

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
February 7, 2006

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: Treasurer Michael Murphy, Chair
 Charlie Kaminski
 George Masten
 Bob Nakahara
 Dave Scott

Members Absent: Debbie Brookman

Other Members Present: Glenn Gorton

Others Present: Joe Dear, Executive Director
 Gary Bruebaker, Chief Investment Officer
 Theresa Whitmarsh, Deputy Director for Operations
 Liz Mendizabal, Public Affairs Director
 Bill Kennett, Senior Investment Officer-Fixed Income
 Jim Lee, Information Systems Manager
 Shawna Killman, Internal Auditor
 Beth Vandehey, Compliance Director
 Alicia Markoff, Portfolio Administrator
 Kristi Walters, Executive Assistant
 Rita Wineinger, 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 and identified Committee members present.

Due to a lack of quorum, action items were deferred until later in the meeting.

[Mr. Kaminski was in attendance at 9:03 a.m.]

INTERNAL AUDITOR REPORT

Internal Audit Report 2006-01 – Fixed Income

Ms. Killman reported on the internal audit of Fixed Income. Ms. Killman provided an overview of fixed income, described the audit objectives, and reported on results as follows: 1) Fixed income transactions are properly documented, reviewed, and approved; 2) The Investment Accounting and custodian records agree, and accurately reflect the fixed income trade processing activity; 3) The Fixed Income unit is complying with WSIB investment policy guidelines, including the use of qualified broker/dealers, 3% cost and 6% market value issue limits, permissible investments, and investment grade requirements; 4) WSIB staff is researching, mitigating, and reporting compliance exceptions to the appropriate level of management in a timely and consistent manner.

In response to questions from the Committee, Ms. Killman indicated that compliance monitoring occurs through daily controls.

[Mr. Gorton was in attendance at 9:08 a.m.]

Ms. Killman said that the overall audit assessment was good with one Level 3 recommendation to report. She recommended that independent compliance monitoring of the Savings Pool fixed income transactions should be implemented. Ms. Killman further indicated that management is in agreement with the recommendation and has committed to an action plan for implementing changes.

Ms. Killman summarized that she found trade orders were properly authorized, complete, accurate, and had a sufficient audit trail. All transactions were compared and in agreement between Financial Control Systems and the custodian bank, providing assurance that data is being processed accurately and completely. Investment compliance was noted in broker/dealer eligibility, permissible investments, investment grade requirements, and 3% cost and 6% market value diversification requirements. The Portfolio Administration unit independently monitors fixed income compliance daily against investment policies through the portfolio order management system (POMS).

Chair Murphy asked for the definition of a compliance rule change. Ms. Killman explained that the POMS system is set up to monitor compliance through the use of “rules” that are defined by staff in the system and represent the actual compliance requirements. There is also a function within POMS that allows staff to update those rules in an automated fashion. It is important to ensure only

authorized staff do that, so that the automated compliance testing is accurate. Mr. Nakahara asked if there is a sufficient audit trail to see who made changes at what time. Ms. Killman assured him that there is before and after capability and that she reviewed to ensure all changes were made by staff outside of the Fixed Income unit.

In response to Mr. Nakahara's question, Ms. Killman indicated there is a list of eligible broker/dealers and staff are responsible for best execution.

Mr. Kennett responded to further questions from the Committee regarding best execution. He indicated that it depends upon the investment and trade, but staff tries to have competition in each transaction. Mr. Bruebaker commented that staff have incentive to get the best deal, as it applies directly to the bottom line.

Audit Recommendations Status Report

There are four items remaining outstanding since last quarter. The expected completion date for the summarization of partnership agreements under Private Equity Audit 2004-01 recommendations have not changed. The expected completion dates for two items regarding the Contact Management System have been adjusted due to external factors. Staff has selected a contact management system; however it has been delayed due to work with the Department of Information Services to bring the WSIB onto the Enterprise Active Directory.

Ms. Killman responded to questions from Mr. Nakahara regarding the ranking of each item. The first three items are considered level 2, but completion is dependent upon work with the Department of Information Services. She indicated that she is comfortable with the slight change in expected completion dates of the contact management system.

Jim Lee responded to questions from the Committee, indicating that the use of the Enterprise Active Directory will not change the method of storing data, but how agencies address each other for e-mail purposes. It also affects how our system interacts with the Department of Information Services network.

FISCAL YEAR 2005 STATE AUDIT REPORT

Steve Wendling, State Auditor's Office, presented the results from the 2005 audit, which covered the period beginning July 1, 2004 and ending June 30, 2005. The audit was planned and conducted using a risk-based approach in accountability for public resources, compliance with state laws and regulations and agency policies, financial statements, and federal compliance. The audit did not examine federal compliance, as there are no major federal programs at the WSIB. The audit did not examine every portion of the Board's financial activities during the audit, but only those areas representing the highest risk of non-compliance, misappropriation or misuse of public resources.

The auditor evaluated the Board's accountability and compliance in the following areas: investment valuations, commingled trust fund allocations, legal and authorized investments, reconciliation of the investment accounting system to the general ledger, current year trading activity, POMS review, conflict of interest, payroll, vendor payments, and payments for travel, meals and conferences. The auditor also performed an audit of the statewide basic financial statements, which are included in the comprehensive annual financial report (CAFR).

In conclusion, Mr. Wendling reported no audit recommendations for the fiscal year 2005 audit. He indicated that this is the 14th consecutive year that the WSIB has had no audit findings.

[Mr. Scott was in attendance at 9:26 a.m.]

Chair Murphy announced that a quorum was present.

