

Audit

Follow-Up

As of March 31, 2011



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Non-Pension Investments

(Report #1020 issued June 21, 2010)

Report #1112

June 16, 2011

Summary

Twenty-seven of the 30 action plan steps established to address the issues identified in our audit of the City's non-pension investments (report #1020) have been completed or otherwise resolved through management decision. Three of those 27 action plan steps were completed during the period covered by this follow up review. Efforts are on-going or plans in process to complete the remaining three steps.

In audit report #1020, we noted that as of June 30, 2009, the market value of all non-pension investments was approximately \$679 million. In that report we concluded that, overall, the Treasurer-Clerk's Office properly and adequately managed and invested available non-pension funds. As reported, no one sector/category lost capital and each sector/category performed reasonably well in relation to existing market conditions and policy benchmarks. The Treasurer-Clerk's Office took timely and appropriate actions to replace two external managers that were not performing well. We also found the Treasurer-Clerk's Office (1) established and implemented a sound and appropriate investment policy; (2) complied with that policy, as well as other legal requirements and industry practices; (3) established proper and adequate controls; (4) monitored activity and performance; and (5) prepared periodic reports showing performance

and status of non-pension investments.

However, one issue was identified that showed a need for the Treasurer-Clerk's Office to revise processes and controls pertaining to the allocation of investment earnings. Specifically, we found the Treasurer-Clerk's Office was allocating earnings based on outdated (static) account balances instead of more appropriate current (dynamic) balances. As described in the report for our first follow up on the initial audit, corrective actions because of this issue included the City's recovery of \$2 million of investment earnings that had been incorrectly allocated to Blueprint 2000, an entity related to but separate from the City.

In addition to the issue relating to incorrect allocations of investment earnings, we identified several areas where we recommended enhancements and improvements to the non-pension investment processes and/or records.

Thirty action plan steps were developed to address the identified issues and areas. Our two follow up reviews conducted to date showed:

- The Treasurer-Clerk's Office has completed or resolved 27 of those 30 steps.
- The Treasurer-Clerk's Office continues to take actions towards the completion of two additional steps.
- Plans are in place to complete the one remaining action step after the two steps noted above have been completed.

Significant actions completed during this current follow up review period included:

- Resolving previously questioned custodian fees, including taking actions to ensure unnecessary charges are no longer assessed. Enhanced reviews of custodian invoices by Treasurer-Clerk management are also now performed (two action plan steps).
- Having applicable external managers certify they reconcile their activity to that reported by the City's custodian and report any unresolved issues to the Treasurer-Clerk's Office.

Remaining actions in process and/or to be completed include:

- Making retroactive calculations and adjustments for investment earnings, relating to City funds that were invested through certain external entities (Galliard and Florida League of Cities) and internally by Treasurer-Clerk investment staff, which were previously incorrectly allocated due to use of outdated (static) account balances.
- Obtaining updated arbitrage determinations for applicable bond proceeds.
- Updating the "Investment Internal Control Procedures" to reflect the current circumstances and processes.

We appreciate the cooperation and assistance provided by Treasurer-Clerk staff during this audit follow-up.

Scope, Objectives, and Methodology

We conducted this audit follow-up in accordance with the International Standards for the Professional Practice of Internal Auditing and Generally Accepted Government Auditing Standards. Those standards require we plan and perform the audit follow-up to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our

findings and conclusions based on our audit follow-up objectives.

Report #1020

The scope of report #1020 included a review of activity and performance of the City's non-pension investments. The objectives were to determine whether:

- The City has a sound and proper non-pension investment policy;
- The City complied with its non-pension investment policy, legal requirements, and sound business practices;
- Contracts and agreements with third parties contain appropriate language and terms to protect the City's interest;
- Investment transactions are properly authorized, executed, documented, and otherwise in the best interest of the City;
- Monitoring and oversight of the non-pension investment function is appropriate;
- Adequate internal controls have been established in regard to the non-pension investment function; and
- Earnings performance has been successful in relation to established benchmarks.

Activity and performance over the three-year period ending June 30, 2009, was reviewed and analyzed, with an emphasis on activity during the one-year period ending June 30, 2009.

