

WASHINGTON STATE INVESTMENT BOARD
Audit Committee Meeting Minutes
February 5, 2008

The Audit Committee met in open public session at 9:00 a.m. at the Washington State Investment Board (WSIB) boardroom at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present: Mason Petit, Chair
George Masten
Bob Nakahara
Mike Ragan

Absent: Charles Kaminski (due to technical problems with the conference equipment)
Sandra Matheson

Others Present: Joe Dear, Executive Director
Theresa Whitmarsh, Chief Operating Officer
Liz Mendizabal, Public Affairs Director
Shawna Killman, Internal Audit Director
Michelle Wieburg, Internal Auditor
Alicia Markoff, Portfolio Administrator
Beth Vandehey, Risk and Compliance Director
Carmen Matsumoto, Compliance Officer
Rita Wineinger, Administrative Assistant

Paul Silver, Assistant Attorney General
Carolyn Cato, State Auditor's Office

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

Chair Petit called the meeting to order at 9:00 a.m.

ADOPTION OF THE NOVEMBER 27, 2007, MINUTES

Mr. Masten moved to approve the November 27, 2007, Audit Committee meeting minutes. Mr. Ragan seconded the motion and the motion carried unanimously.

EXTERNAL AUDITS

State Auditor's Office Fiscal Year 2007 Accountability Audit Report

Ms. Cato presented the results of the 2007 audit, which covered the period beginning July 1, 2006, and ending June 30, 2007. The audit was planned and conducted using a risk-based approach to reviewing the WSIB's accountability for public resources, compliance with state laws and regulations and agency policies, and financial statements. The audit focused on those areas representing the highest risk of non-compliance, misappropriation, or misuse of public resources.

The auditor evaluated the Board's accountability and compliance with certain state laws and regulations and its own policies in the following areas: conflict of interest, disbursements, innovation portfolio, investment holdings, investment management fees, internal control review of investment funds, and the pension fund stabilization account. Ms. Cato also explained that the Board has several accounts material to the state's basic financial statements: earnings on investments, interest and investment earnings, investments non-current, obligations under security lending agreement, equity in commingled trust fund, investments, and net (appreciation) depreciation in fair value. Rather than performing tests of these accounts, the auditor relied upon the certified public accountant's audit of the Board's account balances and financial activity. In response to Mr. Masten's inquiry, Ms. Cato indicated that they did review the working papers of the certified public accountant's audit.

In conclusion, Ms. Cato reported no audit recommendations for the fiscal year 2007 audit. She indicated that this is the 16th consecutive year that the WSIB has had no audit findings.

Mr. Petit moved to approve the 2006-2007 State Auditor's Office Accountability Audit Report on the Washington State Investment Board. Mr. Masten seconded the motion and the motion carried unanimously.

INTERNAL AUDIT

Internal Audit Report 2008-01, Daily Funds Transaction Processing, Pricing, and Unitization

Ms. Killman and Ms. Wieburg presented their review of the Daily Funds Transaction Processing, Pricing, and Unitization, as outlined in the Fiscal Year 2007-2008 Audit Plan. The audit objectives were to determine whether: daily fund investments, unitization, calculation of Net Asset Values and pricing are accurate and timely; the Horizon Funds' rebalancing activities ensure asset allocation parameters are being followed; adequate back-up procedures/controls exist to ensure the funds can be priced each day; performance reporting information is independently calculated and accurately presented; and the WSIB is in compliance with Board policies and contract agreements related to the daily funds.

Ms. Killman indicated the overall assessment of the Daily Valued Funds (DVF's) processing is good, controls are strong, performance information is accurately presented, and processing is in compliance with Board policies; however, she identified two recommendations relating to written agreements between the WSIB and external parties that need to be updated.

1. Recommendation: Written agreements between the WSIB and external record keepers should be established to outline the responsibilities of both parties.

