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City Auditor

## HIGHLIGHTS

Highlights of City Auditor Report #1020, a report to the City Commission and City management

### WHY THIS AUDIT WAS CONDUCTED

As of June 30, 2009, City non-pension investments were valued at \$679 million. Those investments were managed both internally by Treasurer-Clerk staff and externally by third party managers hired by the City. The City established a non-pension investment policy to govern the investment of non-pension funds. The non-pension investments are categorized and managed into a Core Portfolio and several Specialized Portfolios.

This audit was conducted to determine (1) whether the City has a sound non-pension investment policy; (2) compliance with the non-pension investment policy, legal requirements, and sound business practices; (3) whether contracts and agreements with third parties contain appropriate language and terms; (4) whether investment transactions are properly authorized, executed, documented, and appropriate; (5) whether there is adequate monitoring and oversight of the non-pension investment function; (6) whether adequate internal controls have been established; and (7) whether earnings performance has been successful in relation to benchmarks.

### WHAT WE RECOMMENDED

We recommended the investment earnings allocation process be revised and fully automated to address significant allocation errors identified by the audit.

We also recommended the Treasurer-Clerk's Office consider making several enhancements to improve non-pension investment processes and documentation. Those recommendations pertain to:

- The non-pension investment policy.
- Compliance with that policy.
- Federal arbitrage regulations.
- Reporting investment performance and status.
- Third party fees.
- Documenting key investment decisions and processes.
- Internal Controls.

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June 21, 2010

## AUDIT OF CITY NON-PENSION INVESTMENTS

*Overall, the Treasurer-Clerk's Office has successfully, properly, and prudently invested available non-pension assets in accordance with policy and legal requirements and industry practices. One significant issue was identified and several areas were identified where enhancements should be considered.*

### WHAT WE CONCLUDED

Returns on investments have been appropriate, especially under existing market conditions, with no losses of capital. The City has established an adequate investment policy and adequate controls. Third parties are hired and used as appropriate. Treasurer-Clerk management monitors and reviews those third parties as well as investment performance and status. The Treasurer-Clerk's Office is to be commended for maintaining a vigil over non-pension investments and making critical investment decisions that protected the City's invested assets during recent times of financial market uncertainty and instability.

We identified one significant issue regarding the accurate and equitable allocation of non-pension investment earnings. The issue involved significant worksheet errors and use of outdated (static) balances in determining allocations when current (dynamic) balances were more appropriate. Treasurer-Clerk staff has taken measures to address that issue.

We also identified other areas where enhancements to the non-pension investment administrative and oversight functions were recommended. Those recommended enhancements include:

- Updating, clarifying, and enhancing terms and provisions in the current non-pension investment policy.
- Clarifying classifications of certain investments as to portfolio type (i.e., Core or Specialized).
- Obtaining updated and timely arbitrage determinations on investments of bond proceeds.
- Making modifications to the periodic performance status reports to make reported information clearer to users of those reports.
- Increasing the review of periodic performance status reports to ensure accuracy of reported information.
- Enhancing the review of custodian invoices to ensure accuracy of fees paid for those services.
- Maintaining better documentation relative to certain investment transactions.
- Ensuring appropriate account reconciliations are performed in a manner consistent with good internal control practices.
- Improving other internal controls and processes.

Several additional recommendations were made.

We would like to thank the staff in the Treasurer-Clerk's Office and Accounting Services for their assistance during this audit.

Office of the City Auditor

# **Non-Pension Investments**

**AUDIT REPORT #1020**

**June 21, 2010**



Copies of this audit report #1020 may be obtained from the City Auditor's web site (<http://www.talgov.com/auditing/auditreports.cfm>), by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail ([auditors@talgov.com](mailto:auditors@talgov.com)).

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Sam M. McCall, Ph.D, CPA, CGFM, CIA, CGAP, City Auditor

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# Non-Pension Investments



Sam M. McCall, Ph.D, CPA, CGFM, CIA, CGAP  
City Auditor

Report #1020

June 21, 2010

## Executive Summary

*This audit addressed the City's non-pension investment function.*

*Activity and performance during the three-year period ending June 30, 2009 were reviewed.*

*Non-pension assets as of June 30, 2009, were valued at \$679 million.*

***OVERVIEW: Overall, our audit showed the Treasurer-Clerk's Office has successfully, properly, and prudently invested available non-pension assets in accordance with policy and legal requirements and industry practices. Returns on those investments have been appropriate, especially under existing market conditions, with no losses of investment capital. Also, the City has established an adequate investment policy and adequate controls to ensure only proper investment transactions/activities are executed/performed. Third parties (broker/dealers, custodians, external managers, and security lending agents) are hired and used as appropriate. Treasurer-Clerk management and the City's Investment Advisory Committee monitor and review those third parties, as well as investment performance and status. The Treasurer-Clerk's Office is to be commended for maintaining a vigil over non-pension investments and making critical investment decisions that protected the City's invested assets during recent times of financial market uncertainty and instability.***

***Our audit also identified a significant issue regarding the accurate and equitable allocation of non-pension investment earnings. Other areas were identified where enhancements and improvements are recommended to the non-pension investment administrative and oversight functions.***

This audit addressed the City's non-pension investment function. 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. As of that date the City's non-pension investment portfolio was valued at \$679 million. Those investments were managed both internally by

*City non-pension investments are governed by City Commission Policy #234.*

*Overall the Treasurer-Clerk's Office successfully, properly, and adequately managed City non-pension investments.*

*The Treasurer-Clerk's Office is to be commended for timely and prudent decisions and management during recent times of major uncertainty and instability in financial markets.*

Treasurer-Clerk investment staff and externally by third party managers hired by the City. In accordance with sound control practices and industry guidance, the City established a non-pension investment policy (City Commission Policy #234) to govern the investment of non-pension funds.

The results of our audit procedures showed, overall, based on performance, adjusted for several audit issues presented within this report, the Treasurer-Clerk's Office is successfully, properly, and prudently managing and investing available non-pension funds. The Treasurer-Clerk's Office is to be commended for maintaining a vigil over the City's invested non-pension assets and making prudent decisions during recent times of major uncertainty and instability in the financial markets. During the audit period, which includes those times of uncertainty and instability, our review showed that no one sector/category lost capital and each sector/category performed reasonably well, especially in relation to existing market conditions. Prudent actions taken by the Treasurer-Clerk's Office included the timely withdrawal of City non-pension funds invested in the State Board of Administration's (SBA) Local Government Investment Pool (LGIP) because of liquidity concerns. Those concerns arose upon indications the market value of that pool was becoming unstable. Subsequent to the Treasurer-Clerk's last withdrawal of City funds, the State Board of Administration (comprised of the Governor, Chief Financial Officer, and Attorney General) "froze" the SBA LGIP such that municipalities and other local governments were no longer able to access their funds invested in that pool, thereby likely hindering those government's cash management functions. Because of the Treasurer-Clerk's prudent actions, the City was not subjected to those circumstances.

We also found, for the most part, the City and Treasurer-Clerk's Office:

- Established and implemented a sound and appropriate non-pension 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.

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. Specifically, because of undetected worksheet errors and use of outdated balances in an initial (manually-performed) allocation step, some monthly allocations of non-pension investment earnings to benefiting funds were not correct.

*We determined the process for allocating non-pension investment earnings did not ensure equitable distributions of those earnings to benefiting City funds.*

In addition to the issue described above, we identified several areas where we believe the Treasurer-Clerk's Office should consider making changes that enhance and improve non-pension investment processes and/or documentation. Those recommended enhancements include:

- Updating, clarifying, and enhancing certain terms and/or provisions in the current non-pension investment policy to enhance understanding of and ensure consistent and proper interpretation of that policy.
- Clarifying classifications of certain investments as to portfolio type (i.e., "Core" or "Specialized"), as such classifications can significantly impact whether a specific investment is in compliance with policy diversification requirements.
- Identifying minor unintentional instances of policy noncompliance so that Treasurer-Clerk staff can ensure appropriate actions are taken (over time as appropriate) to address such instances.



*Other areas were identified for which enhancements and improvements to the non-pension administrative and oversight functions were recommended.*

- Obtaining approval from the applicable insurance guarantor for the investment (i.e., actually reinvestment) of bond proceeds, for one of the City's numerous bonds, in the State's Special Purpose Investment Account (SPIA). (NOTE: While not yet approved by the insurance guarantor, the investment of those bond proceeds in the SPIA was a prudent action by the Treasurer-Clerk's Office in response to liquidity concerns with the SBA LGIP.)
- Obtaining updated and timely arbitrage determinations on investments of applicable bond proceeds.
- Making certain modifications to the periodic performance status reports that should make reported information clearer to users of those reports (e.g., Investment Advisory Committee members, City Commission, or interested non-city entities or individuals).
- Increasing the review of periodic performance status reports to ensure accuracy of reported information.
- Enhancing the review of custodian invoices to ensure accurate fees are paid for those services.
- Maintaining better documentation that clearly (1) shows security evaluations when considering securities for acquisitions and (2) shows comparable current market values when selling securities in response to unsolicited offers to purchase specific City-owned securities.
- Preparing and retaining additional documentation that helps the Treasurer-Clerk's Office justify the selection of external managers.
- Requesting and obtaining periodic disclosures from authorized brokers/dealers as to existing or recent litigation and/or regulatory violations.

- Obtaining periodic assertions from Treasurer-Clerk investment staff and members of the IAC regarding the existence of any known or potential conflicts of interest.
- Consistently documenting the IAC's review and approval of meeting minutes prepared by Treasurer-Clerk staff.
- Ensuring appropriate account reconciliations are performed in a manner consistent with good internal control practices.
- Having the bank eliminate two unused system administrator permissions created when the vendor updated the wire transfer application.
- Adding language on non-negotiable certificates of deposits that restrict the transfers of matured/redeemed funds into the City's bank account.
- Updating documented internal control procedures to reflect the current operating environment.

*While numerous areas for enhancement and improvement were identified, from an overall perspective the Treasurer-Clerk's current processes and controls are appropriate, accurate, and in accordance with sound practices.*

It is important to note that, while we have identified numerous areas for enhancements and improvements to processes and controls, the Treasurer-Clerk's current processes and controls from an overall perspective are appropriate, accurate, and in accordance with sound business practices and internal control guidelines.

We would like to thank staff in the Treasurer-Clerk's Office and Accounting Services for their assistance during this audit.

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# *Non-Pension Investments*



Sam M. McCall, Ph.D, CPA, CGFM, CIA, CGAP  
City Auditor

**Report #1020**

**June 21, 2010**

## ***Objectives***

*The purpose of this audit was to determine the adequacy and success of the City's non-pension investment function and activities.*

The objectives of this audit were to determine (1) whether the City has a sound and proper non-pension investment policy; (2) whether the City complied with its non-pension investment policy, legal requirements, and sound business practices; (3) whether contracts and agreements with third parties (external managers, custodians, lending agents, etc.) contain appropriate language and terms to protect the City's interests; (4) whether investment transactions are properly authorized, executed, documented, and otherwise in the best interest of the City; (5) whether monitoring and oversight of the non-pension investment function is appropriate; (6) whether adequate internal controls have been established in regard to the non-pension investment function; and (7) whether earnings performance has been successful in relation to established benchmarks.

## ***Scope***

*Investment activity over the last 3-year period was reviewed, with an emphasis on current activity and processes.*

The scope of this audit included a review of activity and performance of the City's non-pension investments. 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. In some instances, activity subsequent to that date was reviewed. The current non-pension investment policy and procedures in effect at the time of our audit fieldwork in summer and fall 2009 were reviewed for purposes of completing our audit objectives stated above.