ADOPTION OF MINUTES – NOVEMBER 1, 2005

Mr. Masten moved to approve the November 1, 2005, Audit Committee meeting minutes. Mr. Scott seconded and the motion carried unanimously.

INTERNAL AUDITOR REPORT – INTERNAL AUDIT REPORT 2006-01, FIXED INCOME

Mr. Masten moved that the Audit Committee accept the Internal Audit Report 2006-01, Fixed Income and forward it to the Board for approval.
Mr. Scott seconded and the motion passed unanimously.

PROXY VOTING

Status Update

Ms. Mendizabal presented the proxy voting status update. She indicated that the WSIB voted a total of 4,182 proxies in 2005, of which 998 were cast in the second half of the year.

The WSIB withheld approximately 4,850 director votes in accordance with policy. The primary concerns were lack of board independence and egregious compensation packages. Of the total 1,260 compensation plans proposed in 2005, the WSIB voted against 325, or 25% percent.

Key issues in the outlook for 2006 include executive compensation and election of directors by majority vote. Ms. Mendizabal highlighted two significant corporate governance program improvements, including Kate Sandboe's acceptance of the Corporate Governance Policy Analyst position to manage the voting process and governance issues full-time. The WSIB also transitioned electronic voting to Glass Lewis & Co, which will improve oversight and reporting consistency.

Mr. Masten inquired about the WSIB's voting record. Ms. Mendizabal indicated that because we have transitioned from Barclays Global Investments to Glass Lewis, the numbers are similar but do not provide a comparable comparison. Overall, the voting record for 2004 as compared to 2005 is relatively close.

Chair Murphy asked staff to work proactively with other states on the compensation issue. Ms. Mendizabal said staff would follow-through and report back to the committee on the progress of those activities.

Policy 2.05.200 Revision

Ms. Mendizabal presented a change to the Proxy Voting Policy 2.05.200. as recommended by Glass Lewis & Co. The proposed change states that the WSIB will support shareholder and company proposals for a majority vote standard requiring that directors must receive a majority of votes cast to be elected. Thus shareholders will be able to collectively vote to reject a director they believe does or will not pursue their best interests.

Chair Murphy asked staff to send letters to the largest companies in the WSIB portfolio to communicate the policy change. Ms. Mendizabal said that a list of target companies would be presented at the next Committee meeting.

Mr. Masten moved that the Audit Committee recommend that the Board approve the Proxy Voting Policy 2.05.200 revision, to include Election of Directors by Majority. Mr. Scott seconded and the motion passed unanimously.

DAILY VALUED FUNDS ANNUAL REPORT

Ms. Markoff provided an annual report on all daily valued funds errors. This is the third year of reporting and there have not been any errors that impacted the price. During this year, however, there was an immaterial error of \$1,843.69, which overstated the accumulated accrued interest in the Savings Pool. The error was discovered during the regular monthly reconciliation process and an adjustment was made to correct the error. The error occurred in the accounting of the interest and did not impact cash.

Chair Murphy asked if it was due to 365-day accrual. Ms. Markoff responded that most Guaranteed Investment Contracts are accrued at 365; however, a new one was incorrectly set up to accrue at 365 instead of the 360 day accrual that the company uses to accrue interest, which resulted in a slight overstatement.

EDUCATION SESSION – ENTERPRISE RISK MANAGEMENT

Ms. Whitmarsh introduced Ms. Vandehey to provide an overview of the agency's Enterprise Risk Management (ERM) system. Enterprise risk management enables management to effectively deal with uncertainty and assess risk and opportunity, enhancing the capacity to build value.

In 2003, staff conducted an initial risk assessment and began the first discussion of enterprise risk management capabilities and effectiveness. In 2004, a risk management strategy was developed into a framework and an ERM team was formed. In 2005, the ERM team developed the tools to implement the framework. The team includes equal representation of staff from both operations and investments.

Ms. Vandehey said that risk management is a process that is continual and evolving in nature so that it remains dynamic and relevant to agency business as the agency changes over time. The WSIB's strategy to risk management includes: Board policy, the ERM team and framework, an error/incident system, risk reporting, risk assessment, and education.

In 2006, the WSIB plans to expand the ERM program by adopting applicable sections of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) control framework.

The Committee discussed how the risk management approach interfaces with the internal audit function, as well as with external audits of the agency. Ms. Vandehey indicated that she participates on several committees that are analyzing Sarbanes Oxley and COSO, and will be working with Peterson and Sullivan on these issues. Mr. Dear emphasized that the ERM team is empowered and will continue to get encouragement and support from management. There was some concern from the Committee for the internal auditor to remain independent of any internal committees dealing with risk. Mr. Dear indicated that Ms. Killman participates on the ERM team as a consultant, not a team member.

Chair Murphy asked if the fraudulent capital call error referenced in the education materials was reported to law enforcement. Ms. Whitmarsh responded, indicating that staff reported the incident to

the bank involved. The bank advised that the account which had generated the capital call was shut down. Ms. Whitmarsh indicated that she would follow-up with the bank to ascertain the outcome of this incident.

Mr. Kaminski raised a concern with the risk reporting structure and suggested that a mechanism could be set-up to bring critical issues directly to the Committee or Board.

Mr. Nakahara suggested that the further education on Sarbanes Oxley requirements would be helpful. The Committee discussed complaints received from other entities that the requirements of Sarbanes Oxley were too costly. Chair Murphy indicated the WSIB is doing their job well and just needs to formalize and document those processes.

OTHER ITEMS

There was no further business to come before the Committee and the meeting adjourned 10:30 a.m.