Management's Action Plan: Management will work with the Department of Retirement Systems (DRS) to establish the appropriate written agreements.

The Committee discussed the service agreements between the WSIB and external record keepers. Ms. Killman explained that the actual contracts are signed by DRS; however, it is important that the service agreements are accurately maintained.

2. Recommendation: WSIB staff should determine and document whether the record keeper audits covering those items not addressed in their SAS-70 audits have been performed, the reports

reviewed, and any issues appropriately resolved. WSIB should then work with legal counsel to update the interagency agreement with DRS regarding DVFs that outlines the current responsibilities in writing.

Management's Action Plan: Management will work with internal audit to determine where oversight for this function should reside within the WSIB and ensure appropriate oversight is implemented. Management will work with DRS to update the interagency agreement regarding DVFs.

Chair Petit asked why there was no completion date associated with this level one recommendation. Ms. Whitmarsh explained that the recommendations resulting from this audit will be added to the Audit Recommendations Status Report and management will review and determine the expected completion date, which will be reported at the next Audit Committee meeting. Mr. Dear indicated that any level one recommendation will be addressed immediately.

Chair Petit moved to accept Internal Audit Report 2008-01, Daily Funds, Transaction Processing, and Unitization. Mr. Ragan seconded the motion.

Mr. Masten asked for clarification regarding the motion. Ms. Killman responded that the motion was to forward the audit report to the Board.

The motion carried unanimously.

Mr. Nakahara asked if, based on these findings, Ms. Killman had considered expanding the scope of future audits to ensure other similar areas are appropriately reviewed. Ms. Killman explained that the next audit will be focused on the external manager relationships related to the defined contribution plans and contract review will be a part of that audit. Ms. Killman indicated that the review of the internally managed defined contribution plan options during the current audit, as well as the externally managed options in the upcoming audit, will together provide adequate coverage of the defined contribution plan investments under management of the Board.

Audit Recommendations Status Report

Ms. Killman presented the Audit Recommendation Status Report. Since the last quarterly report, management letter recommendations made by external auditors Peterson Sullivan were added to the report. In addition, Public Affairs and Investment Accounting staff continued work on a revised performance reporting review process. There are a total of four outstanding prior audit recommendations.

The first recommendation involves alternative asset valuation. The completion date for this item has been shifted to August 15, 2008. Ms. Whitmarsh explained that, while staff has made significant progress on this item and satisfied the auditors during the last financial reporting audit cycle, staff believes additional work is required due to the complexity of alternative asset valuation. The issue of alternative asset valuation is constantly shifting, the industry standard is not completely clear, and staff anticipates interpretation of the auditing guidance will continue to evolve with each new reporting period. Ms. Whitmarsh indicated the August 15, 2008 completion date was set in conjunction with the beginning of the 2007-2008 financial audit.

The Committee discussed the need for more work around documenting the WSIB's understanding of the how alternative assets are valued and how the WSIB will document that understanding for audit purposes. Ms. Whitmarsh commented that the general partners have audits done by external auditors and they are subject to the same requirements, which gives the WSIB some assurance that the partners are valuing correctly. Mr. Masten added that these are still auditors hired by the general partners. In response to Mr. Nakahara's question regarding resources, Mr. Dear explained that staff resources are stretched and additional resources will be requested in the next budget cycle.

The second recommendation that staff is working on relates to automating the performance reporting process. Ms. Killman explained, at the time of this recommendation, management had two initiatives underway to improve the automation. The custody conversion to JPMorgan Chase and the data warehouse are expected to both automate many report processes. The expected completion date was based on the assumptions last year about the initiation of the data warehouse project and the order of deliverables. Ms. Whitmarsh indicated that selecting and finalizing the contract with the data warehouse vendor took much longer than staff anticipated, delaying the initiation of the project. Furthermore, during the business requirements gathering phase, management made the decision to switch the priority of the data warehouse deliverables to concentration risk analysis as the first deliverable and performance reporting as the second deliverable. At this time, staff does not have the ability to conduct concentration risk analysis across the portfolio, but it does have the ability to produce timely and accurate performance reports, even though they are produced with many manual processes. As soon as the data warehouse plan is finalized in the next few weeks, staff will set a new date for completion of performance reporting automation. Chair Petit commented that this is an important addition to what WSIB will be able to do and capabilities will be improved as a result of completing the data warehouse project.