## ***Methodology***

We conducted various audit procedures to address the stated objectives. Those procedures included making audit observations, conducting interviews of knowledgeable personnel, and inspecting and analyzing applicable records and reports. Specific audit methodologies and procedures included the following:

*We identified and reviewed methodologies and processes, made observations, interviewed knowledgeable staff, and analyzed recorded activity.*

- We identified governing ordinances, statutes, policies, and other legal provisions and determined compliance therewith.
- We compared City policies and procedures with established industry standards.
- We compared earnings performance against established benchmarks.
- We reviewed investment earnings to ensure they were properly and equitably allocated to applicable City funds and functions.
- We determined if income (e.g., interest) due to the City based on investments held was actually received by the City.
- We reviewed the City's holdings to ensure individual securities met policy requirements as to type, credit rating, and maturity durations.
- We determined if bond proceeds and reserves were invested and accounted for pursuant to controlling bond covenants.
- We reviewed transactions (purchases, sales, transfers, etc.) to ensure they were appropriate, properly accounted for, and in accordance with controlling policy and legal provisions and sound business practices.
- We determined if fees paid to applicable third parties (custodian, external managers, and security lending agent) were proper and reasonable.
- We determined if adequate, accurate, and complete reports on non-pension investment activity were prepared periodically and provided to management and the City's Investment Advisory Committee (IAC).
- We determined if external managers and broker-dealers were selected using proper due diligence and competitive practices as appropriate.

*Various detailed audit procedures were performed.*

- We determined if agreements with third parties (external managers, broker-dealers, custodian, security lending agent) were adequate and proper.
- We determined if required periodic reports were obtained from third parties (external managers, broker-dealers, custodian, security lending agent) and reviewed by Treasurer-Clerk staff.
- We reviewed the adequacy of internal controls established for various non-pension investment activities including cash analyses, securing and collateralizing investments, transferring funds (includes electronic transfers), and purchasing and selling individual securities.

We conducted this audit 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 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 objectives.

## ***Background***

*The Office of the Treasurer-Clerk is responsible for investing and managing non-pension investments.*

**Investment Policy.** The City's invested non-pension funds are primarily comprised of:

- Operating cash from various City funds that temporarily is not needed for disbursement. Examples include revenues (City share of state taxes, state and federal grants, utility revenues, etc.) received in amounts greater than impending disbursements.
- Bond proceeds not immediately disbursed for the projects or purposes for which the related bonds were issued.
- Bond reserves, which must be held (not disbursed) and invested pursuant to bond covenants.

*City Commission Policy #234 was established to govern City non-pension investments.*

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. Pursuant to that policy, non-pension assets should 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. Those three objectives are prioritized. Accordingly, while earnings are important, assets should not be invested in a manner that significantly increases the risk of capital loss (i.e., loss of invested principal) or limits the ability of the City to liquidate invested funds for disbursement needs without incurring a significant loss or penalty.

Pursuant to industry standards and guidance other basic non-pension investment principles were incorporated into City Commission Policy #234. Those principles include:

- Diversification – Investments should be diversified by type and institution so as to reduce exposure to risk.
- Maturity Limitations – Investments should mature at structured intervals and within reasonable periods to meet perceived liquidity needs and also to mitigate (or take advantage of) market price volatility (e.g., due to interest rate changes).
- Credit Quality – Only securities that meet the minimum established credit ratings should be purchased.
- Safekeeping, Custody, and Collateralization – Investment instruments should be adequately maintained and secured through a third-party custodian. Adequate and proper collateral should be maintained for applicable investments.
- Performance Measurement and Evaluation – Performance (earnings) should be monitored and measured and compared against established performance expectations, such as industry or policy benchmarks.

*City Commission Policy #234 incorporates essential investment principles.*

- External Managers – External investment managers may be used to assist with management of non-pension investments.
- Investment Advisory Committee – An investment oversight committee should (could) be established to ensure sound investment practices are followed.
- Internal Controls – Controls and procedures should be in place to address areas such as risk identification and mitigation, segregation of incompatible duties among staff, custodial and safekeeping, executing transactions (e.g., wire transfers for purchases and sales of securities and receipt of interest earnings), and monitoring activity and operations.

*The City's non-pension investments are classified into the Core Portfolio and several Specialized Portfolios.*

**Composition.** City Commission Policy #234 categorizes City non-pension investments into two basic groups: (1) Core Portfolio and (2) Specialized Portfolios. The Core Portfolio is all non-pension investments that are not classified as Specialized Portfolios. Specialized Portfolios are established for non-pension investments governed by legal restrictions or constraints in addition to those established by City Commission Policy #234, such as bond covenants or trust agreements. Currently, the most significant Specialized Portfolio is comprised of bond reserve funds, which are governed by specific legal covenants created when the applicable bonds were issued.

*As of June 30, 2009, the Treasurer-Clerk reported a market value of \$679 million for all City non-pension investments.*

In addition to the Core and Specialized Portfolios, a Securities Lending Portfolio was established by policy to account for non-pension investment securities loaned by the City's contracted securities lending agent. The securities lending program allows the City to earn incremental income through the investment of collateral (generally cash) provided the City for the loaned securities.

As of June 30, 2009, the Office of the Treasurer-Clerk reported the market value of all non-pension investments was approximately **\$679 million**. The classification of those investments by portfolio and by managing entity (i.e., internally managed by City staff or



externally managed by a non-City institution), as determined by audit, is shown below in Table 1.

<b>Table 1 – City Non-Pension Investments as of June 30, 2009</b>		
<u>Portfolio</u>	<u>Manager</u>	<u>Market Value</u>
CORE	Internally Managed by City staff <i>(Note 1)</i>	\$269,111,000
CORE	Managed by External Managers <i>(Note 2)</i>	\$373,167,000
SPECIALIZED – Bond Reserves	Managed by External Managers <i>(Note 3)</i>	\$29,899,000
SPECIALIZED – Other <i>(Note 4)</i>	Managed by External Managers <i>(Note 5)</i>	\$6,540,000
<b>TOTAL</b> <i>(Note 6)</i>		<b>\$678,717,000</b>
NOTE 1:	All investment activity for these investments (e.g., purchases and sales of individual securities) is directed by investment staff within the Office of the Treasurer-Clerk.	
NOTE 2:	The three primary external managers as of June 30, 2009 were Galliard Capital Management Inc., Florida League of Cities Local Government Investment Pool, and State of Florida Special Purpose Investment Account. City non-pension assets are provided to these entities to invest on behalf of the City.	
NOTE 3:	Bond reserves as represented on this table and the Treasurer-Clerk's June 30, 2009 performance report were invested through the State of Florida Special Purpose Investment Account.	
NOTE 4:	Other Specialized Portfolios consist of (1) funds of approximately \$6.5 million invested pursuant to a trust agreement established to decommission the Crystal River Nuclear Plant (owned by Progress Energy Florida, Inc., but the City was a former partner and is required to maintain these investments) and (2) funds of approximately \$68,000 received from the State of Florida for police and firefighter pension benefits.	
NOTE 5:	The trust agreement for decommission of the Crystal River Nuclear Plant provides for those funds to be invested through the State Board of Administration; the police and firefighter funds are invested through the State of Florida Special Purpose Investment Account.	
NOTE 6:	Certain non-pension investments are not reflected above; such as certain bond proceeds and bond reserves and the securities lending portfolio. Those lack of disclosures by the Treasurer-Clerk's Office are addressed as audit issues in subsequent sections of this report.	

*The Treasurer-Clerk's Office was proactive in prudently acting to protect the City's invested non-pension assets during times of major financial market instability and upheaval.*

**Financial environment.** The last half of the period included in the scope of this audit was during times of major financial market instability and upheaval. During those times most investors incurred significant losses of values in their investment portfolios. Our discussions with Treasurer-Clerk investment staff and related observations show 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. Examples of significant and prudent actions taken included:

- Timely withdrawing City non-pension funds (totaling \$215 million) invested in the State Board of Administration's (SBA) Local Government Investment Pool (LGIP) because of liquidity concerns. Those concerns arose upon indications the market value of that pool was becoming unstable. The Treasurer-Clerk's office made the withdrawals in a systematic and controlled manner throughout the month of November 2007. Subsequent to the Treasurer-Clerk's last withdrawal of City funds, the State Board of Administration "froze" the SBA LGIP such that municipalities and other local governments were no longer able to access their funds invested in that pool, thereby likely hindering those government's cash management functions.

The Treasurer-Clerk temporarily reinvested the funds withdrawn from the SBA LGIP in the City's bank. Upon appropriate research by Treasurer-Clerk's staff, those funds were withdrawn from the bank and reinvested in the State of Florida Special Purpose Investment Account (SPIA) managed by the State Treasurer. After additional research and revising the City's non-pension investment policy, an external "enhanced cash" manager was hired and a portion of the funds formerly invested with the SBA LGIP were reinvested through that manager.

To date, the funds invested in the SPIA and through the external enhanced cash manager have performed well.

- As described on page 11 of this report, the Treasurer-Clerk's Office earns the City incremental investment income through a contracted securities lending agent. This is a prudent and common industry practice. To protect the City's investments, the contract and non-pension investment policy restrict the investment of that collateral (by the securities lending agent) to certain types and categories of securities. Examples of allowed securities include U.S. Government issued securities, non-negotiable certificates of deposits, repurchase agreements, bank and deposit notes, asset-backed securities, and corporate notes.

*Prudent actions taken by the Treasurer-Clerk's Office included (1) withdrawing City funds from the SBA LGIP in a timely manner and (2) restricting the investments of collateral by the contracted securities lending to relatively safe securities.*

Policy and contract provisions also establish credit quality requirements and maturity/liquidity limitations for invested collateral. When the significant downturn in the financial markets began and certain investment categories became more risky (e.g., asset-backed securities), the Treasurer-Clerk acted prudently and instructed the contracted securities lending agent to invest collateral only in overnight repurchase agreements that were fully backed (collateralized) by U.S. Government securities (which in turn are guaranteed by the U.S. Government). That action significantly reduced the City's exposure to losses of investment principal and earnings.

*During times of significant instability and uncertainty in financial markets, the Treasurer-Clerk's Office continued to maintain respectable earnings on the City's non-pension investments.*

The above are two examples of timely and prudent actions taken by the Treasurer-Clerk's Office to protect City invested assets during times of significant financial uncertainty. These actions demonstrate that Treasurer-Clerk investment staff maintained a constant vigil over City non-pension investments during that period. Furthermore, as evidenced by the investment returns reflected in Table 2 on page 15 of this report, the Treasurer-Clerk's Office continued to have respectable earnings instead of incurring losses during the times of significant downturns in the financial markets. The Treasurer-Clerk's Office is to be commended for their efforts and prudent actions.

## Overall Summary

*Overall, the Treasurer-Clerks' office has properly and adequately invested and managed available non-pension funds.*

The results of audit procedures showed, overall, based on performance, adjusted for several audit issues presented within this report, the Treasurer-Clerk's Office is properly and adequately managing and investing available non-pension funds. Our review showed that no one sector/category lost capital and each sector/category performed reasonably well in relation to existing market conditions and policy benchmarks (also adjusted for applicable audit issues). 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 invest funds formerly managed by those managers in appropriate investment vehicles. (One of those instances, the withdrawal of funds from the SBA LGIP and reinvestment in SPIA and the enhanced cash

manager is described above.) Those new investment vehicles, consisting of new external managers and a different government investment pool, have performed well to date. As described on pages 12 through 14 of this report, the Treasurer-Clerk's Office is to be commended for taking timely and prudent actions to protect the City's invested non-pension assets during the recent period of major instability and uncertainty in applicable financial markets.