Report #1112

This is our second follow-up on action plan steps identified in audit report #1020. The purpose of this follow up is to report on the progress and status of efforts to complete action plan steps due for completion as of March 31, 2011. Our initial follow up engagement (Report #1108) addressed the progress and status of action plan steps due as of September 30, 2010. To determine the status of the action plan steps, we interviewed staff, made observations, and reviewed relevant documentation.

Background

The City's invested non-pension funds are primarily comprised of (1) operating cash that temporarily is not needed for disbursement, (2) bond proceeds not immediately disbursed for the projects or purposes for which the related bonds were issued, and (3) bond reserves which must be held and invested pursuant to bond covenants. The Office of the Treasurer-Clerk is responsible for investing and managing the City's non-pension assets. City Commission Policy #234 governs investment of non-pension funds. That policy provides for non-pension assets to be invested prudently and in a manner that (1) preserves capital, (2) ensures liquidity to meet operating and capital needs, and (3) maximizes earnings within established risk levels.

City non-pension investments are categorized into two basic groups: (1) Core Portfolio and (2) Specialized Portfolios. As of June 30, 2009, the Office of the Treasurer-Clerk reported the market value of all non-pension investments was approximately \$679 million. Those funds were invested and managed internally by Treasurer-Clerk staff and through contracted external managers and available government investment pools.

The last half of the period included in the scope of our audit was during times of major financial market instability and upheaval. During those times we noted the Treasurer-Clerk's Office maintained a close vigil on the City's non-pension investments and acted prudently during that period to protect the City's invested assets.

Previous Conditions and Current Status

In report #1020, we noted that, overall, based on performance adjusted for several audit issues presented in the report, the Treasurer-Clerk's Office properly and adequately managed and invested available non-pension funds. Our review showed no one sector/category lost capital and each sector/category performed reasonably well in relation to existing market conditions and policy benchmarks. For two instances where

external managers were not performing well, the Treasurer-Clerk's Office took timely and appropriate action to replace the managers and reinvest the applicable funds. We also found that, for the most part, the Treasurer-Clerk's Office:

- Established and implemented a sound and appropriate investment policy.
- Complied with the non-pension investment policy, other applicable legal requirements, and industry practices.
- Established proper and adequate controls and processes, consistent with industry standards.
- Monitored activity, including that of applicable third parties.
- Prepared periodic reports showing performance and status of non-pension investments.

However, one issue was identified that showed a need for the Treasurer-Clerk's Office to revise processes and controls pertaining to the allocation of non-pension investment earnings. As noted in our initial follow up report (#1108) for this audit, corrective actions because of this issue included the City's recovery of \$2 million of investment earnings that had been incorrectly allocated to Blueprint 2000, an entity related to but separate from the City.

In addition to the issue relating to incorrect allocations of investment earnings, we identified several areas where we recommended enhancements and improvements to the non-pension investment processes and/or records.

Thirty action plan steps were developed to address the identified issues. Each of those 30 steps was due for completion as of March 31, 2011. As shown below in Table 1:

- The Treasurer-Clerk's Office has completed or resolved 27 of those 30 steps.
- The Treasurer-Clerk's Office is in the process of completing two additional steps.

- Actions to complete the last step will be initiated once the two steps noted above are completed and/or resolved.

We commend the Treasurer-Clerk’s Office for the corrective actions taken.

**Table 1
Action Plan Steps from Audit Report #1020
Due as of March 31, 2011, and Current Status**

Action Plan Steps Due as of March 31, 2011	Current Status
Ensure equitable allocations of investment earnings	
<ul style="list-style-type: none"> • Updated (dynamic) account balances will be used to determine allocation percentages for each month’s allocation of non-pension investment earnings for the Core Portfolio. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • The portion of the earnings allocation process performed manually will be automated. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Earning allocations for the Core Portfolio since the summer 2008 will be recalculated retroactively using appropriate proportions (i.e., monthly earnings will be allocated based on proportional balances determined for each month). Adjustments will be made to affected funds. 	<ul style="list-style-type: none"> ❖ In our report (#1108) for the initial follow up on Audit of Non-Pension Investments (#1020), we reported the Treasurer-Clerk’s Office retroactively recalculated investment earning allocations using updated and appropriate (dynamic) investment balances for the investment category involving both City and Blueprint 2000 funds. Those recalculations were for fiscal years 2008, 2009, and 2010. Appropriate adjustments were made based on those retroactive calculations. As reported, those adjustments resulted in a transfer of \$2,044,087 from Blueprint 2000 to the City, as earnings had been incorrectly allocated to Blueprint 2000 when outdated (static) account balances were used as described in the initial audit report. In that initial follow up report, we also reported the Treasurer-Clerk’s Office inadvertently excluded one month’s investment earnings from the adjusting recalculations. Accordingly, an additional adjustment of \$68,700 was noted as necessary for that month. Furthermore, in our initial follow up report, we reported no retroactive calculations or adjustments were made for other investment categories (i.e., categories not involving both the City and Blueprint 2000 funds) for which earnings had been allocated using outdated