The third outstanding recommendation also relates to investment performance reporting. It was recommended that a more robust review process with clearly defined review guidelines, procedures, and responsibilities be developed. The date for completion was extended, based on a review that Internal Audit conducted of the updated processes and remaining concerns related to the documentation of the review.

The fourth recommendation involved the most recent Peterson Sullivan Management Letter reviewed by the Committee at its last meeting. It was recommended that detailed records and manual calculations be reviewed during the financial statement preparation process. Staff should specifically ensure version control and formula changes are adequately controlled. The expected completion date of this item has not changed. Both Investment Accounting and Fixed Income staff will review current preparation processes and implement improvements as recommended by Peterson Sullivan to ensure these issues do not arise in preparation of risk disclosure schedules in the notes to financial statements going forward. As staff prepares the financial statements for next year, they will be extra diligent on version control and if there are any changes to formulas, they will be reviewed, tested, and documented.

MANAGEMENT

Financial Reporting – Daily Funds Annual Report

Ms. Markoff provided the DVFs annual report. She reported that no errors occurred above the tolerance level that impacted any of the five DVFs (Savings Pool, Bond Fund, and Short, Mid, and

Long Horizon Funds) closing unit prices. There were no instances where (1) the funds were unable to complete calculating the day's unit price; (2) the managers' or bond prices were unable to be obtained; or, (3) delays in closing that were specific to WSIB.

Ms. Markoff reported there were two immaterial errors that occurred during 2007; however, neither error impacted the final daily unit price of the funds. The first error occurred on April 4, 2007. The daily interest factor staff receives from the money market manager to determine how much interest was earned on cash for daily interest accrual purposes in the valuation of the funds is posted to a toll free number. Another notification is sent by email with an attachment to their Web site, informing staff it has been updated with the day's interest factors. This email is usually received after 4:00 p.m., which is the deadline for having the final daily unit prices to the Deferred Compensation, Judicial Retirement Account, and Plan 3 record keepers. The phone message gave an interest factor of .000141855. After the unit prices were finalized and sent to the record keepers, staff received the email notification and a different factor was noted for the money market fund, .000141856; a difference of .000000001. In response to a question from Mr. Nakahara, this error was so insignificant that its cause was not investigated.

The second error, on May 24, 2007, an expense of \$10.17 was paid out of the Bond Fund. This amount was deducted out of the cash balance but was not taken out of the accrued expenses. Therefore, the Net Asset Value of the Bond Fund was understated by \$10.17. This error did not impact the final daily unit price. This was corrected immediately.

Based on Board policy, this report will be brought to the Audit Committee again next year. The Board will continue to be notified of any error that impacts the unit price by more than the tolerance level, \$0.01/unit on a timely basis.

Risk Management – Enterprise Risk Management Report

Ms. Vandehey presented the Enterprise Risk Management (ERM) Report, which provided an overview of the agency's ERM program, risk results for 2007, and future risk projects for 2008.

Mr. Nakahara suggested that Public Equity and Private Markets committees should be included in the risk management oversight slide to reflect their role with respect to overseeing investment risk.

The key risks categories have been identified as fiduciary risk, market risk, strategic risk, government environment risk, operational risk, and reputation risk. In 2007, the risk most reported was operational, the risk that losses could arise from short-comings or failures in internal or external processes, people, or systems. This type of risk is managed by continuous improvements of control structure, commitment to creating an environment where staff continues to learn and institute state of the art practices, and active mitigation of identified key operational risks. Reputation risk was the next most assigned description in the database. The WSIB actively mitigates any risk event that may affect reputation by analyzing how an event might impact the reputation, actively assess the impact, and improving or modifying controls and processes as a result.