<b>Table 2 – Historical Performance and status as of June 30, 2009</b>			
<b><u>Category/segment</u></b>	<b><u>1-year</u></b>	<b><u>3-year annualized (Note 1)</u></b>	<b><u>Market Value</u></b>
Internally managed securities	3.97%	3.86%	\$250,111,000
State of Florida Special Purpose Investment Account (SPIA)	2.56%	3.34%	\$229,812,000
Florida League of Cities (FLOC) Local Government Investment Pool	2.55%	3.86%	\$79,171,000
Galliard Capital Management, Inc. (external manager)	4.95%	(Note 2)	\$64,184,000
Wachovia Short Term Investment Fund	0.39%	2.89%	\$19,000,000
Specialized Portfolios (Note 3)	2.36%	2.78%	\$36,439,000
<b>TOTAL Non-Pension Investments</b>	<b>3.29%</b>	<b>(Note 4)</b>	<b>\$678,717,000</b> (Note 5)
Policy “performance” benchmark	2.42%	(Note 4)	Not Applicable
Policy “structure” benchmark	3.42%	(Note 4)	Not Applicable
<i>Note 1</i>	Three-year annualized returns are those reported by the Treasurer-Clerk's Office.		
<i>Note 2</i>	Not applicable as of June 30, 2009, as this external manager was hired in April 2007.		
<i>Note 3</i>	Comprised of investments of bond reserves and other funds as described in Note 4 of Table 1 on page 12 of this report.		
<i>Note 4</i>	These returns were not calculated by Treasurer-Clerk staff.		
<i>Note 5</i>	This does not reflect (1) approximately \$67 million of bonds proceeds and reserves investments that earned from 3.12% to 4.92% or (2) the Securities Lending Portfolio for which incremental income is earned on invested collateral. See Note 6 in Table 1 on page 12 of this report		

We also found that, for the most part, the City Treasurer-Clerk's Office:

*For the most part, the City's non-pension investment policy is sound and appropriate; funds are invested in accordance with policy and legal requirements; controls and procedures are appropriate and adequate; and reports are prepared to demonstrate performance and status.*

- Established and implemented a sound and appropriate non-pension 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.

*We identified one significant issue. That issue involved the equitable allocation of non-pension investment earnings.*

**Audit Issue.** 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. Specifically, because of undetected worksheet errors and use of outdated balances in an initial (manually-performed) allocation step, some monthly allocations of non-pension investment earnings to benefiting funds were not correct. (NOTE: The secondary allocation step in which non-bond proceeds investment earnings were allocated to benefiting City funds through an automated allocation process was correct and equitable. However, the total amount allocated by that automated process was impacted by the errors occurring in the initial manually performed allocation step.) This audit issue is addressed in **PART 1** of this report.

**Recommended Enhancements.** In addition to the issue described above, we identified several areas where we believe the Treasurer-Clerk's Office should consider making changes that enhance and improve non-pension investment processes and/or documentation. Those recommended enhancements include:

- Updating, clarifying, and enhancing certain terms and/or provisions in the current non-pension investment policy to enhance understanding of and ensure consistent and proper interpretation of that policy.
- Clarifying classifications of certain investments as to portfolio type (i.e., “Core” or “Specialized”), as such classifications can significantly impact whether a specific investment is in compliance with policy diversification requirements.
- Identifying minor unintentional instances of policy noncompliance so that Treasurer-Clerk staff can ensure appropriate actions are taken (over time as appropriate) to address such instances.
- Obtaining approval from the applicable insurance guarantor for the investment (i.e., actually reinvestment) of bond proceeds, for one of the City’s numerous bonds, in the State’s SPIA. (NOTE: The investment of those bond proceeds in the SPIA was a prudent action by the Treasurer-Clerk’s Office in response to liquidity concerns with the SBA LGIP.)
- Obtaining updated and timely arbitrage determinations on investments of applicable bond proceeds.
- Making certain modifications to the periodic performance status reports that should make reported information clearer to users of those reports (e.g., Investment Advisory Committee members, City Commission, or interested non-city entities or individuals).
- Increasing the review of periodic performance status reports to ensure accuracy of reported information.
- Enhancing the review of custodian invoices to ensure accurate fees are paid for those services.
- Maintaining better documentation that clearly (1) shows security evaluations when considering securities for acquisitions and (2) shows comparable current market values when selling securities

*In addition to the one issue identified above, we identified several areas where we believe the Treasurer-Clerk’s Office should consider making changes that enhance and improve non-pension investment processes and/or documentation.*

in response to unsolicited offers to purchase specific City-owned securities.

- Preparing and retaining additional documentation that helps the Treasurer-Clerk's Office justify the selection of external managers.
- Requesting and obtaining periodic disclosures from authorized brokers/dealers as to existing or recent litigation and/or regulatory violations.
- Obtaining periodic assertions from Treasurer-Clerk investment staff and members of the IAC regarding the existence of any known or potential conflicts of interest.
- Consistently documenting the IAC's review and approval of meeting minutes prepared by Treasurer-Clerk staff.
- Ensuring appropriate account reconciliations are performed in a manner consistent with good internal control practices.
- Having the bank eliminate two unused system administrator permissions created when the vendor updated the wire transfer application.
- Adding language on non-negotiable certificates of deposits that restrict the transfers of matured/redeemed funds into the City's bank account.
- Updating documented internal control procedures to reflect the current operating environment.

*It is important to note that, while we have identified these numerous areas where we recommend enhancements and improvements, the Treasurer-Clerk's processes and controls from an overall perspective are appropriate, accurate, and in accordance with sound business practices and internal control guidelines.*

It is important to note that, while we have identified numerous areas for enhancements and improvements to processes and controls, the Treasurer-Clerk's current processes and controls from an overall perspective are appropriate, accurate, and in accordance with sound business practices and internal control guidelines.

These other areas are categorized and addressed in **PARTS 2, 3, and 4** of this report.

## PART 1

### AUDIT ISSUE – ALLOCATION OF INVESTMENT EARNINGS

#### *Allocation of Investment Earnings*

*Earnings on commingled invested assets should be equitably allocated to benefiting City funds.*

*The Treasurer-Clerk's allocation of investment earnings is accomplished through a two-step process.*

**Overview.** As described in the background section of this report, much of the invested non-pension assets are comprised of (1) excess working capital (i.e., operating cash not needed for impending disbursements) and (2) bond proceeds not immediately disbursed for applicable projects. The excess working capital and unexpended bond proceeds belong to the various City activities, functions, and programs. Under governmental accounting, assets of those activities, functions, and programs are tracked and accounted for in “funds.” Each fund is unique in that it accounts for specific activities, functions, and/or programs. For example, bond proceeds and/or working capital for the Electric Utility may be accounted for in one fund, while bond proceeds and/or working capital for Underground Utilities are accounted for in another fund. Similarly, working capital for other City functions (such as police, fire, building inspection, and aviation) is tracked in unique funds established for each of those functions.

Excess operating cash and bond proceeds from all funds, for the most part, are commingled and invested together. Accordingly, earnings on those commingled investments should be allocated to each fund based on the fund’s proportional share of total investments. For example, if invested bond proceeds for the Electric Utility represent 10% of all invested assets, the Electric Utility fund established for those bond proceeds should be allocated 10% of the earnings.

The allocation of commingled investment earnings is a two-step process. Earnings are identified and allocated monthly. In the first step, Treasurer-Clerk investment staff use a worksheet to determine each of the primary (or “first level”) fund’s share of a month’s earnings. Those primary funds consist of the individual funds used to account for bond proceeds and one single generic fund used to account for the investment of excess working capital received from



all funds. During our review there were seven primary funds, consisting of six funds accounting for the different bond proceeds and the one generic fund accounting for all invested working capital. The first-step allocation, in essence, segregates and allocates investment earnings among/to the applicable bond funds and the fund accounting for excess working capital. That allocation is a manual process based on each fund's proportional share of total investments as documented on Treasurer-Clerk staff's worksheets.

In the second step, funds allocated to the generic fund (which accounts for invested working capital for all funds) under the first step are in turn allocated to each of the actual City funds that contributed to (or "own a share of") that invested working capital. Similar to the first-step allocation, those second-step allocations are based on each contributing ("owner") fund's proportional share of total invested working capital. However, unlike that first-step allocation, the second-step allocation is automated. That automation occurred several years ago based on the combined efforts of Treasurer-Clerk and Accounting Services staffs.

*The process used by Treasurer-Clerk staff to allocate investment earnings did not ensure an equitable and fair distribution.*

**The first step in the process for allocating investment earnings on commingled assets did not ensure equitable distributions to benefiting City funds and activities.** As noted above, non-pension investment earnings are allocated to benefiting funds through a two-step process. We did not note any issues with the second-step allocation process. In regard to first-step allocations, our review showed the Treasurer-Clerk's Office logically allocates investment earnings on commingled assets to applicable participating funds based on each fund's proportional share (percentage) of total investments. However, we found those percentages have not been routinely updated as the applicable investment balances changed. Specifically, for each investment category (e.g., internally managed, externally managed, etc.), each primary fund's proportional share within the category was last determined during a point in time during summer 2008 (i.e., depending on the investment category a specific date in May 2008, June 2008, or September 2008). Those percentages have been used since that time to allocate monthly earnings (i.e., up through the time of our audit fieldwork in June

2009). This did not ensure proper allocations for months subsequent to those points in time during summer 2008, as each fund's proportional share of total investments varies over time. That variance occurs because the revenues and expenditures for the projects/activities accounted for in those different funds do not occur at the same frequencies and proportions. In essence, the percentages (or proportions) that were valid in summer 2008 were not still valid during subsequent months and quarters. To summarize, the Treasurer-Clerk's staff used "static" percentages when "dynamic" percentages were appropriate.

In addition to allocating earnings using static proportions, we determined that Treasurer-Clerk's staff made a worksheet error when determining the proportions (allocation percentages) in summer 2008. That error resulted in an overstatement of total invested assets by \$30 million in one primary fund.

*The potential impact of the allocation flaw and worksheet error could be significant.*

To determine the potential impact of using static allocation percentages and the worksheet error noted above, we determined what the allocations should have been for the month of June 2009, on the assumption that the invested asset balances within each fund were correct on the first day of that month. Our analysis showed that funds established for Blueprint 2000 were over-allocated earnings of \$141,759, while various City funds were under-allocated earnings in differing amounts that totaled \$141,759. (Blueprint 2000 is a related entity that invests its available funds through the City.) This analysis is indicative that the use of static allocation percentages and the noted worksheet error may have resulted in significant over and under-allocations of non-pension investment earnings.

To determine the actual impact of the static allocation process and worksheet error will require Treasurer-Clerk staff to retroactively calculate investment account balances using appropriate updated allocation percentages (e.g., updated monthly) and corrections for the \$30 million overstatement. Because of the potential significance, we recommend such retroactive calculations be

performed and appropriate investment earning adjustments be made to affected City funds.

We recommend that Treasurer-Clerk staff revise the first-step allocation process to allocate investment income using updated (dynamic) balances. Consideration should be given to automating that process, similar to the automation established for the second-step allocation process. (NOTE: In response to this issue, the Treasurer-Clerk's Office indicated the earnings allocation process has subsequently been automated in its entirety, such that there is no longer a separate first-step manual allocation. The revised process as described allocates earnings based on dynamic balances. We will review that revised process in our initial follow-up engagement to ascertain and report on the Treasurer-Clerk's success in addressing the issues identified in this audit.)

**An error was also noted in the allocation of earnings on investments of bond reserves.** Similar to the above process involving commingling of excess working capital and unexpended bond proceeds, the Treasurer-Clerk commingles bond reserve funds for investment purposes. (NOTE: Bond reserve funds are amounts required to be held and invested during the life of the bond to ensure a "reserve" is available to meet debt service payments, opposed to unexpended bond proceeds which are only held until needed for the applicable operating or capital projects funded by those bonds.) As previously noted, we found the Treasurer-Clerk's staff logically allocates investment earnings on those commingled bond reserve assets to applicable participating funds based on each fund's proportional share of total investments.

While the allocation process was logical and appropriate, Treasurer-Clerk staff mistakenly excluded investments of one bond reserve from the earnings allocations during the 13-month period September 2008 through September 2009 (date of our fieldwork). The excluded invested bond reserves totaled \$10,137,000, which represented almost 34% of all bond reserves (\$28,833,754). As a result, earnings of \$754,610 on bond reserves during that 13-month period were incorrectly allocated. Those incorrect allocations

*Investments of one bond reserve were mistakenly excluded from the earnings allocation during the 13-month period ended September 30, 2009; resulting in inaccurate allocations of earnings in amounts ranging to a \$148,720 over-allocation to the Sewer Fund and a \$207,962 under-allocation to the Electric Fund.*

resulted in over and under-allocations among the funds noted in Table 2 below.

