

# **Final Audit Follow-up**

*As of March 31, 2008*



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City Auditor

## **Pension Investments**

*(Report #0621, Issued July 10, 2006)*

**Report #0812**

**June 30, 2008**

### **Summary**

**The Treasurer-Clerk's (T/C) Office and Accounting Services have completed 29 of the 32 action plan steps that were established to address issues identified in audit report #0621. T/C staff has made progress in completing the three remaining steps. Responsibility for following up to ensure completion of those three steps is turned over to T/C management.**

In audit report #0621, we reviewed investment performance and activity for the City defined benefit and defined contribution pension plans. We found that, overall, the City had achieved its investment return goals and, as a result, the City's pension plans were in sound financial condition. However, areas were identified where improvements and enhancements were needed. For example:

- Adjustments and reallocations of investments were needed in a few instances to ensure pension funds are invested in compliance with state law and the City's investment policy.
- A separate investment policy was needed for the City's defined contribution plans.
- Various enhancements were needed in the monitoring and oversight functions.

Thirty-two action plan steps were established to address those issues. We found that T/C and Accounting Services staffs successfully completed 29 of those 32 steps. T/C staff has made progress in completing the three remaining steps.

Significant actions completed include:

- Transferring sufficient funds invested in international securities to domestic securities, in order to bring the City's portfolio into compliance with the 10% maximum allowed for police and firefighter plans;
- Establishing a separate investment policy for the City's defined contribution plans;
- Revising the investment policy for the City's defined benefit plan to address various issues identified in the audit;
- Measuring and evaluating investment performance net of fees as required by the investment policy for the defined benefit plan;
- Addressing investment policy benchmarks and key policy requirements in contracts with external managers;
- Preparing and retaining documentation that explains and justifies decisions made in the selection of external managers and funds;
- Enhancing reviews of custodian invoices;
- Requiring an external manager to reinvest City assets (held in unallowable securities) in allowable securities;
- Establishing and using checklists to ensure that external managers comply with key policy and contractual provisions and requirements;
- Reassigning system permissions to improve controls over wire transfers;
- Retaining all applicable contractual documents and related records;
- Resolving bank account reconciliation issues and enhancing the reconciliation process for the City's bank account;

- Providing Investment Advisory Committee (IAC) meeting minutes to T/C management and the IAC for their formal review and approval; and
- Establishing written procedures for various processes and practices.

Significant progress has been made by T/C staff on the three remaining steps. However, as of March 31, 2008, those steps had not been completed. Those three action plan steps include:

- Reconfirming authorization instructions with the custodian and third party administrator on an annual basis;
- Requiring all external managers to periodically certify that they are reconciling their records with records maintained by the City's custodian; and
- Ensuring future contracts with external managers require that the managers (1) reconcile their records and activity with that reported by the custodian, (2) report any significant unresolved errors or differences, and (3) periodically certify to the T/C that those reconciliations are being performed.

Responsibility for following up to ensure completion of those three steps is turned over to T/C management.

We appreciate the assistance provided by T/C staff during this follow-up.

### ***Scope, Objectives, and Methodology***

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

### ***Original Report #0621***

The scope of report #0621 included a review of investment performance and activity for both the City's defined benefit and defined contribution pension plans. The current investment policy and T/C's procedures in effect at the time of our audit fieldwork during fall

2005/winter 2006 were reviewed for purposes of completing our audit objectives. For the most part, investment transactions and activity during the three-year period July 2002 through June 2005 were evaluated, with a primary focus on activity during the one-year period July 2004 through June 2005. In a few instances, activity was reviewed through September 30, 2005.

The objectives of the audit were to:

- Examine the City's performance in achieving investment return goals for the pension plans.
- Compare the City's pension investment performance to that of other similar public pension plans.
- Determine whether the City's pension investment activity was in compliance with governing state laws and other legal requirements.
- Determine the adequacy of and compliance with the T/C's pension investment policy.
- Examine the T/C's procedures and methods for evaluating and monitoring pension investment performance.
- Examine the T/C's process and procedures for selecting external managers and investment funds for the pension program.
- Determine whether external managers, custodial agents, third party administrators, and consultants complied with applicable contractual terms and conditions.
- Determine the adequacy of internal controls over execution of pension investment transactions and other aspects of the pension investment process.

