further approval at the May 19, 2005, Board meeting. Ms. Matheson seconded and the motion passed unanimously.**

## **EDUCATION SESSION – SARBANES OXLEY**

Ms. Vandehey presented an education session on the impacts of the Sarbanes Oxley Act of 2002 (SOX or the Act). Under the Act, public companies are subject to new requirements to report the effectiveness of internal controls over financial reporting. The basic premise of the Act is that effective internal controls are fundamental to investor confidence because they help deter fraud and prevent inaccurate financial statements. The failure of such companies as Enron and WorldCom caused the U.S. Government to step in with new regulations aimed to correct perceived structural weaknesses in financial reporting and corporate governance at publicly trade corporations. The session provided information about the Act's requirements, gave an overview of how it is affecting non-public companies, and provided an analysis on the gaps that exist between the act's requirements and the WSIB's audit committee charter and other Board policies.

During the presentation Ms. Matheson asked how SOX requirements add to costs. Ms. Vandehey stated that documenting the internal controls and how to test them are major costs added by outside accounting firms. Mr. Nakahara asked if review of private companies includes their independent directors, committees, and financial responsibilities. Ms. Vandehey stated that because they are private, they are not required to follow the Act; however, it is becoming a best practice. Mr. Kaminski asked if the reviews were conducted only with the general partners or the companies included in the portfolios. Ms. Vandehey responded that only the general partners are reviewed.

Chair Murphy asked about the SOX comparison identifying the gaps between the WSIB and SOX. Treasurer Murphy asked if the WSIB would be moving toward compliance with SOX requirements. Mr. Dear stated that the annual report we assembled for 2004 set up the framework for GAAP compliant financials. He expects that GAAP compliant financials will be ready for FY 2006. The staff will discuss this progress at future Committee meetings. Ms. Vandehey stated that the only public pension fund in the U.S. that has implemented SOX is CalPERS.

## **CONFLICT OF INTEREST POLICY 2.00.100 REVISION – GIFT REPORTING**

Mr. Silver presented proposed revisions to the current Conflict of Interest Policy 2.00.100. The Board had requested a review of the gift reporting and monitoring section to address three areas: make the requirements clearer as to what gifts are to be reported, make gift reporting coincide with the annual financial affairs reporting, and avoid the need for multiple reporting. Mr. Silver identified on pages 4 and 5 the changes to the amount to be reported. Mr. Silver identified two proposed changes on page 7, allowing the WSIB Board members to submit a copy of the report they currently submit to the Legislature and change the reporting from monthly to annually. Chair Murphy also noted the change to campaign contributions.

**Ms. Brookman moved that the Audit Committee accept the Conflict of Interest Policy 2.00.100 revision and forward it to the Board for further approval at the May 19, 2005, Board meeting. Ms. Matheson seconded and the motion passed unanimously.**

#### **DAILY VALUED FUNDS OPERATIONS REPORT 2004**

Ms. Markoff reported that there have been no immaterial or material errors relating to the operations of the daily valued funds during the past year. Ms. Matheson asked for the types of errors that could occur. Ms. Markoff responded that staff could incorrectly enter a price from the investment managers or enter a plan's daily investment activity into the wrong fund and stated there are controls in place to assist with catching errors. Mr. Nakahara asked about the materiality level of the errors. Ms. Markoff stated that an error would be considered material if it resulted in the unit price being incorrect by more than one cent per unit, which was found to be in accordance with industry standard when the policy was created. Chair Murphy stated that he would encourage Ms. Matheson to review with Ms. Markoff the current process and if necessary, the committee would revisit the policy again.

#### **INTERNAL AUDIT RECRUITMENT**

Chair Murphy stated that Ms. Vandehey had been given a promotional opportunity as Compliance Director and according to policy the Committee has the opportunity to participate in the recruitment process for the new Internal Auditor. He further stated that recruitment is posted and staff will review the submitted applicants and present final selections to the Committee and either have a full Committee or sub-Committee participate in finalist interviews. Mr. Nakahara asked if the Committee was able to review the position description and copies were distributed to the Committee. Ms. Brookman suggested a sub-Committee versus a full Committee. Chair Murphy stated that Ms. Matheson, Mr. Nakahara, and he could participate in the finalist interviews.

#### **OTHER ITEMS**

Mr. Dear stated there has been a request for a change in the August Audit Committee meeting to September 6, 2005. Members will be contacted regarding their availability.

Mr. Kaminski stated that the Seattle Society of Financial Analysts would be presenting a session on the new performance reporting standards on a global basis on Friday afternoon at the Rainier Club.

There was no further business to come before the Committee and the meeting adjourned at 10:25 A.M.