<b>Table2 – Over and Under-allocation of Bond reserve earnings</b>				
<b>FUND</b>	<b>Amount Allocated</b>	<b><u>Amount That Should Have Been Allocated</u></b>	<b>Over/Under Allocation</b>	
Electric	\$142,493	\$350,455	\$207,962	Under-allocated
Water	\$86,927	\$57,391	\$29,536	Over-allocated
Sewer	\$437,691	\$288,971	\$148,720	Over-allocated
Gas	\$59,321	\$39,165	\$20,156	Over-allocated
Airport	\$28,178	\$18,628	\$9,550	Over-allocated

We recommend Treasurer-Clerk staff make adjustments to the allocation formula used in allocating bond reserve investment earnings for the noted mistake. Additionally, appropriate adjustments correcting the previously recorded earnings allocations should be made.

**PART 2**

**RECOMMENDED ENHANCEMENTS - POLICY AND COMPLIANCE**

***Investment Policy – Adequacy, Accuracy, and Completeness***

**Overview.** In meeting one of our stated audit objectives, we reviewed City Commission Policy #234 to determine if it complied with State statutes governing non-pension investments and was otherwise in accordance with industry standards and guidance. We found, for the most part, the City’s non-pension investment policy is adequate, accurate, complete, and in compliance/accordance with legal provisions and industry standards/guidance. For example, the policy establishes and, for the most part, adequately addresses legal authority, risk tolerances, priorities of investment objectives, ethics, diversification and maturity requirements, staff and management responsibilities, security selection and acquisition, due diligence in selecting institutions and broker/dealers, use of a third party custodian, establishing written operating procedures, performance

benchmarks, and periodic reporting on performance and status. As noted in the following, we did identify some areas where the Treasurer-Clerk's Office should consider updates, clarifications, and enhancements to that policy. Those areas are addressed in the following paragraphs.

**While the City Commission Policy #234 is generally adequate, accurate, complete, and in accordance with legal provisions and industry standards, we identified certain areas where corrections, clarifications, and enhancements should be considered at the next scheduled update.** As stated above, we found that policy is, for the most part, in accordance with governing State statutes, the City's Charter, and industry standards and guidance. Yet, several areas were identified where changes should be considered. Specifically:

*City Commission Policy #234 is generally adequate, accurate, complete, and in compliance/accordance with legal provisions and industry standards and guidance.*

- The Policy currently references two legal provisions that are no longer valid, including (1) Section 166.261, Florida Statutes that was repealed in 2000, and (2) Section 65.1 of the City Charter, which was repealed between 2002 and 2003. Areas covered by those repealed provisions either remain incorporated in the current policy through reference to other statutes (i.e., requirements for municipal investments) or are no longer applicable to the City's non-pension investments (i.e., investing in City of Tallahassee revenue certificates).
- Section 234.109B of the current policy addresses investing in U.S. Agency securities. Unlike all other security categories addressed in the policy, that section does not clearly address or establish (1) diversification requirements (the maximum and/or minimum portions of the portfolio that should be invested in this category), or (2) maximum maturity durations for purchased securities. In response to our inquiry on this matter, Treasurer-Clerk staff indicated that this U.S Agency security category (Section 234.109B) should be combined with the previous policy security category listed in the policy under Section 234.109A (i.e., U.S. Government securities other than

*Clarifications and updates to certain provisions of City Commission Policy #234 should be considered.*

“agencies”), and the diversification/maturity requirements addressed in the current policy for those Section 234.109A securities applied to each and both categories individually and/or jointly, as appropriate. While that explanation is logical and consistent with earlier policy versions, that understanding is not apparent from reading the policy. Clarification of those provisions should help ensure all individuals and entities using the policy have a proper and correct understanding.

- The term “portfolio percentage” is used in various places within the policy for purposes of specifying the maximum or minimum investment amounts for diversification purposes. However, based on discussions with Treasurer-Clerk staff, that term is interpreted differently depending on the section in which it is used. For example, staff indicated that for purposes of determining the maximum and minimum portfolio shares for “internally managed investments,” the policy portfolio percentage is defined as the Core Portfolio excluding government sponsored investment pools and investments managed by contracted external managers. Yet, for purposes of determining the maximum and minimum portfolio shares for those government sponsored investment pools and investments managed by contracted external managers, the policy portfolio percentage is defined as the total Core Portfolio. The manner in which the term “portfolio percentage” is defined makes a significant difference as to determining policy diversification requirements. Accordingly, consideration should be given to clarifying the policy to define that term in each applicable circumstance.
- Consideration should be given to correcting two minor policy inaccuracies, including (1) replacing the term “corporation” with the term “government” when addressing maximum investments allowed in municipal fixed-income securities and (2) changing a policy reference to the correct policy attachment.

- Consideration should be given to adding a policy provision that provides for checking appropriate regulatory websites for any disciplinary actions and references for potential broker/dealers considered for the acquisition/disposition of internally managed securities.

We recommend the Treasurer-Clerk's Office consider making policy revisions to address the circumstances described above.

## ***Compliance with Investment Policy Requirements***

*Investments generally met policy requirements as to credit ratings, diversification, maturity durations, and volatility.*

**Overview.** One of our audit objectives including determining if the City complied with its non-pension investment policy, City Commission Policy #234. Specific areas for which we determined policy compliance included:

- Allowable investments as to type, class, and category of security.
- Whether securities met minimum credit ratings.
- Diversification requirements - maximum and minimum amounts invested in a particular type, class, or category.
- Maturity requirements – maximum periods to the date the security matures.
- Market volatility requirements – the market value of the portfolio should remain within 5% of the par value of the investments comprising the portfolio.

Overall, we found the Treasurer-Clerk's Office ensures that appropriate and allowable investments are made and that policy requirements are met as to credit ratings, diversification, maturity durations, and volatility. We did, however, note the following circumstances for which we recommend the Treasurer-Clerk consider making appropriate enhancements.

*There was an inconsistency in how bond proceeds investments were classified and reported.*

**Proceeds of one bond were invested in a formal investment agreement (i.e., a “guaranteed investment contract” or GIC), and, unlike other bond proceeds investments, that GIC investment was classified as a separate “specialized portfolio” instead of being classified as part of the City’s “Core Portfolio”.**

City Non-Pension Investment Policy #234 provides for both the Core Portfolio and specialized portfolios. The intent of the Core Portfolio as defined by the policy is to provide the Treasurer-Clerk sufficient latitude to effectively manage the City’s unrestricted financial assets so as to meet the (policy) objectives and to control the risks as outlined in the policy. The policy provides specialized portfolios are for non-pension investments that, for various reasons, fall outside the parameters established to govern the Core Portfolio. Reasons stated by the policy for specialized portfolios may be:

- The funds are governed under specific legal constraints such as bond covenants or trust agreements that define their investment parameters.
- The related securities come to the City as gifts, in lieu of debts owed the City, or in conjunction with unique agreements the City might enter into.

Two of the larger specialized portfolios established by the Treasurer-Clerk’s Office based on these policy provisions include the following:

- Bond Reserve Funds – These funds represent the portion of bond proceeds required by the respective bond covenants to be held in reserve to ensure funds are available to make required debt payments. (Valued at approximately \$30 million.)
- Nuclear Decommissioning Funds – These represent funds set aside for the eventual decommissioning of the nuclear power plant in Crystal City for which the City used to own a minor share. The City does not “own” these funds but is legally required to maintain these funds and to invest the funds with the



State Board of Administration. (Valued at approximately \$6.5 million.)

*While most investments of unexpended bond proceeds were classified as part of the Core Portfolio, bond proceeds invested through a GIC were classified as a specialized portfolio.*

One significant component of City non-pension investments is unexpended bond proceeds. Unlike bond reserve funds that are required to be held and invested during the life of a bond to ensure a “reserve” is available to meet debt service payments, unexpended bond proceeds are only held and invested until needed for the applicable operating or capital projects funded by those bonds. Similar to bond reserve funds, investments of bond proceeds are subject to the provisions established by the respective bond covenants. Our review of applicable bond covenants show that most provide various investment options.

We found that there was some inconsistency in the Treasurer-Clerk’s classifications of bond proceeds investments. Specifically, the majority of unexpended bond proceeds were commingled with excess working capital and invested, classified, and reported as part of the Core Portfolio. However, the bond proceeds for one bond were invested through a guaranteed investment contract (GIC) and classified as a specialized portfolio. The GIC is a type of investment vehicle allowed by both the applicable bond covenant and City non-pension investment policy. The policy allows portions of the Core Portfolio to be invested in GICs.

We found the GIC investment (\$70 million was the initial investment) was not included on periodic performance and status reports prepared by the Treasurer-Clerk’s Office for non-pension investments. (See discussion on page 34 of this report.) Accordingly, the classification of this investment as a specialized portfolio is based on assertions and explanations provided by the Treasurer-Clerk’s Office.

When this GIC matured subsequent to our audit fieldwork, the remaining unexpended proceeds in the amount of \$60 million were reinvested in other security vehicles, including the State’s SPIA. That \$60 million investment has been properly included and reported on subsequent performance and status reports prepared by

*Inconsistent classifications may result in the questioning of intent and purpose.*

the Treasurer-Clerk's Office. Unlike when those funds were invested in the GIC, they are now reported and classified as part of the Core Portfolio.

We noted that if the initial GIC investment had been classified as part of the Core Portfolio, it would have been in violation of the City's non-pension investment policy. Specifically, the policy provides the City should invest no more than \$10 million with one entity and no more than 5% of the total portfolio (interpreted to be the Core Portfolio) in GICs at anytime. If classified as part of the Core Portfolio, the GIC would have violated both provisions, as the \$70 investment far exceeded the \$10 million limitation and also represented 8.5% of total non-pension investments (i.e., more than the 5% limitation).

We acknowledge the policy provides the Treasurer-Clerk's Office some discretion as to whether bond proceeds investments are classified as part of the Core Portfolio or as specialized portfolios (e.g., bond proceeds investments are governed to some degree by the respective bond covenants). We also acknowledge the GIC investment was a prudent investment that generated earnings comparable to other non-pension investments. However, the different classifications and treatments described in the above circumstances raises questions as to the Treasurer-Clerk's Office purpose and intent. Accordingly, we recommend the Treasurer-Clerk's Office consider establishing documented criteria for determining and documenting how bond proceeds investments should be classified and reported.

*Consideration should be given to enhancing existing reviews to detect all instances of policy noncompliance.*

**Two relatively minor policy maturity duration requirements were not met as of June 30, 2009.** City Commission Policy #234 established various requirements for maximum maturity durations, generally at least one requirement for each allowed security type/category. Our analysis showed that 16 of those requirements were applicable as of June 30, 2009. We found the City's non-pension investment portfolio complied with 14 of those

requirements, but was not in compliance with the remaining two. Those two instances included:

- Section 234.109 Part 1, Item D3 provides the (weighted) average days to maturity for corporate securities shall not exceed 2.5 years (913 days). Corporate securities held in the Core Portfolio on June 30, 2009, had a weighted average maturity of 2.67 years (976 days). Corporate securities at that date were valued at \$57 million, representing approximately 8.5% of the total reported non-pension portfolio value.
- Section 234.109 Part 1, Item E3 provides the (weighted) average days to maturity for municipal fixed income securities shall not exceed 2.5 years (913 days). Municipal securities held in the Core Portfolio on June 30, 2009, had a weighted average to maturity of 2.65 years (968 days). Municipal fixed income securities at that date were valued at \$28.6 million, representing approximately 4.2% of the total reported non-pension portfolio value.

In response to our inquiry as to these instances of policy noncompliance, Treasurer-Clerk staff stated sometimes when attempts are made to balance the overall portfolio as to diversification and total durations, unintentional non-compliance occurs as noted above. An example provided included efforts by Treasurer-Clerk staff to extend overall portfolio maturity durations to offset (a then current) significant investment of the portfolio in short-term investments, without the realization of the impact those decisions had on policy requirements for individual categories.