### ***Report #0812***

This is our second and final follow-up on action plan steps identified in audit report #0621. In our first follow-up, we reported on the progress and status of efforts to implement action plan steps due as of March 31, 2007. At the request of the T/C's office, we delayed following up on steps due September 30, 2007, until initiation of this follow-up in April 2008. This request was made because T/C staff had temporarily delayed completion of several remaining outstanding action plan steps (initially due by September 30, 2007) until December 31, 2007. To obtain information, we conducted interviews with key staff, made observations, and reviewed relevant documentation.

**Previous Conditions and Current Status**

In report #0621, we found that, overall, the City had achieved its investment return goals and, as a result, the City’s pension plans were in sound financial condition. However, areas were identified where improvements and enhancements were needed. Issues identified included, for example, the need to: (1) adjust amounts invested in international securities so that the police and firefighter pension plans do not exceed the 10% maximum allowed by state law; (2) create a formal investment policy for the defined contribution plans; (3) revise and clarify provisions in the defined benefit plan investment policy; and (4) enhance monitoring and oversight to ensure that:

- Performance is properly measured.
- Contracts contain appropriate terms and conditions.
- Better records are prepared and retained to justify and support manager and fund selections.
- Custodian fees are accurately invoiced in accordance with contractual terms.
- Managers invest City pension funds only in accordance with policy and contractual requirements.
- Key records are retained and available.
- Internal controls are adequate.

Thirty-two action plan steps were developed to address the identified issues. Table 1 below provides a summary of those 32 action steps due for completion and their current status.

**Table 1  
Action Plan Steps from Report #0621  
due as of March 31, 2008, and Current Status**

Action Plan Steps	Current Status
<b>OFFICE OF THE TREASURER-CLERK</b>	
<b>Ensure compliance with controlling laws and regulations</b>	
<ul style="list-style-type: none"> <li>• Appropriate adjustments will be made to defined benefit plan investments such that no more than 10% of police and firefighter plan assets are invested in international securities.</li> </ul>	<p>√ The Treasurer-Clerk made adjustments to the defined benefit plan investments such that no more than 10% of total plan assets are invested in international securities. Our review showed that as of March 31, 2008, only 8.61% of plan assets were invested in international securities. As also noted in the following action step, the defined benefit plan investment policy was recently revised to restrict investment of plan assets in international securities to no more than 10% of total plan assets. Those actions ensure that police and firefighter pension funds are invested in accordance with controlling laws, as each of those two plans “own” a pro rata share of each category of total plan assets. (NOTE: Total plan assets are comprised of pension funds for general employees, police, and firefighters.)</p>
<ul style="list-style-type: none"> <li>• The defined benefit plan investment policy will be revised to provide that no more than 10% of plan assets “owned” by the police and firefighter plans will be invested in international securities.</li> </ul>	<p>√ One of the approved revisions to the defined benefit plan investment policy was to limit investments in international securities to no more than 10% of total plan assets. Those policy revisions were approved by the City Commission in December 2007.</p>