	<p>(static) account balances. Those categories included (1) internally managed investments, (2) investments through an external manager (Galliard), and (3) investments through the Florida League of Cities.</p> <p>In our current review, we found the Treasurer-Clerk’s Office is in the process of calculating and determining appropriate adjustments to make for those other investment categories. Those adjustments are being calculated and determined using updated (dynamic) account balances. Our current review showed that because of the intricate adjustment process and significant amount of detailed prior activity that must be reviewed, the Treasurer-Clerk’s staff had not finalized the calculations and made the needed adjustments. The Treasurer-Clerk’s Office indicated it plans to complete those calculations and determinations and make the necessary adjustments by mid-summer 2011. The final adjustment for the investment category involving both City and Blueprint 2000 funds will also be made by that date. We will follow up on and review those calculations, determinations, and resulting adjustments in our subsequent follow up engagement.</p>
<ul style="list-style-type: none"> • Adjustments will be made to correct the over and under-allocations of bond reserve earnings as identified in the initial audit report (page 23 of that report). 	<p>✓ Completed in a prior period.</p>
<ul style="list-style-type: none"> • Future allocations of earnings on bond reserves will be corrected for the worksheet error explained in the initial audit report (pages 22 and 23 of report #1020). 	<p>✓ Completed in a prior period.</p>
<p>Ensure an adequate and proper policy</p>	
<ul style="list-style-type: none"> • City Commission Policy #234 will be updated to make the corrections, clarifications, and enhancements as described on pages 23 through 26, 40, and 49 of the audit report. 	<p>✓ Completed in a prior period.</p>
<p>Ensure compliance with policy requirements</p>	
<ul style="list-style-type: none"> • Criteria will be developed for classification and reporting of bond proceeds investments as to portfolio type. 	<p>✓ Completed in a prior period.</p>

<ul style="list-style-type: none"> • The reporting and oversight process will be enhanced to identify all (even minor) violations of policy maturity duration requirements. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Written approval will be sought from Ambac Assurance for investment of the Airport System Revenue Refunding Bonds (2004 series) in the State of Florida SPIA. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<p>Comply with federal arbitrage requirements</p>	
<ul style="list-style-type: none"> • Updated arbitrage determinations will be made. 	<ul style="list-style-type: none"> ❖ The City is required by the Internal Revenue Service (IRS) to determine if earnings on invested bond proceeds exceed the maximum allowed earnings rate pursuant to federal “arbitrage” regulations. If those earnings are found to exceed the maximum earnings rate, the City will be required to pay a “rebate” to the IRS on the excess earnings. In the initial audit we reported that timely arbitrage determinations had not been completed for applicable bond issuances and recommended consideration be given to obtaining such updated determinations. In our initial audit follow up review report (#1108) we found and reported the Treasurer-Clerk’s Office was in the process of obtaining updated arbitrage determinations as recommended. During this second follow up review, the Treasurer-Clerk’s Office indicated the retroactive interest earning reallocations described above (see the third action plan step in this table) may impact the arbitrage determinations as those reallocations likely will impact the amount of earnings on applicable invested bond proceeds. Accordingly, the Treasurer-Clerk’s Office made the prudent decision to wait until the interest reallocations for prior periods are calculated and finalized and correcting entries made before resuming the process of obtaining updated arbitrage determinations. Accordingly, we will follow up on this action plan step in our subsequent follow up engagement.
<p>Ensure accurate, informative, and complete performance and status reports</p>	
<ul style="list-style-type: none"> • Reports prepared by the Treasury Analyst will be reviewed by the Deputy Treasurer-Clerk for accuracy and completeness prior to 	<ul style="list-style-type: none"> ✓ Completed in a prior period.