We acknowledge the Treasurer-Clerks' Office does track and review investments to ensure compliance with certain (but not all) policy provisions and that the resulting minor instances of noncompliance likely resulted from prudent investment decisions and actions by the Treasurer-Clerk's Office. We are aware the City's non-pension investment policy acknowledges the non-pension investment portfolio will not always be in compliance with each and every policy provision; and, when such noncompliance

occurs the Treasurer-Clerk's Office should take measured and prudent steps to bring the portfolio back into compliance over an appropriate period so as not to jeopardize preservation of principal and potential investment earnings. Yet, initiating actions to address such instances requires Treasurer-Clerk staff to be aware the noncompliance occurred and exists. Accordingly, we recommend the Treasurer-Clerk's Office consider enhancing its existing review process to detect all policy noncompliance so that appropriate corrective actions can be initiated.

**For one circumstance where the Treasurer-Clerk's Office took prudent actions to secure invested assets by transferring them to a different investment vehicle; the Treasurer-Clerk's Office should consider obtaining documented approval of the new investment vehicle from the applicable insurance guarantor.**

*To ensure complete compliance with a bond covenant, the Treasurer-Clerk's Office should consider obtaining guarantor approval for a prudent transfer of related bond reserves to a different investment vehicle.*

Our review showed individual securities held in the Core and specialized portfolios appeared to be allowed pursuant to the City's non-pension investment policy and governing bond covenants. Yet, as described in the following paragraph, for one prudent transfer of funds to a new investment vehicle, it may be appropriate for the Treasurer-Clerk's Office to obtain subsequent approval from the applicable guarantor.

As described on pages 12 through 15 of this report, the Treasurer-Clerk's Office took timely and prudent actions to transfer non-pension funds invested in the SBA LGIP to the State of Florida SPIA. Among the funds transferred were the required reserves of \$7,355,000 for the Airport System Revenue Refunding Bonds, issued in 2004. Based on the terms of the bond covenant, it is not apparent that investment of those funds in vehicles involving some intermediate-term fixed income instruments (such as the State SPIA) are appropriate, without approval from the insurance guarantor. We have no reason to doubt such approval will be granted. However, as an additional safeguard and to ensure complete compliance with the bond covenant, we recommend the Treasurer-Clerk's Office consider obtaining that approval from the insurance guarantor.

## ***Federal Arbitrage Regulations***

*The Treasurer-Clerk's  
Office should consider  
obtaining updated  
arbitrage determinations  
for applicable bond  
issuances.*

**Overview.** 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. Because of the complexity of federal arbitrage regulations and calculations, the City has traditionally hired a professional firm (Arbitrage Compliance Specialists, Inc.) to make the arbitrage determinations for the City.

**The Treasurer-Clerk's Office should consider obtaining timely arbitrage determinations on investments of applicable bond proceeds.** The most recent documented arbitrage determinations covered earnings through 2003 and 2005. Treasurer-Clerk staff acknowledged the required determinations have not been timely made. However, Treasurer-Clerk staff also indicated their confidence that no rebates will be owed due to (1) the relatively low interest rates on current outstanding bond issuances and (2) the current earnings environment (low interest rates).

We acknowledge these circumstances and assertions. However, to ensure compliance with IRS requirements, we recommend the Treasurer-Clerk's Office consider obtaining updated arbitrage determinations for applicable bond issuances.

## PART 3

### RECOMMENDED ENHANCEMENTS - REPORTING PERFORMANCE AND STATUS

#### *Reporting Investment Performance and Status*

*Treasurer-Clerk  
investment staff prepares  
and distributes periodic  
reports reflecting  
performance and status  
of the City's non-pension  
investments.*

**Overview.** In accordance with industry practices and good internal controls, the Treasurer-Clerk's Office prepares periodic performance and status reports on the City's non-pension investments. Those reports are prepared for each quarter (and monthly when requested or needed) and provided to Treasurer-Clerk management and the City's Investment Advisory Committee (IAC) for their review and evaluation. These periodic reports reflect:

- Individual investment holdings at cost, book, and market values and grouped/categorized by:
  - Type/class of security (U.S. Treasuries, certificates of deposit, corporate bonds, municipal bonds, mortgage-backed securities, etc.)
  - Type portfolio (Core or Specialized)
  - Manager (internally managed or external manager)
- Investment performance for the most recent month, quarter, year, 3-year period, as well as fiscal year-to-date. Those earnings are shown for both the entire non-pension investment portfolio and by category as described in the prior bullet. Earnings are reported as "rates of return" and not as specific dollar amounts.
- Policy and other benchmark performance (rates of returns) against which investment performance by the Core portfolio can be compared.
- Percentages of the portfolio held in certain categories compared to diversification requirements established in City Commission Policy #234 (i.e., the policy establishes maximum and minimum amounts to be invested in specified categories).
- Securities purchased, sold, and matured during the quarter.

- Days to maturity for individual securities.

These reports are generated using the “Tracker” System, an investment software package purchased by the Treasurer-Clerk’s Office. Treasurer-Clerk staff enters investment activity in that software, including purchases, sales, market values, and characteristics of each security such as par value, interest rate, maturity date, etc. Based on entered information, the software generates reports reflecting the information described above.

**Enhancements and clarifications to periodic performance and status reports would help ensure a proper and correct understanding by users other than Treasurer-Clerk staff (e.g., IAC members, City Commission, other interested parties).**

Overall, we found the periodic reports generated from the Tracker software by Treasurer-Clerk staff to be meaningful, appropriate, and accurate. However, we noted several areas where we believe those reports could be enhanced. Those areas include the following:

*The periodic reporting process could be enhanced.*

- Efforts should be made to ensure all non-pension investments and related activity is reported. Total investments reported on report prepared as of June 30, 2009 totaled \$679 million (market value), with a reported overall rate of return of 2.76% for the most recent one-year period. While that represented the majority of all City-owned non-pension investments, the following investments and related earnings rates were excluded:
  - Bond proceeds of \$59 million, invested through a “guaranteed investment contract” pursuant to the applicable bond covenant. (NOTE: When the guaranteed investment contract matured in September 2009, those funds were re-invested and properly included on the quarterly report prepared as of September 30, 2009.) The rate of return on that investment was a guaranteed 3.12%.

*Investments valued at \$70 million and representing 9% of the total portfolio were not reflected on the June 30, 2009 report.*

- Bond reserve funds of \$7.7 million invested in a “forward delivery agreement” pursuant to the applicable bond covenant. (A forward delivery agreement is a type of investment agreement.) The rate of return on that investment was a guaranteed 4.918%.
- A money market account maintained through the third-party custodian and used to deposit security lending income and pay various investment fees, valued at \$2.8 million. The rate of return on that investment was approximately 0.9%.

In summary, investments of approximately \$70 million (9% of total City-owned non-pension investments) and the related earnings were not reflected on the June 30, 2009 report. While excluding those investments likely had no adverse impact on investments or investment decisions, not reporting them may preclude interested parties outside the Treasurer-Clerk’s Office (e.g., IAC members, City Commission, other interested parties) from being aware of those investments.

*Consideration should be given to reporting balances and activity of the Securities Lending Portfolio on the periodic reports.*

- Consideration should be given to reflecting balances and activity for the Security Lending Portfolio on future performance and status reports. On June 30, 2009, the Specialized Portfolio was valued at \$101 million, with fiscal year-to-date earnings totaling \$726,101. (The Security Lending Portfolio is a specialized portfolio that represents invested funds held by the City’s custodian as collateral for City-owned securities loaned to other entities through the Securities Lending Program. The invested collateral is returned to the borrowing entity when the loaned securities are returned to the City. The City, however, retains a portion of the earnings on that invested collateral.) We acknowledge that the securities lending portfolio arguably do not represent City-owned assets and should not be shown as such on the periodic reports. However, it would likely be beneficial and meaningful to report those



holdings and related earnings in some manner on the periodic reports.

*Consideration should be given to reporting balances and activity consistent with the classifications and categories established in City Commission Policy #234.*

- Consideration should be given to classifying and reporting investments on the periodic reports in a manner that is consistent with the City Commission Policy #234. City Commission Policy #234 provides that the Core Portfolio represents all investments of non-pension assets that are not governed by other legal constraints (i.e., other than the policy) and are not accounted for in a specialized portfolio. Pursuant to the policy, Core Portfolio investments are to be managed both (1) internally by Treasurer-Clerk staff and (2) externally by contracted investment managers and government-sponsored investment pools. We found that the periodic performance and status reports reflect some City-owned investments in categories that are not consistent with those policy provisions. Specifically, Core Portfolio investments through (1) two government-sponsored investment pools (State of Florida Special Purpose Investment Account and Florida League of Cities Local Government Investment Pool), (2) the contracted external manager (Galliard Capital Management, Inc.), and (3) the City's bank (money market account) were not included in the amounts shown and reported on the summary page as "Total Core Portfolio" investments. Those "excluded" amounts were reported on the summary page, but were not documented or denoted as part of the Core Portfolio. Those excluded amounts totaled \$392 million. The amounts reported as "Total Core Portfolio" investments totaled \$250 million and were comprised only of securities purchased and managed directly by Treasurer-Clerk staff. Classifications and reporting consistently with policy classifications and categories may enhance proper interpretation and understanding of those reports by parties other than Treasurer-Clerk staff (e.g., IAC members, City Commission, other interested parties).

*Consideration should be given to reporting on compliance with additional policy diversification requirements.*

- Consideration should be given to reporting on compliance with additional policy diversification requirements. The Treasurer-Clerk's staff includes various tables and graphs within the periodic performance and status reports to demonstrate compliance (or noncompliance) with various policy diversification requirements. Those presentations are useful and meaningful. For example, one graph and one table shows compliance with policy diversification requirements for the portion of the Core Portfolio actively and directly managed by Treasurer-Clerk investment staff. Another graph shows compliance with policy diversification requirements for investments managed by external managers. To provide additional useful information, we recommend the Treasurer-Clerk's Office consider adding other tables/graphs to demonstrate compliance (or noncompliance) with other policy requirements, such as;
  - Maximum amounts that can be invested in local government investment pools.
  - Maximum amounts that can be invested in allowed money market funds.
  - Maximum amounts that can be invested through individual external managers.

Also, consideration should be given to adding a table and/or graph to demonstrate compliance (or noncompliance) with policy diversification requirements for the Core Portfolio in its entirety as defined in City Commission Policy #234.

That additional reporting should be useful to City and Treasurer-Clerk management, the IAC, and other interested parties.

*Consideration should be given to using the same basis when graphically showing diversification of different portfolio segments.*

- Consideration should be given to preparing graphical representations, showing diversification of different portfolio segments, using a consistent basis. Throughout the 20-page report prepared as of June 30, 2009, were five graphical representations showing a breakdown of various portfolio segments by securities category. In our review we determined three of the graphs were prepared based on market values while the other two were based on amortized book values. The report did not indicate the bases or disclose that different bases were used for these graphs. While the overall differences between “market” and “amortized book” values were generally not significant, using different bases without explanation may result in misinterpretation of the presented information.

Enhancements and clarifications to address the above circumstances should help provide more useful and meaningful information to Treasurer-Clerk management and members of the IAC, as well as other interested parties such as the City Commission. We recommend the Treasurer-Clerk’s Office consider making those enhancements and clarifications.

**Improvements should be considered to help ensure the accuracy of certain reported information.** We found the periodic reports to be useful, meaningful, and for the most part accurate and supported by underlying records. However, we identified areas indicating some inaccuracies and/or errors in reported information. Those areas include:

- In one instance, rates of return for City non-pension investments were inadvertently reported based on investment “book values” instead of “market values”. The periodic performance and status reports reflect earnings (rates of return) for individual sectors and categories as well as overall rates of return for the entire non-pension investment portfolio. To provide report readers and users the most useful information, the Treasurer-Clerk’s Office’s intent is to report returns on a “market value” basis instead of a “book value” basis. We found when

*Investment rates of return on the June 30, 2009 report were inadvertently reported based on book values instead of market values.*

preparing the June 30, 2009 report, Treasurer-Clerk staff correctly reported market value rates of return for the individual sectors and categories. However, rates of return as reported for the overall portfolio were based on book values. As a result the overall portfolio's return was reported as 2.76% when it should have been reported as 3.29%. This appeared to have occurred when staff inadvertently selected rates from the incorrect column on supporting Tracker system reports.