<b>Ensure an adequate and appropriate investment policy</b>	
<ul style="list-style-type: none"> <li>A separate investment policy will be established for the City's defined contribution plans. Essential elements addressed in the audit report will be addressed in that policy.</li> </ul>	√ Completed in a prior period.
<ul style="list-style-type: none"> <li>The defined benefit plan will be revised to (1) provide for a system of internal controls and (2) documented operational procedures.</li> </ul>	√ As noted above, the defined benefit plan investment policy was revised in December 2007. One of the revisions requires the establishment of a system of internal controls to ensure that plan assets are properly safeguarded, accounted for, and managed. That revision addresses minimum internal controls that must be addressed. The revised plan also provides operating policies and procedures.
<ul style="list-style-type: none"> <li>The defined benefit policy will be modified to clarify that investment of plan assets in real estate are not limited to the one named external manager.</li> </ul>	√ As noted above, the defined benefit plan investment policy was revised in December 2007. As part of the revisions, changes were made that clarify investment of plan assets in real estate are not restricted to any specific external manager. Among other things, policy wording revisions were made such that specific managers are not named within the policy.
<b>Ensure adequate monitoring and evaluation of investment performance</b>	
<ul style="list-style-type: none"> <li>The City's investment consultant will be requested to measure and report investment performance net of fees as required by the City's defined benefit investment policy.</li> </ul>	√ Completed in a prior period.
<ul style="list-style-type: none"> <li>Future contracts executed with external investment managers will address investment policy benchmarks.</li> </ul>	√ Completed in a prior period.
<ul style="list-style-type: none"> <li>Procedures and methods for the evaluation of investment performance for both the defined benefit and defined contribution plans will be formalized and documented.</li> </ul>	√ Completed in a prior period.
<b>Ensure appropriate selection of external managers and investment funds</b>	
<ul style="list-style-type: none"> <li>Adequate documentation will be prepared and retained that explains and justifies decisions made in the selection of managers and funds.</li> </ul>	√ Completed in a prior period.
<ul style="list-style-type: none"> <li>For the defined contribution plans, adequate documentation will be maintained showing specific funds evaluated and considered as well as the criteria and factors used in the evaluations.</li> </ul>	√ Completed in a prior period.
<ul style="list-style-type: none"> <li>Procedures used in the selection and hiring of external managers and investment funds will be formalized and documented.</li> </ul>	√ Completed in a prior period.
<b>Ensure proper fees are paid to the custodian</b>	
<ul style="list-style-type: none"> <li>T/C staff will enhance their review of custodian fee invoices to ensure that invoiced amounts are in accordance with contractual terms and fee schedules.</li> </ul>	√ Completed in a prior period.

<ul style="list-style-type: none"> <li>T/C staff will determine if the undercharge reported by the custodian is accurate in amount. In the event that substantiated undercharges are less than the overcharges identified in the audit, funds will be recovered from the custodian for the difference.</li> </ul>	<p>√ T/C staff obtained detailed information on the undercharges from the custodian and determined that information was reasonable and substantiated the undercharged amount asserted by the custodian. As the amount of those undercharges (\$32,799) exceeded the overcharges of \$24,750 identified in the initial audit, T/C staff will not seek recovery of the overcharges. As noted in the initial audit report, the custodian agreed to forego requesting recovery of the noted undercharges.</p>
<ul style="list-style-type: none"> <li>State Street (custodian) will be requested to make available detail of the individual trade transactions for which the City is charged. T/C staff will use that information to develop a baseline of reasonable transactions, against which future invoiced transactions can be compared. Any unexpected variations from that baseline will be investigated for the purpose of ensuring invoiced trade fees are reasonable.</li> </ul>	<p>√ Designated T/C staff now have access to a new State Street website that provides detailed information on trade transactions for periods that can be designated by T/C staff. Once assessed, that information can be sorted and reviewed by T/C staff for purposes of ensuring charges for trade transactions on quarterly invoices are correct.</p>
<ul style="list-style-type: none"> <li>Procedures for reviewing custodian invoices and ensuring that invoiced amounts are correct and reasonable will be documented.</li> </ul>	<p>√ Completed in a prior period.</p>
<p><b>Ensure external managers comply with policy and contractual provisions and requirements</b></p>	
<ul style="list-style-type: none"> <li>The one manager where the audit identified investments in instruments not allowed by the City’s investment policy will be instructed to reinvest those assets in allowable instruments.</li> </ul>	<p>√ The manager disposed of (sold) the unallowable securities (inverse floaters and interest-only mortgage-backed securities) and reinvested the assets in allowable securities.</p>
<ul style="list-style-type: none"> <li>The two managers where the audit identified investments outside the parameters allowed by the applicable contracts will be instructed to reinvest those assets within those parameters.</li> </ul>	<p>√ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>Formal written procedures will be established to address the process of approving payment of manager fees based on manager-reported values instead of custodian-reported values. Those procedures will provide a dollar threshold to delineate when those fees should be paid as invoiced or rejected and instead paid based on custodian-reported values.</li> </ul>	<p>√ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>Future contracts with external managers will address, either by direct reference or through an attached appendix, required compliance with key investment policy requirements.</li> </ul>	<p>√ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>Applicable contractual documents, including fee schedules, will be timely obtained and retained in T/C files. Filing efforts will be improved such that those records will be made available in a timely manner upon appropriate request.</li> </ul>	<p>√ Completed in a prior period.</p>