distribution of those reports to management and the IAC.	
<ul style="list-style-type: none"> All non-pension investments will be addressed in the periodic reports, including GICs and the Securities Lending Portfolio. 	✓ Completed in a prior period.
<ul style="list-style-type: none"> Investments will be classified on periodic reports in a manner that is consistent with classifications in an updated City Commission Policy #234. 	✓ Completed in a prior period.
<ul style="list-style-type: none"> The periodic reports will be enhanced to report on additional policy requirements (e.g., duration) as addressed on pages 29 through 31 of the audit report. 	✓ Completed in a prior period.
<ul style="list-style-type: none"> Graphical representations of non-pension investments will be prepared on the same basis or the bases will be disclosed in a legend to the graphs. 	✓ Completed in a prior period.
<ul style="list-style-type: none"> Weighted averages will be properly applied when disaggregating and reporting performance and maturity durations for applicable investment categories. 	✓ Completed in a prior period.
<ul style="list-style-type: none"> Policy benchmarks will be accurately and correctly determined. 	✓ Completed in a prior period.
Provide for adequate controls and processes	
<ul style="list-style-type: none"> Efforts will be made to recover the net overcharge of \$13,445 from the custodian. 	<p>✓ The bulk of the net overcharge was comprised of the following two circumstances:</p> <ul style="list-style-type: none"> The contracted custodian billed the City a “custody fee” for a portfolio tracked and analyzed by the custodian but not “custodied” (responsible for physical custody) by the custodian on behalf of the City (\$14,320 overcharge during a two-year period). That portfolio was the City’s non-pension investments through the Florida League of Cities. The contracted custodian billed the City performance analysis and reporting fees for the same portfolio twice (\$875 overcharge during a two-year period). <p>The remaining amounts represent net undercharges by the custodian.</p>

	<p>In response to our initial audit recommendations, the Treasurer-Clerk's Office contacted and discussed these questioned charges with the contracted custodian. The Treasurer-Clerk's Office indicated that, based on those discussions:</p> <ul style="list-style-type: none">- The "custody fee" charged for the City's investments through the Florida League of Cities was and continues to be appropriate. According to the Treasurer-Clerk's Office, the custodian asserted that fee was appropriate and applicable as long as the custodian tracked, analyzed, and reported activity and performance of that portfolio, even if they were not responsible for the physical custody of the related assets. The Treasurer-Clerk's Office determined it is currently appropriate and desirable for the custodian to continue to track, analyze, and report on the activity and balances for that portfolio; as it provides the Treasurer-Clerk's Office a meaningful comparison to activity and performance tracked and reported separately by Treasurer-Clerk staff. As a result, recovery of those fees will no longer be pursued.- Appropriate corrective action was made to stop the billing of performance analysis and reporting fees for the same portfolio twice. The duplicate billing for that portfolio was found to be the result of a unique circumstance in which that portfolio had previously been combined with another portfolio for a combined analysis. Under the circumstances, a separate analysis for the portfolio was also appropriate. However, when the other portfolio was discontinued (i.e., applicable funds reinvested in a different portfolio), the custodian continued to
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	<p>analyze the remaining portfolio under both the “combined” category and “separate” category. Upon bringing this duplicate charge to their attention, the Treasurer-Clerk’s Office took appropriate action to have the custodian terminate the unnecessary duplicate analysis. Our review of the subsequent custodian invoice showed this duplicate fee is no longer billed.</p> <p>These reported actions resolved this issue.</p>
<ul style="list-style-type: none"> • The Deputy Treasurer-Clerk will ensure that fees billed by the custodian are accurate and reasonable. 	<ul style="list-style-type: none"> ✓ Our current review showed the Deputy Treasurer-Clerk is reviewing the periodic custodian invoices and ensuring billed fees are accurate and reasonable.
<ul style="list-style-type: none"> • Adequate documentation will be retained for future transactions to clearly demonstrate the evaluation of and justification for securities selected through competitive solicitation. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Adequate documentation will be retained for future transactions to clearly demonstrate that fair and reasonable prices (i.e., comparable to current market values) were received in connection with unsolicited sales of individual securities. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Requests for essential/critical background information on brokers/dealers will be enhanced to request disclosures/assertions as to recent or current litigation or regulatory violations. 	<ul style="list-style-type: none"> ✓ Completed/resolved in a prior period.
<ul style="list-style-type: none"> • Annual disclosures and assertions as to conflicts of interest will be required from key Treasurer-Clerk staff and IAC members. The investment policy will be revised to provide for those annual disclosures/assertions. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Efforts will be enhanced to ensure IAC meeting minutes are reviewed and approved by Treasurer-Clerk management and the IAC. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> • Treasurer-Clerk staff will work with Accounting Services staff to arrange for periodic account statements to be provided directly to, or accessed directly by, 	<ul style="list-style-type: none"> ✓ Completed in a prior period.