*“Weighted averages” should have been applied when disaggregating and reporting performance for U.S. Agency securities as two separate categories.*

- Treasurer-Clerk staff should have applied “weighted averages” when disaggregating and reporting performance for U.S. Agency securities as two separate categories. In reporting performance for U.S. Agency securities, Treasurer-Clerk staff classifies those securities into two categories, comprised of (1) mortgage-backed securities and (2) non mortgage-backed securities. We found that when determining and reporting the summary rates of return for each of those two categories, Treasurer-Clerk staff used “simple averages” of the returns for individual securities within those categories, whereas “weighted averages” of the returns for those individual securities were appropriate. As a result, the rates of return reported for the two categories were not accurate (i.e., returns for non mortgaged-backed securities was reported as 6.14% when it should have been 6.74% and returns for mortgage-backed securities were reported at 9.09% when it should have been 9.6%).

*Policy performance benchmarks were not correctly determined and reported.*

- The two policy performance benchmarks were not correctly and accurately determined and reported by Treasurer-Clerk staff. City Commission Policy #234 establishes two separate benchmarks for analyzing performance. The “performance” benchmark is designed to analyze performance of the Core Portfolio against a passive market portfolio with a similar structure of maturities and types of investments. The “structure” benchmark is designed to compare performance of the Core Portfolio against expected performance in an environment of stable interest rates. While the June 30, 2009,

report reflects those benchmarks as calculated by Treasurer-Clerk staff, we determined the following:

- In calculating the structure benchmark, Treasurer-Clerk staff used incorrect “assumed portfolio compositions.”
- Treasurer-Clerk staff made errors in determining the actual portfolio composition by maturity ranges when calculating the performance benchmark.
- For one of the four standard return rates used to develop the benchmarks, incorrect return rates were identified and used in the calculations for both the performance and structure benchmarks.

These described instances resulted in incomplete and inaccurate benchmarks.

Additionally, when determining the actual portfolio composition by maturity range in connection with calculating the benchmarks, Treasurer-Clerk staff considered only a portion of the Core Portfolio. Specifically, only internally managed investments and investments through the State of Florida Special Purpose Investment Account were considered in determining the benchmarks. Investments through other Core Portfolio investments, including government investment pools (Florida League of Cities Local Government Investment Pool) and the contracted external manager (Galliard Capital Management, Inc.) were not considered. In response to our inquiry on this matter, Treasurer-Clerk staff responded it was their intent to use these policy benchmarks only for comparison to performance of the internally managed investments and investments through the State of Florida Special Purpose Investment Account, and not to the entire Core Portfolio. That stated response appears contradictory to the current non-pension investment policy, which implies the benchmarks are applicable to the Core Portfolio as a whole. Accordingly, the Treasurer-Clerk’s Office should consider making appropriate revisions

and clarifications to the City's non-pension investment policy specifying the portion of the Core Portfolio to which these benchmarks are applicable.

*“Days to maturity” for two of the nine investment categories were incorrectly calculated and reported.*

- “Days to maturity” for two of the nine investment categories were incorrectly calculated and reported. As noted in the background section of this report, one important investment principle adopted by the City is the establishment of maturity limitations on investments. Those limitations ensure liquidity needs are met and mitigate the risk of market price volatility for the City's non-pension investments. City Commission Policy #234 establishes maximum maturity periods for each category of investments. Those maximum periods are established for individual investments within each category (e.g., must mature within 5 years), and sometimes for each category of investments as a “weighted average” (e.g., weighted average time to maturity for all securities in a category must be less than 2.5 years).

We found that the Tracker software used by the City properly calculates and reports weighted average time to maturity for each investment category. However, Treasurer-Clerk staff do not use that software in determining and reporting weighted average time to maturity for two investment categories: (1) mortgage-backed securities and (2) U.S. Government Agency securities. Those average times to maturity are manually calculated by Treasurer-Clerk staff as the nature of those two categories precludes system-generated calculations by the Tracker software. Our review of the calculations determined and reported on the June 30, 2009 report showed Treasurer-Clerk staff calculated and reported “simple averages” instead of “weighted averages” for those two categories of investments. As a result, weighted average time to maturity for mortgage-backed securities was reported as 8,883 days when it should have been 7,140 days; and for U.S. Government Agency securities the time was reported as 628 days when it should have been 950 days. Inaccurate reporting of this category may

misinform management or other report users as to the portfolio's degree of compliance or non-compliance with governing policy requirements.

The above instances are indicative that improvements and enhancements should be made to the report preparation and review processes. We recommend the Treasurer-Clerk's Office consider making appropriate improvements and enhancements to address the noted areas.

## PART 4

### RECOMMENDED ENHANCEMENTS - PROCESSES AND INTERNAL CONTROLS

#### *Third Party Fees*

**Overview.** In connection with our audit objective to ascertain if investment transactions were proper and appropriate, we reviewed fees paid by the City Treasurer-Clerk's Office to third parties for services rendered. Applicable third parties and/or services included:

- State Street Corporation (State Street) as third party custodian.
- Galliard Capital Management, Inc. as external manager.
- MBIA Capital Management Corporation as external manager (services commenced subsequent to June 2009).
- Government investment pools (State of Florida SPIA and Florida League of Cities).

With the exception of the following issue, we found fees paid for third party services were correct, proper, and in accordance with controlling contractual provisions.

**Enhancements should be considered to the process of reviewing State Street invoices prior to authorization of payment.**

Pursuant to the contract for services, State Street is entitled to the following:

- Annual custody fee equal to one basis point (1/100<sup>th</sup> of one percent) of the portfolio balance.
- Annual portfolio fee of \$5,000 for each actively managed portfolio and \$500 for each passive or pooled portfolio.
- Annual performance management fee (i.e., for providing analytical services) of \$1,500 for individual portfolios and \$500 for commingled portfolios.
- Various transaction fees and out-of-pocket expenses.

We reviewed invoices from September 2007 through June 2009 for compliance with some or all of the noted fee provisions. Total fees paid for those eight quarters totaled \$131,650. Our review showed those fees to be correct and appropriate except for the following:

*Inappropriate charges resulted in the City paying a net over-charge of \$13,445 to the custodian for services over the last eight quarters.*

- State Street billed the City a custody fee for portfolios that were tracked and analyzed by State Street but not “custodied” on behalf of the City. The applicable portfolios were the Florida League of Cities Local Government Investment Pool (LGIP) and the State Board of Administration Local Government Trust Fund (LGTF). (The SBA LGTF is no longer used by the City except for investment of the funds retained on behalf of Progress Energy for decommissioning of the Crystal River Nuclear Power Plant). Resulting overcharges paid by the City for the eight quarters totaled \$14,320.
- When billing the City for performance management (analytical) services, State Street in essence billed the City for the same portfolio twice. Those overcharges appear to be attributable to prior circumstances where the applicable portfolio had been combined with another portfolio (no longer tracked and analyzed) for a combined analysis in addition to individual portfolio analyses. When the tracking and analysis of the former portfolio was discontinued by the City, State Street continued to bill the City for a “combined analysis” that in essence was an analysis of just one portfolio also analyzed separately. Resulting overcharges paid by the City over the eight applicable quarters totaled \$875.

*Appropriate efforts should be made to recover identified overcharges.*



- Billing errors were identified resulting in State Street under and over-billing the City for performance management services. The City was under-billed \$1,750 based on the net impact of those errors.

In summary, the identified over and under-charges resulted in a net over-charge to the City in the amount of \$13,445.

We recommend Treasurer-Clerk staff consider enhancing their review of custodian invoices to ensure that fees are correctly billed and paid. We also recommend the Treasurer-Clerk's Office make appropriate efforts to recover the net \$13,445 overcharge.

## ***Documenting Key Investment Decisions, Processes, and Information***

*Appropriate and adequate documentation was generally prepared and retained to demonstrate key decisions, processes, and information pertinent to non-pension investments.*

**Overview.** Clearly demonstrating that proper and prudent decisions are made, and that non-pension activity is otherwise appropriate and proper, requires the Treasurer-Clerk's Office to adequately document various transactions and processes. For example, adequate documentation of the following should be prepared and retained:

- Evaluation and selection of securities when making purchases.
- Justification that prices offered by broker/dealers, and accepted by the Treasurer-Clerk's Office, for securities sold are comparable to the securities' market values.
- Evaluation and selection of third parties for various investment services (custodian, broker/dealers, external managers, and securities lending agent).
- Informative background information and assertions by broker/dealers authorized to provide services to the City.
- Assertions by key Treasurer-Clerk investment staff and IAC members as to whether any potential or actual conflicts of interest exist.
- Review and approval of IAC meeting minutes.

(NOTE: There are numerous other required and necessary documentations in addition to the above examples, which are shown because they relate to the areas discussed below.)

For the most part, our audit showed appropriate and adequate documentation was prepared and retained to adequately demonstrate decisions, processes, and information pertinent to non-pension investments. However, we identified the following areas that, in our opinion, indicate the need for enhanced documentation.

*Efforts should be increased to ensure records demonstrating competitive acquisitions of securities are maintained.*

**Efforts should be enhanced to retain records demonstrating the evaluation of securities acquired through a competitive solicitation process.** In connection with our audit we selected for review four security purchases made by Treasurer-Clerk staff in June 2009 for the internally managed segment of the Core Portfolio. Those purchases were made using a competitive solicitation process, whereby Treasurer-Clerk staff solicited offers from authorized brokers/dealers. For two of those purchases (both municipal fixed-income securities with prices exceeding \$1 million each), Treasurer-Clerk staff did not retain records showing the accumulation and evaluation of all received offers. Accordingly, while all other aspects of the purchases were appropriate and allowable, the Treasurer-Clerk's Office did not retain sufficient documentation clearly demonstrating the most preferable and favorable securities were purchased. Adequate and complete documentation was retained for the two other sampled acquisitions. We recommend Treasurer-Clerk staff retain applicable records that clearly demonstrate security evaluations and justification for securities selected/purchased.

*Consideration should be given to maintaining documentation showing prices received and paid for unsolicited security sales are comparable to market values.*

**Treasurer-Clerk staff should better document that prices offered/paid for sold securities are comparable to market values.** The overall process for selling internally managed securities was found to be appropriate and logical. In instances where brokers/dealers make an unsolicited offer to purchase City-owned securities, Treasurer-Clerk staff stated they compare the offered price to available market values to ensure the offer is reasonable and favorable to the City. If determined fair and favorable, the security may be sold. We found that documentation of those market prices and comparisons are generally not retained. To clearly demonstrate the City received fair and favorable prices when selling securities, we recommend the Treasurer-Clerk's

Office consider preparing and retaining evidence that a fair and favorable price was received. An example of such records would be documented comparisons of offered prices to current market values identified through financial websites available to Treasurer-Clerk staff.

**Consideration should be given to enhancing the process for selecting external managers, as well as the documentation prepared and retained for those selections.**

We reviewed the Treasurer-Clerk's most recent selection of an external manager. The contract with the newest manager, MBIA Capital Management Corporation (MBIA), was executed in late June 2009. We found that records, for the most part, showed an appropriate and prudent process was used and selection made. For example, records prepared by the City's contracted investment advisor showed that MBIA was clearly one of the top candidates. Yet, that process would have been better if the Treasurer-Clerk's Office:

*Consideration should be given to enhancing documentation demonstrating the selection of external managers.*

- Documented the participants (e.g., Treasurer-Clerk staff and IAC members) making/approving the decision to hire the external managers.
- Documented the dates those key decisions were made.
- Prepared and retained summary notes on key discussions during the selection process.
- Documented all factors considered in making the selection (historical performance, fees, experience, past or current regulatory violations, etc.).

