

Audit

Follow Up

As of March 31, 2007



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Pension Investments

(Report #0621, Issued July 10, 2006)

Report #0722

July 2, 2007

Summary

The Treasurer-Clerk's (T/C) Office and Accounting Services have completed 20 of the 25 action plan steps that were due for completion as of March 31, 2007. T/C staff has made progress in completing three of the remaining five steps due for their completion.

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. Twenty-five of those steps were due for completion as of March 31, 2007. We found that T/C and Accounting Services staffs successfully completed 20 of those 25 steps. T/C staff has made progress in completing three of the other five steps due for their completion.

Significant actions completed include:

- Establishing a separate investment policy for the City's defined contribution plans;

- 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;
- 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;
- Sending updated authorization instructions to the City's custodian and third party administrator; and
- Establishing written procedures for various processes and practices.

The actions due as of March 31, 2007, and remaining to be completed (by the T/C's Office) 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;
- Determining if the undercharge reported by the City's custodian is accurate in amount and sufficient to offset the overcharge identified in the initial audit;
- Requiring an external manager to reallocate City pension assets held in unallowable securities (inverse floaters

and interest-only mortgage-backed securities) to allowable securities;

- Using recently established checklists to ensure that external managers comply with key policy and contractual provisions and requirements; and
- Consistently providing Investment Advisory Committee (IAC) meeting minutes to T/C management and the IAC for their formal review and approval.

T/C staff indicated that it plans to complete these outstanding action plan steps in the near future.

Scope, Objectives, and Methodology

The audit and subsequent follow up engagement were conducted in accordance with Generally Accepted Government Auditing Standards and the Standards for the Professional Practice of Internal Auditing and accordingly included such tests of the records and other auditing procedures as were considered necessary.

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 #0722

The purpose of this follow up is to report on the progress and status in completing the action plan steps due for completion as of March 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; and (3) 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. Twenty-five of those 32 steps were due for completion as of March 31,

2007. Table 1 below provides a summary of those 25 action steps due for completion and their current status.

**Table 1
Action Plan Steps from Report #0621
due as of March 31, 2007, and Current Status**

Action Plan Steps	Current Status
OFFICE OF THE TREASURER-CLERK	
Ensure compliance with controlling laws and regulations	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> ◇ During March 2007, the Treasurer-Clerk's (T/C) Office authorized the transition of approximately \$35 million invested in international securities to domestic securities. As of March 31, 2007, approximately \$30 million of that amount had been moved as directed. As a result, the portion of the City's portfolio invested in international securities went from approximately 15% to 12.65%. In response to our follow up inquiry, T/C staff indicated that additional amounts would be moved in the future to bring the City's portfolio into compliance with the 10% maximum allowed for police and firefighter plans.
Ensure an adequate and appropriate investment policy	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> √ On February 14, 2007, the Sinking Fund Commission approved the T/C's proposed investment policy for the City's defined contribution plans. That policy addresses essential elements recommended by industry guidance.
Ensure adequate monitoring and evaluation of investment performance	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> √ In the quarterly performance evaluations, the investment consultant now measures and reports investment performance net of manager fees, as well as gross of those fees (i.e., investment returns are now measured and reported both after and before manager fees are deducted).
<ul style="list-style-type: none"> Future contracts executed with external investment managers will address investment policy benchmarks. 	<ul style="list-style-type: none"> √ The most recent contract executed with a new external manager contains an explicit provision that the manager shall invest the assets in accordance with the City's Pension Investment Policy and includes that policy in an appendix to the contract. The policy specifies the benchmarks for the different investment styles. Accordingly, the contract communicates the performance benchmarks expected of the manager.
<ul style="list-style-type: none"> Procedures and methods for the evaluation of investment performance for both the defined benefit and defined contribution plans will be formalized and documented. 	<ul style="list-style-type: none"> √ Written procedures have been established for evaluating performance of the City's defined benefit and defined contribution plans.
Ensure appropriate selection of external managers and investment funds	
<ul style="list-style-type: none"> Adequate documentation will be prepared and retained that explains and justifies decisions made in the selection of managers and funds. 	<ul style="list-style-type: none"> √ In the most recent selections of an external manager for the defined benefit plan and a fund for the defined contribution plans, the T/C's Office prepared documentation to substantiate and support the

	<p>selection decisions. Those records show that the external manager was selected based on its quantitative approach, past performance, disciplined nature in investment style, and experience and track record of the staff that would be assigned to manage the City's portfolio. In regard to the defined contribution plans, those records show that the applicable fund was selected based on its relative performance. Fees were also taken into consideration. Those selection decisions were substantiated by analyses and comparisons provided by the City's investment consultant.</p>
<ul style="list-style-type: none"> 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. 	<p>√ For the most recent fund selections, appropriate documentation was prepared and retained that identified the funds evaluated and considered, as well as the criteria and factors used in evaluating those funds.</p>
<ul style="list-style-type: none"> Procedures used in the selection and hiring of external managers and investment funds will be formalized and documented. 	<p>√ The T/C's Office formally documented the procedures used in selecting and hiring external managers and funds.</p>
<p>Ensure proper fees are paid to the custodian</p>	
<ul style="list-style-type: none"> 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. 	<p>√ T/C staff indicated that they now validate and verify the accuracy and propriety of fees included on the custodian invoices. To substantiate that claim, we selected and reviewed during our follow up fieldwork the custodian's invoice paid for the quarter ended December 31, 2006. We found that all charges on that paid invoice were accurate, allowed, valid, and in accordance with the contractual fee schedule.</p>
<ul style="list-style-type: none"> 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. 	<p>X As of the end of our follow up fieldwork, T/C staff had not determined if the undercharge reported by the custodian was accurate in amount.</p>
<ul style="list-style-type: none"> Procedures for reviewing custodian invoices and ensuring that invoiced amounts are correct and reasonable will be documented. 	<p>√ The T/C's Office formally documented the procedures for reviewing custodian invoices for use in ensuring that invoiced fees are correct and reasonable.</p>
<p>Ensure external managers comply with policy and contractual provisions and requirements</p>	
<ul style="list-style-type: none"> 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. 	<p>X On July 26, 2006, the T/C sent a letter to the manager directing the manager to reinvest the assets (held in unallowable securities) in allowable securities. We noted that as of March 31, 2007, the manager had not complied with that request. In response to our inquiry on this matter, T/C staff indicated that they had temporarily delayed requiring the manager to comply with that request because revisions to the current investment policy were being considered. However, after a final decision was made not to revise the policy, T/C staff did not follow through with the manager to ensure that the assets were moved as initially requested. We recommend that the T/C ensure that the pension assets still invested in unallowable securities (inverse floaters and interest-only mortgage-backed securities) are reinvested in allowable securities.</p>