Accounting Services.	
<ul style="list-style-type: none"> Treasurer-Clerk staff will reconcile the temporary clearing account, established for investment receipts, on a monthly basis. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> Treasurer-Clerk staff will have applicable external managers certify they reconcile their activity to that reported by the custodian and will report any unresolved issues to the Treasurer-Clerk’s Office. 	<ul style="list-style-type: none"> ✓ In response to requests from the Treasurer-Clerk’s Office, the two applicable external managers provided signed assertions indicating (1) they reconcile their records and activities for the City’s account to the records maintained for those accounts by the City’s custodian and (2) will report any unresolved issues resulting from those reconciliations to the Treasurer-Clerk’s Office. The Treasurer-Clerk’s Office intends to obtain such signed assertions on an annual basis.
<ul style="list-style-type: none"> The two system administrator permissions addressed in the audit report will be deleted. 	<ul style="list-style-type: none"> ✓ Completed in a prior period.
<ul style="list-style-type: none"> Treasurer-Clerk staff will ensure future agreements executed for non-negotiable CDs restrict the transfer of matured/redeemed funds to the City’s bank account. 	<ul style="list-style-type: none"> ✓ Completed/resolved in a prior period.
<ul style="list-style-type: none"> The “Investment Internal Control Procedures” will be updated to reflect current circumstances and processes. 	<ul style="list-style-type: none"> ✘ As similarly reported in the prior follow up audit report, the Treasurer-Clerk’s Office has not yet updated the internal operating procedures to accurately reflect the current operating environment. The Treasurer-Clerk’s Office indicated the procedures would be updated when all other action plan steps are completed. Accordingly, we will follow up on this step in our subsequent follow up engagement.

Table Legend:

- Issue to be addressed from the original audit.

- ✓ Issue addressed and resolved.

- ❖ Action initiated but not completed.

- ✘ Action plan step not completed.

Conclusion

Table 1 above shows significant effort in the completion of the 30 action plan steps established to address the issues identified in our initial audit, as 27 of those 30 steps have now been completed. As reported in our initial follow up report (#1108), the most significant action included the City's recovery of approximately \$2 million in investment earnings that had been incorrectly allocated to Blueprint 2000.

During the period covered by this follow up engagement, the Treasurer-Clerk's Office completed three action plan steps and continued to work on the three remaining steps.

Actions completed during this follow up reporting period included:

- Resolving previously questioned custodian fees, including taking actions to ensure unnecessary charges are no longer assessed. Enhanced reviews of custodian invoices by Treasurer-Clerk management are also now performed (two action plan steps).
- Having applicable external managers certify they reconcile their activity to that reported by the City's custodian and report any unresolved issues to the Treasurer-Clerk's Office.

Remaining actions in process and/or to be completed include:

- Making retroactive calculations and adjustments for investment earnings, relating to City funds that were invested through certain external entities (Galliard and Florida League of Cities) and internally by Treasurer-Clerk investment staff, which were previously incorrectly allocated due to use of outdated (static) account balances.
- Obtaining updated arbitrage determinations for applicable bond proceeds.
- Updating the "Investment Internal Control Procedures" to reflect the current circumstances and processes.

We appreciate the cooperation and assistance provided by Treasurer-Clerk staff during this audit follow-up.

Appointed Official's Response

Interim City Treasurer-Clerk:

The audit of non-pension investments identified action plan steps to improve processes and controls. Most of these changes have been made; prompt completion of the few remaining items will finalize the steps for improvement. The Treasurer-Clerk would like to thank the City Auditor for his diligent efforts in this audit and his assistance in implementation of the action steps.

Copies of this audit follow-up #1112 or audit report #1020 may be obtained from the City Auditor's website (<http://talgov.com/auditing/index.cfm>) or via request by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (Office of the City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail (auditors@talgov.com).

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