In addition, while we acknowledge the selection process is inherently subjective to some degree, the Treasurer-Clerk's Office should consider:

- Assigning "weights" to each criterion used when selecting an external manager (or other third party).
- Scoring the responses to each of those weighted criteria.
- Determining total scores for each response.

- Comparing final scores to formally determine (document) the best response and to justify the final selection.

Adoption of those processes by the Treasurer-Clerk's Office should help ensure the most "objective" compilation, analysis, and selection is performed/made. In addition, such documentation helps demonstrate to interested and vested entities (e.g., the IAC, City Commission, or private citizens) not participating in the selection process, that the selection was done properly, fairly, and in the best interest of the City.

We recommend the Treasurer-Clerk's Office consider enhancing the external manager selection process, and documentation thereof, using measures such as those identified above. (NOTE: In discussions on this issue, the Treasurer-Clerk acknowledged the circumstances and benefits intended by the audit recommendation. The Treasurer-Clerk also indicated that due to the significant variations in circumstances, multiple decisions, and subjective nature of the selection process that it was more efficient to continue current practices. Accordingly, no action plan step was developed and included in Appendix A of this report for this issue.)

*The Treasurer-Clerk's Office obtains critical background information and appropriate assertions from brokers/dealers authorized to provide investment security services to the City.*

**Consideration should be given to requesting broker/dealers to make additional disclosures when providing periodic updated background information and assertions.** In accordance with industry practices, the Treasurer-Clerk's Office has a process to obtain essential background information and assertions (certifications) from broker/dealers authorized to provide services relating to the purchase and sale of internally managed securities. Specifically, each authorized broker/dealer is requested to provide detailed information on their firm, including (1) name, (2) address, (3) contact information, (4) age of firm, (5) size of firm (e.g., number of brokers), (6) specialties, (7) staff experience, (8) references, and (9) available research/pricing equipment. Furthermore, each authorized broker/dealer is requested to complete and return a signed assertion certifying (1) they have reasonable procedures to monitor firm activities; (2) sales staff dealing with the City have been informed of the City's investment

objectives, policies, risk constraints, and other pertinent factors; (3) the firm will exercise due diligence in informing the City of foreseeable risks, and that (4) the City's account representative has read and understands the investment policies of the City and will use their best efforts to comply with those written policies. While that background information and certifications do not guarantee all investment transactions are in the City's best interest, they do serve as a strong indication as to the intent of the brokers/dealers.

*Consideration should be given to requesting broker/dealers to disclose any litigation or regulatory violation applicable to their firm in recent or current periods.*

We found the City generally has obtained background information and certifications from each broker/dealer through which the City conducts purchases and sales of securities for the internally managed segment of the Core Portfolio. In addition to information/certifications currently requested and provided, the Treasurer-Clerks' Office should consider requesting the broker/dealers to certify and disclose any litigation or regulatory violations applicable to their firm in recent or current periods. That information, currently not requested, could potentially disclose circumstances that could warrant the City no longer conducting business with a broker/dealer.

*Treasurer-Clerk investment and managerial staff and IAC members should be free of any conflicts of interests.*

**In response to our audit inquiry and recommendation, the Treasurer-Clerk started requiring applicable Treasurer-Clerk management and investment staff, as well as the IAC members, to make annual documented assertions regarding the existence of any known or potential conflicts of interests.** Section 234.03 of City Commission Policy #234 provides, in part, that officers and employees of the City who are involved in the investment process shall refrain from personal business activity which could conflict with State statutes, City ordinances, or proper management of the City's investment program, or which could impair their ability to make impartial investment decisions. Furthermore, that policy section states that investment officials and employees, including members of the IAC, shall disclose to the City Commission any material financial interests in any investment firms or financial institutions that conduct business with the City, and shall refrain from undertaking personal investment transactions with the same

individual with whom business is conducted on behalf of the City. Those policy provisions are intended to help preclude inappropriate investment transactions/activity that is not in the best interest of the City.

During the initial stages of our audit, we inquired as to what documented assertions/certifications were made by applicable Treasurer-Clerk investment and management staff, and members of the IAC, in regard to these policy provisions. While we found that certain assertions are made by IAC members on their applications to become members of the IAC, those assertions were made only on their initial application, and not periodically throughout their initial three-year (and subsequent) terms. Additionally, while the Treasurer-Clerk, as an appointed official, completes an annual financial disclosure form, that form normally would only disclose “ownership” or “positions” in certain types of businesses, including banks, credit unions, and insurance companies. That annual form does not address (1) the conduct of personal investment transactions with the same individuals with whom investment business is conducted on behalf of the City and (2) investment firms other than those listed (i.e., banks, credit unions, and insurance companies).

*In response to our recommendation, the Treasurer-Clerk started requiring and providing/obtaining periodic assertions from investment staff and IAC members regarding known or potential conflicts of interests.*

In response to our inquiry and recommendations on this matter, the Treasurer-Clerk’s Office created adequate and appropriate annual forms to be completed by the Treasurer-Clerk, applicable management and investment staff, and IAC members. Those forms are designed to require those individuals to disclose any conflicts of interest and to certify their independence in regard to the City investment process and activity. The applicable individuals completed these forms during the period September through December 2009. Two of the three IAC members did disclose potential conflicts that should be considered as investment transactions are executed.

We commend the Treasurer-Clerk for those actions. We recommend the Treasurer-Clerk’s Office consider adopting into

City Commission Policy #234 a requirement for these annual disclosures.

**Efforts should be increased to maintain evidence of the IAC's review and approval of the meeting minutes prepared by Treasurer-Clerk's staff.** The IAC meets quarterly with key Treasurer-Clerk management and investment staff. During those meetings the performance and status of City investments are discussed, including earnings, holdings, and policy compliance. Other areas and topics are addressed as applicable and needed. For example, when applicable, the status and decisions made in regard to selection of a new broker/dealer or external manager are discussed. Approvals by the IAC are obtained during those meetings when required by Commission Policy #234.

*Efforts should be enhanced to ensure that minutes prepared for quarterly IAC meetings are reviewed and approved by Treasurer-Clerk management and the IAC.*

As required by sound business practices, the Treasurer-Clerk's Office prepares minutes documenting the discussions and key decisions/approvals made during the quarterly meetings. As also required by sound business practices, those minutes are generally provided to Treasurer-Clerk management and IAC members for formal review and approval. However, our review of the IAC meetings for the last 13 quarters showed no evidence of formal review and approval for three quarterly IAC meetings, with two of those being relatively recent meetings in February 2009 and November 2008. Because of the significance of the issues discussed and decisions/approval made, we recommend efforts be made to ensure each set of meeting minutes is formally reviewed and approved, with documentation of that review and approval prepared and retained.

## ***Other Internal Controls***

*Accounting Services performs reconciliations of applicable third party account statements to activity reported in the City's PeopleSoft Financials System.*

**Overview.** Various areas and components of internal controls were addressed by our audit in addition to those addressed in the previous sections of this report. Those areas included, for example, (1) account reconciliations, (2) controls over wire transfers, and (3) instructions provided to financial institutions and external managers restricting the movement of funds to City bank accounts. For the most part, we found the Treasurer-Clerk's Office established

appropriate and adequate controls for those other areas. Three areas were identified for which enhancements should be considered.

**Enhancements are needed to account reconciliation processes involving City non-pension investments.** Account reconciliations are an important control to ensure transactions and activities are accurately recorded in an entity's financial accounting system. If timely and properly performed, reconciliations will assist not only in the detection of recording errors but also help in identification of fraudulent activity. Our audit disclosed the following three instances where City reconciliation processes for non-pension investments should be strengthened.

- For two non-pension investment accounts, the applicable third party statements used in the reconciliation process were not independently obtained; thereby limiting the likelihood inappropriate activity would be detected. One critical reconciliation process involving non-pension investments is reconciling account balances recorded in the City's accounting system (PeopleSoft Financials) to account balances reported by various third parties (custodians and external managers). To help in detection of fraudulent transactions and activity, those account reconciliations should be performed by employees that do (1) not have access to and/or custody of the applicable assets (non-pension investments) and (2) not generate or execute related transactions, such as purchases and sales of securities and movement of funds. Additionally, the reconciling staff should obtain the third party statements used in those reconciliations directly from the third parties. In accordance with those internal control principles, the City's Accounting Services staff (and not Treasurer-Clerk staff) conducts the reconciliations for City non-pension investments; for the most part using third party account statements obtained directly from the custodians and external managers, or accessed directly (by Accounting Services staff) using secured websites established on their behalf by those custodians/external managers.



*Accounting Services staff did not independently obtain third party statements for two non-pension investment accounts; thereby increasing the risk that inappropriate activity would not be detected.*

While most third party account statements were independently obtained in the manner described, we determined that statements for the State of Florida Special Purpose Investment Account (SPIA) and one of the guaranteed investment contracts (GICs) were not obtained directly by Accounting Services staff. The statements used for those account reconciliations were instead received or extracted (from a secured website) by Treasurer-Clerk investment staff and provided to Accounting Services. To restrict the capability of covering up fraudulent diversions of City assets by Treasurer-Clerk investment staff, those SPIA and GIC account statements should be obtained directly by Accounting Services staff. We recommend that steps be taken to have all third party statements provided directly to Accounting Services. In regard to the SPIA accounts, consideration should be given to providing applicable Accounting Services staff access to the SPIA website that displays the applicable statements.

*Treasurer-Clerk staff should reconcile balances recorded in a temporary clearing account to ensure that receipts are properly and timely recorded as investment income.*

- Efforts should be enhanced to ensure non-pension investment income transferred to the City by the custodian (State Street) is accurately and timely recorded in PeopleSoft Financials, the City's official accounting system. Investment income submitted to the City by State Street is received and properly deposited by the City's Revenue Office. The Revenue Office initially records the receipt of that income in a temporary PeopleSoft Financials clearing account established for the Treasurer-Clerk's investment staff. To be properly recorded as non-pension investment income requires generation of a journal entry by Treasurer-Clerk investment staff, which in essence moves the funds from the clearing account to the correct investment income account. Not timely identifying and properly recording items reflected in the temporary clearing account will result in income not being properly classified in the City's financial records.

We determined that items in the temporary clearing account were timely and properly identified and recorded by Treasurer-

Clerk staff, and proper journal entries prepared and generally submitted to have the receipts properly recorded as investment income. However, in one instance we found a journal entry, prepared by Treasurer-Clerk staff to record a clearing account receipt of \$236,250 as investment income, was inadvertently not submitted to Accounting Services staff. As of the date of our audit fieldwork in December 2009, that journal entry had not been submitted for three months. This was not detected because there is no periodic reconciliation of the clearing account balance. Accordingly, we recommend the Treasurer-Clerk's Office commence periodic reconciliations of the balances in the temporary clearing account as a means to ensure the receipts are properly and timely "removed" and recorded as investment income.

- Treasurer-Clerk staff should consider comparing activity and balances reported by certain external managers on their periodic account statements to activity/balances reported by the third party custodian for those external managers. We determined that Treasurer-Clerk staff do not reconcile, or compare for reasonableness, activity/balances reported by external managers to activity/balances reported for those external managers by the third party custodian, State Street. Such reconciliations or comparisons would serve to detect errors as reported by either the external manager or the custodian; and to ensure that activity reported by the custodian and relied upon by the City is accurate and complete. If such reconciliations or comparisons had been performed, a \$1,043,349 reporting error by the custodian would have been timely detected. As that error was not timely detected, investment balances reported on the Treasurer-Clerk's March 31, 2008, quarterly performance and status report were overstated by that amount. (The error was subsequently detected and corrected by the custodian.) If performed, such reconciliations or comparisons would also help detect any intentional misstatements by custodian staff for the purpose of covering up any diversion of City assets managed by the external manager but held by the custodian.