The Committee discussed how the core business processes are identified graphically using a heat map. Ms. Vandehey explained that all core business processes fall into the low likelihood/high impact or low

impact/low likelihood quadrants. High impact/low likelihood ratings do not mean the controls are weak, but that staff realize those areas are very important to the overall operations of the agency.

2008 objectives include ensuring the consideration of risk is the central process staff deploys in investment management and building out the investment risk analysis tool set. The ERM program will continue its effort to expand and ensure the consideration of risk is central to all the agency's management activities.

Chair Petit asked if the scope of the ERM program will be expanded. Mr. Dear indicated there is a plan underway to expand the program in 2008; however, to fully implement a comprehensive risk program will require additional resources.

In response to a question from Mr. Masten, Mr. Dear clarified the fiduciary risk definition refers to legal services retained by the Board, which includes both the Assistant Attorney General and Bill Song.

Compliance Monitoring – Investment Compliance Report

Ms. Vandehey provided an overview of the investment compliance program and the new applications in use at the WSIB and then introduced Ms. Matsumoto, who presented the Private Equity Investment Compliance Report. Ms. Vandehey explained the agency created the Compliance Program independent of the Investment Division in 2003. This is to separate compliance management from compliance reporting, provide an absolute segregation of duties, and strengthen the control structure for the agency. In the fall, public equity, fixed income, and the cash overlay program were transitioned from the prior Charles River Compliance Program to the JP Morgan Compliance System. The JP Morgan Compliance System runs approximately 5,500 tests on 166 rules on a daily basis. Over the past twelve months WSIB has had a high rate of compliance. With the JP Morgan Compliance System, all exceptions are tracked electronically on an on-line Web based system. Compliance projects for this year and next year include real estate and tangible assets.

Private equity compliance testing began in October 2006, with ten funds selected from the WSIB's core portfolio. Starting with ten core funds allowed staff to test the WSIB's largest relationships and modify the compliance process to become comfortable with the testing and gain assurance that core general partners were in compliance before testing all funds. Once the compliance process was in place, funds were tested on a rotational basis each quarter. Annual private equity compliance testing has improved the control processes over accounting data; provided assurance that general partners are in compliance with the material terms of their limited partnership agreements; provided comfort that private equity investments are managed with reasonable care; and, improved transparency over private equity investments.

As of January 28, 2008, 127 funds have been tested. These 127 funds represent all of the general partners in the private equity portfolio and testing has been completed on 101 funds. Of the 101 funds completed, all were in compliance with the ten testing areas. Compliance testing remains open on 26 funds, which represent 11 general partners. Of these 11 general partners, some have provided information and staff still has outstanding issues with them. Other general partners have been politely non-responsive. Mr. Nakahara asked what additional things are being done with the key partners that may provide additional comfort that they are minding our best interest. Ms. Matsumoto responded that when testing the ten testing areas, staff gets more information than just the specific response to

questions from the general partner. This provides additional understanding about the general partner and the fund itself. Mr. Nakahara also asked if any of the funds tested were in the area of real estate. Ms. Matsumoto explained that a compliance program similar to the private equity program will be rolled out for the real estate portfolio in 2008.

OTHER ITEMS

Internal Auditor Evaluation

Chair Petit called the Audit Committee into executive session at 10:39 a.m. to review and discuss the performance of a public employee. He said the executive session was expected to last approximately 20 minutes.

[The Audit Committee recessed at 10:39 a.m. and reconvened in executive session at 10:50 a.m.]

[The Audit Committee reconvened in open session at 11:04 a.m.]

There was no further business to come before the Committee and the meeting adjourned at 11:05 a.m.