<ul style="list-style-type: none"> <li>A formal process will be established to ensure that external managers comply with key policy and contractual provisions and requirements. A standardized checklist will be developed and used to assist in that process. Completed checklists (one for each external manager) and any other applicable records used in this process will be retained as evidence of this monitoring process.</li> </ul>	<p>✓ As reported in the initial follow-up report (#0722) on this audit, the T/C's Office developed written procedures and a standard checklist for conducting annual determinations of each external manager's compliance with key policy and contractual provisions and requirements. During this current follow-up engagement, the T/C's Office commenced use of the checklist to determine external managers' compliance for the fiscal year ended September 30, 2007. The completed checklists are on file in the T/C's Office.</p>
<p><b>Ensure reported security lending income is accurate and proper</b></p>	
<ul style="list-style-type: none"> <li>A formal process will be established for the periodic review of reported security lending activity to ensure that function is properly and efficiently administered and reported earnings are reasonable.</li> </ul>	<p>✓ Completed in a prior period.</p>
<p><b>Ensure adequate internal controls are in place</b></p>	
<ul style="list-style-type: none"> <li>One of the two system administrator permissions currently assigned to the Treasury Analyst will be reassigned to the Deputy Treasurer-Clerk.</li> </ul>	<p>✓ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>Authorization instructions for the custodian and the third party administrator will be updated to reflect the current mayor and bank.</li> </ul>	<p>✓ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>Authorization instructions will be updated and re-sent or reconfirmed at least annually. To document the custodian's and third party administrator's receipt and acknowledgement of those instructions, those entities will be required to sign, date, and return copies of the submitted instructions to T/C staff. Those signed and dated acknowledgements will be retained in T/C files.</li> </ul>	<p>➔ T/C staff indicated at the end of our follow-up fieldwork in May 2008, that those authorization instructions had not been updated and/or re-confirmed with the custodian and third party administrator in the past 12 months. The most recent updated instructions/confirmations were dated March 9, 2006 for the custodian and May 16, 2007 for the third party administrator. T/C management indicated on May 29, 2008, that staff was in the process of re-confirming the instructions with both the custodian and third party administrator. Responsibility for ensuring final resolution of this issue is turned over to T/C management.</p>
<ul style="list-style-type: none"> <li>Copies of each signed withdrawal authorization letter will be retained in T/C files.</li> </ul>	<p>✓ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>To better protect the City in the event of unauthorized transfers of pension funds, the T/C's Office will either (1) increase the current \$1 million insurance cap under the existing government crime policy or (2) purchase separate fidelity bonds for applicable employees in the T/C's Office, in amounts sufficient to insure the City for potential fraudulent wire (or electronic) transfers.</li> </ul>	<p>✓ Completed (resolved) in a prior period.</p>
<ul style="list-style-type: none"> <li>External managers will be required to submit periodic statements certifying that they are reconciling their records and activity with the records and activity as reported by the custodian. External managers will be required to report to T/C staff any unresolved errors or differences.</li> </ul>	<p>➔ At the end of calendar year 2007 and beginning of calendar year 2008, T/C staff obtained statements from the majority of current external managers (1) certifying that they reconciled their records and activity with that reported by the custodian and (2) acknowledging that any significant unresolved errors or differences identified in those reconciliations would be reported to the T/C. Specifically, positive certifications were</p>