*As a means to detect errors and potentially detect improper activity, the Treasurer-Clerk's Office should provide for periodic reconciliations and/or comparisons of activity on applicable external manager statements to activity reflected on custodian statements.*

This same issue has been reported in several prior audits involving the Treasurer-Clerk's pension investment function. Actions taken by the Treasurer-Clerk's Office in response to those prior report issues was to require the external managers to certify that they conduct the described reconciliations, and report to Treasurer-Clerk staff any issues identified that are not satisfactorily resolved. Accordingly, we recommend that similar actions be developed and taken for the City's non-pension investments managed by an external manager but in custody of and tracked by the City's third party custodian. (NOTE: This issue is applicable to two of the City's current non-pension investment external managers – Galliard Capital Management, Inc. and MBIA.)

**Two system administrator permissions in the City's wire transfer system need to be deleted.**

Overall, we found the City has established adequate controls over wire transfers of funds for investment (and other purposes). For example:

*Overall the Treasurer-Clerk has appropriate and adequate controls established in regard to electronic funds transfers.*

- No one employee can successfully complete a wire transfer, as the applicable software requires one employee to generate the transaction and a separate employee to approve it before it can be executed.
- Employees are assigned unique system permissions that allow them to perform only authorized functions.
- User passwords are protected.

Within the wire transfer system, "system administrators" are delegated the authority to establish and assign individual system permissions to Treasurer-Clerk staff based on their assigned functions/duties within the concepts of a proper internal control structure. Because of the inherent risk of system administrator privileges, the system is set up such that it takes two separate system administrator permissions to create and assign unique system permissions to an individual; one to create the permission

*The Treasurer-Clerk's Office should delete two system administrator permissions within the City's wire transfer system that are no longer needed.*

and another one to approve that permission. That control precludes an individual with system administrator privileges from assigning incompatible permissions to him or herself, such as the ability to both generate and approve the same transaction.

Our review of existing system permissions at the time of our audit fieldwork disclosed assigned permissions were logical, appropriate, and in accordance with good internal control practices. However, we identified two system administrator permissions that were not assigned to Treasurer-Clerk's staff. In discussions with the applicable software vendor and Treasurer-Clerk's staff, it was determined those two permissions were likely created by the vendor during a recent system upgrade in April 2008. Because of the inherent risk associated with improperly assigned system administrator privileges and the possibility those two permissions could be improperly reactivated, we recommend the Treasurer-Clerk's office have those two permissions deleted from the system. (NOTE: Subsequent to our fieldwork we observed the deletion of those two permissions by Treasurer-Clerk management.)

*Language should be added to any future agreements executed for non-negotiable CDs that restrict the transfer of matured/redeemed funds to the City's bank account.*

**In future instances where non-pension funds are invested in non-negotiable certificate of deposits, consideration should be given to including language in the applicable agreement restricting the transfers of funds upon maturity/redemption to the City's bank account.** During the period of our review, the Treasurer-Clerk's Office invested \$20 million in two non-negotiable certificates of deposits, each for \$10 million and with two separate financial institutions. Upon maturity, the respective institutions properly transferred the proceeds to the City's bank account.

We reviewed one of those two certificates. We noted there was no restriction in the executed agreement (certificate) as to where the funds could be transferred upon maturity or redemption of the certificate. When the certificate matured, the City's treasury analyst instructed the bank to wire transfer the funds to the City's bank account. While the bank complied with that request, we noted

that the treasury analyst was not one of the City officials authorized to instruct the bank as to disposition of the funds. In response to our inquiry as to risks incurred by the City if the bank had transferred the redeemed funds to an inappropriate bank account based on a fraudulent request from/instruction by the treasury analyst, Treasurer-Clerk management indicated the bank would be liable. The stated reasons were that the bank would have executed the inappropriate transaction based on an instruction from someone other than an authorized official.

We do not dispute management's assertion that the City would have recourse against the bank in the described circumstances. However, taking such recourse action in the event of a fraudulent funds transfer (e.g., initiated by the treasury analyst) would likely be costly to the City.

We recommend the Treasurer-Clerk's Office include, on future agreements for non-negotiable certificates of deposit, language restricting the transfer of maturing/redeemed funds to a specified City bank account. Including such language should further strengthen controls and mitigate the risk of fraudulent transfers, and increase the City's stance in regard to legal recourse against the bank for fraudulent transfers.

## Written Operating Procedures

*The Treasurer-Clerk's "Investment Internal Control Procedures" are generally appropriate and comprehensive.*

**Overview.** In accordance with good business practices and industry guidance, the Treasurer-Clerk's Office established documented "Investment Internal Control Procedures." Our review showed those procedures to be appropriate and generally comprehensive. Two recommendations are made in the following to improve those procedures.

**Written procedures should be updated to reflect the current operating environment.** While we found the Treasurer-Clerk's internal control procedures to be appropriate and comprehensive, they do not reflect some current circumstances and processes. For example:

- The policy identifies four key positions whereas the applicable roles were consolidated into three positions several years ago.
- The procedures address the provisions of “confirmations” from brokers, dealers, issuers, managers, etc. directly to the City’s “Finance department” for use in preparing applicable journal entries. Under current processes, such confirmations are received by Treasurer-Clerk staff that prepare and submit the applicable journal entries to Accounting Services, a City unit created from the reorganization of the former Finance department several years ago.
- Various forms and systems referenced in the procedures have subsequently been replaced with new forms and systems.

To make these procedures more applicable and meaningful to Treasurer-Clerk staff, we recommend consideration be given to updating them to reflect current operating conditions and circumstances.

*Consideration should be given to updating the Treasurer-Clerk’s “Investment Internal Control Procedures” to address current operating conditions and circumstances and to further enhance the usefulness of those procedures to staff.*

In addition to the above, we identified other current operating practices and controls that would be appropriate to include in these procedures. Accordingly, under the separation of duties section of the procedures, consideration should be given to adding the following:

- The current practice of requiring each decision by Treasurer-Clerk investment staff for the purchase, sale, or otherwise investment/liquidation of funds to be approved by the Deputy Treasurer-Clerk.
- The current practice of requiring documented approval on each general ledger journal entry prepared by Treasurer-Clerk investment staff.
- The current practice of requiring two employees to execute a wire transfer of City funds.

The incorporation of those current controls/practices would further enhance the usefulness of those procedures, especially to staff in the event of staffing changes or turnover.

## Conclusion

*Overall, non-pension investments were properly and adequately managed by the Treasurer-Clerk's Office.*

Our audit showed the Treasurer-Clerk's Office has, for the most part, properly and adequately invested available non-pension assets in accordance with policy and legal requirements and industry practices. Returns on those investments have been appropriate under existing market conditions, with no losses of investment capital. The City has established an adequate investment policy and adequate controls to ensure only proper investment transactions/activities are executed/performed. Third parties (broker/dealers, custodians, external managers, and security lending agents) are hired and used as appropriate. Treasurer-Clerk management and the City's Investment Advisory Committee monitor and review those third parties, as well as investment performance and status.

*Implementation of recommended enhancements and improvements should help the Treasurer-Clerk further mitigate applicable risks.*

Our audit also identified one significant issue and several areas that are indicative of the need for enhancements and improvements in the non-pension investment administrative and oversight functions. If implemented as recommended, these enhancements and improvements will help the Treasurer-Clerk's office further mitigate the risk of (1) inequitable allocations of earnings, (2) inappropriate investments, (3) investment decisions based on incomplete or inaccurate information, (3) noncompliance with policy and legal requirements, (4) overpayments of fees to third parties, and (5) undetected diversions of City assets due to lack of adequate controls.

We would like to thank staff in the Treasurer-Clerk's Office and Accounting Services for their assistance during this audit.

***Appointed  
Official's  
Response***

**City Treasurer-Clerk:** The Treasurer-Clerk would like to thank the City Auditor for his thorough review of the City's non-pension investment program. The period covered by the audit was a difficult time in the financial markets and broader economy, and we appreciate the recognition of prudent actions taken by the Treasurer/Clerk's Office during this time period. We also appreciate the identification of potential areas of improvement regarding certain actions, documentation and reporting. We look forward to taking these additional steps to enhance what we believe to be a sound policy and approach to investing the City's assets.



### *Appendix A – Action Plan*

Action Steps	Responsible Employee	Target Date
<b>A. Objective:</b>	<b>Ensure equitable allocations of investment earnings.</b>	
1. 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.	Tom Carman	8/1/2010
2. The portion of the earnings allocation process performed manually will be automated.	Tom Carman	8/1/2010
3. 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.	Tom Carman	9/30/2010
4. Adjustments will be made to correct the over and under-allocations of bond reserve earnings as identified on page 23 of this report.	Tom Carman	9/30/2010
5. Future allocations of earnings on bond reserves will be corrected for the worksheet error explained on pages 22 and 23 of this report.	Tom Carman	9/30/2010
<b>B. Objective:</b>	<b>Ensure an adequate and proper policy.</b>	
1. 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.	Tom Carman	9/30/2010
<b>C. Objective:</b>	<b>Ensure compliance with policy requirements.</b>	
1. Criteria will be developed for classification and reporting of bond proceeds investments as to portfolio type.	Tom Carman	9/30/2010

Action Steps	Responsible Employee	Target Date
2. The reporting and oversight process will be enhanced to identify all (even minor) violations of policy maturity duration requirements.	Tom Carman	9/30/2010
3. 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.	Jim Cooke	9/30/2010
<b>D. Objective:</b>	<b>Comply with federal arbitrage requirements.</b>	
1. Updated arbitrage determination will be made.	Jim Cooke	9/30/2010
<b>E. Objective:</b>	<b>Ensure accurate, informative, and complete performance and status reports.</b>	
1. Reports prepared by the Treasury Analyst will be reviewed by the Deputy Treasurer-Clerk for accuracy and completeness prior to distribution of those reports to management and the IAC.	Jim Cooke	8/14/2010
2. All non-pension investments will be addressed in the periodic reports, including GICs and the Securities Lending Portfolio.	Tom Carman	9/30/2010
3. Investments will be classified on periodic reports in a manner that is consistent with classifications in an updated City Commission Policy #234.	Tom Carman	9/30/2010
4. 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.	Tom Carman	8/14/2010
5. 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.	Tom Carman	8/14/2010
6. Weighted averages will be properly applied when disaggregating and reporting performance and maturity durations for applicable investment categories.	Tom Carman	8/14/2010

7. Policy benchmarks will be accurately and correctly determined.	Tom Carman	8/14/2010
<b>F. Objective:</b>	<b>Provide for adequate controls and processes.</b>	
1. Efforts will be made to recover the net overcharge of \$13,445 from the custodian.	Tom Carman	8/1/2010
2. The Deputy Treasurer-Clerk will ensure that fees billed by the custodian are accurate and reasonable.	Jim Cooke	9/30/2010
3. Adequate documentation will be retained for future transactions to clearly demonstrate the evaluation of and justification for securities selected through competitive solicitation.	Tom Carman	6/1/2010 *
4. 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.	Tom Carman	6/1/2010 *
5. 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.	Tom Carman	9/30/2010
6. 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.	Tom Carman	9/30/2010
7. Efforts will be enhanced to ensure IAC meeting minutes are reviewed and approved by Treasurer-Clerk management and the IAC.	Tom Carman	8/14/2010
8. Treasurer-Clerk staff will work with Accounting Services staff to arrange for periodic account statements to be provided directly to, or accessed directly by, Accounting Services.	Tom Carman	6/1/2010 *
9. Treasurer-Clerk staff will reconcile the temporary clearing account, established for investment receipts, on a monthly basis.	Tom Carman	6/1/2010 *

<p>10. 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.</p>	<p>Tom Carman</p>	<p>9/30/2010</p>
<p>11. The two system administrator permissions addressed in the audit report will be deleted.</p>	<p>Jim Cooke</p>	<p>7/1/2010</p>
<p>12. 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.</p>	<p>Tom Carman</p>	<p>Will be implemented upon next acquisition of a non-negotiable CD</p>
<p>13. The “Investment Internal Control Procedures” will be updated to reflect current circumstances and processes.</p>	<p>Tom Carman</p>	<p>9/30/2010</p>

\*Per department, action plan step has been completed as of indicated date. Completion will be verified during the audit follow-up process.