	<p>received from 14 of the 19 currently active external managers. In regard to the five remaining external managers, no statements were received from three managers and the statements from the other two managers indicated that the required reconciliations were not done. (One of those managers stated that information from the custodian necessary to perform the reconciliations was not received.)</p> <p>As noted in the initial audit report, such reconciliations serve to detect errors or fraudulent activity committed by custodian staff. As also noted in the initial audit report, had those reconciliations been performed by one manager, that manager and T/C staff likely would have detected that cash distributions were incorrectly being submitted directly to a City operating (non-pension) account instead of to the custodian. Accordingly, we continue to encourage the T/C to require and obtain evidence that the required reconciliations are performed. This issue is turned over to T/C management to ensure appropriate resolution.</p>
<ul style="list-style-type: none"> <li>• Future contracts with external managers will require that the manager (1) reconcile their records and activity with that reported by the custodian, (2) report any significant unresolved errors or differences, and (3) periodically certify to the T/C that those reconciliations are being performed.</li> </ul>	<p>➔ T/C staff provided evidence that this action had been completed for one of two recently executed contracts through a contract addendum executed April 22, 2008. For the other recently executed contract, T/C management indicated on May 29, 2008, that the original contract did not contain the reconciliation and certification language. T/C management indicated that a contract addendum would also be executed with that external manager requiring that manager to reconcile its records with the records of the custodian and report any unresolved errors or differences to the T/C. This issue is turned over to T/C management to ensure appropriate resolution.</p>
<ul style="list-style-type: none"> <li>• Investment Advisory Committee (IAC) meeting minutes will be provided to T/C management and the IAC members for their formal review and approval.</li> </ul>	<p>✓ Meeting minutes prepared for quarterly IAC meetings are now provided to T/C management and IAC members for their review and approval in the subsequent quarterly IAC meeting. Approval of the IAC meeting minutes is documented.</p>
<b>ACCOUNTING SERVICES</b>	
<b>Ensure adequate internal controls are in place</b>	
<ul style="list-style-type: none"> <li>• The bank account reconciliation process will be corrected such that unresolved differences are adequately identified, researched, and either resolved or reported to management.</li> </ul>	<p>✓ Completed in a prior period.</p>
<ul style="list-style-type: none"> <li>• Review of the bank account reconciliation process will be enhanced.</li> </ul>	<p>✓ Completed in a prior period.</p>

**Table Legend:**

- Issue addressed in the original audit
- ✓ Issue addressed and resolved
- ➔ Issue partially addressed, responsibility for final resolution turned over to T/C management.

## Conclusion

The T/C's Office and Accounting Services have been successful in completing and resolving 29 of the 32 action plan steps established to address issues identified in the initial audit.

Significant progress has been made by T/C staff on the three remaining steps. However, as of March 31, 2008, those steps had not been completed. Those three action plan steps include:

- Reconfirming authorization instructions with the custodian and third party administrator on an annual basis;
- Requiring external managers to periodically certify that they are reconciling their records with records maintained by the City's custodian; and
- Ensuring future contracts with external managers require that the managers (1) reconcile their records and activity with that reported by the custodian, (2) report any significant unresolved errors or differences, and (3) periodically certify to the T/C that those reconciliations are being performed.

Responsibility for following up to ensure completion of those three steps is turned over to T/C management.

We appreciate the assistance provided by T/C staff during this follow-up.

## Appointed Official's Response

### City Treasurer-Clerk:

The Office of the Treasurer-Clerk is aware of each of the open items as of March 31, 2008. We would like to note that steps have been taken to address each of these three items.

We would like to thank the City Auditor for his professionalism in working with us during the audit and follow-up periods. We also are pleased that the result of the audit has been to make improvements and enhancements to a plan that "achieved its investment goals" and is in "sound financial condition."

Copies of this audit follow-up #0812 or audit report #0621 may be obtained from the City Auditor's website (<http://talgov.com/auditing/index.cfm>) or via request by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (Office of the City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail ([auditors@talgov.com](mailto:auditors@talgov.com)).

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