<ul style="list-style-type: none"> 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. 	<p>√ In July 2006, T/C staff instructed both managers to invest and maintain investments of City pension assets in accordance with contractual requirements. We noted that as of March 31, 2007, one of the managers had complied with that request as the number of individual holdings (35) was now within the range (25 to 35) allowed by the contract. In regard to the other manager, a subsequent interpretation from the manager shows that the manager was not in violation of the contractual requirements relating to maximum amounts that can be invested in a single industry. That interpretation appears reasonable and was accepted by the T/C's Office.</p>
<ul style="list-style-type: none"> 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. 	<p>√ Written procedures were prepared that specify steps to ensure that invoiced manager fees are proper, accurate, and in accordance with applicable contractual provisions prior to approving payment. Those procedures provide, in part, that fees should generally be based on custodian-reported values. Those procedures also address actions when manager-reported balances (on which fees are sometimes based) are more or less than the custodian-reported balances (on which fees should be based). For example, the procedures provide that if a fee charged based on manager-reported balances is \$500 or more greater than what the fee would be based on custodian-reported balances, T/C staff must contact the manager and custodian to resolve and/or verify the validity of the difference before approving payment of the fee.</p>
<ul style="list-style-type: none"> Future contracts with external managers will address, either by direct reference or through an attached appendix, required compliance with key investment policy requirements. 	<p>√ The most recent contract executed with a new external manager contains an explicit provision that the manager shall invest the City's pension assets in accordance with the City's Pension Investment Policy and includes that policy in an appendix to the contract.</p>
<ul style="list-style-type: none"> 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. 	<p>√ Contracts and fee schedules were on file and available in the T/C's Office for the two most recent external managers hired to invest and manage City pension funds. Also, certain related documents (manager fee invoices, account statements, etc.) are now being imaged and stored in the T/C's electronic imaging system.</p>
<ul style="list-style-type: none"> 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. 	<p>◇ The T/C's Office has 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. As of the end of our follow up fieldwork, T/C staff had not used those checklists to determine external managers' compliance with key policy and contractual provisions.</p>
<p>Ensure reported security lending income is accurate and proper</p>	
<ul style="list-style-type: none"> 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. 	<p>√ T/C staff have formalized and documented their review of security lending activity. Among other things, those documented reviews determine if allocations of earnings are accurate and whether those earnings are reasonable. Reports are also</p>

	obtained and reviewed that document compliance with contractual collateral requirements.
Ensure adequate internal controls are in place	
<ul style="list-style-type: none"> One of the two system administrator permissions currently assigned to the Treasury Analyst will be reassigned to the Deputy Treasurer-Clerk. 	<ul style="list-style-type: none"> √ To ensure adequate controls, one of those two system administrator permissions has been reassigned to the Treasurer-Clerk.
<ul style="list-style-type: none"> Authorization instructions for the custodian and the third party administrator will be updated to reflect the current mayor and bank. 	<ul style="list-style-type: none"> √ Updated authorization instructions were sent to the custodian and third party administrator.
<ul style="list-style-type: none"> Copies of each signed withdrawal authorization letter will be retained in T/C files. 	<ul style="list-style-type: none"> √ Signed withdrawal authorization letters were on file for recent withdrawals.
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> ◆ The City T/C has subsequently reconsidered the initial audit recommendation and related action plan step and opted to not increase the insurance coverage under the current government crime policy (\$1million cap) and not to purchase separate fidelity bonds for the applicable employees. The T/C indicated the primary reasons were (1) the existing controls currently in place (some of which were put into place as a result of other audit recommendations) should help preclude any one individual from fraudulently transferring City funds to an unauthorized account and (2) the inability to determine an appropriate cap or coverage limit. In conclusion, the T/C's Office considered the audit recommendation and made the decision to accept the risk identified in the initial audit because of circumstances, including other mitigating controls.
<ul style="list-style-type: none"> Investment Advisory Committee (IAC) meeting minutes will be provided to T/C management and the IAC members for their formal review and approval. 	<ul style="list-style-type: none"> ◇ Meeting minutes for the summer 2006 quarterly IAC meeting were provided to the IAC in the subsequent (fall 2006) meeting for review and approval. That review and approval was documented in the fall 2006 meeting minutes. However, there was no evidence that the fall 2006 meeting minutes were provided to the IAC for review and approval in the subsequent (winter 2007) IAC meeting. To ensure that key decisions and discussions in the quarterly IAC meetings are accurately documented, T/C staff should ensure that minutes for each meeting are formalized and submitted for review and approval in the subsequent IAC meetings.
ACCOUNTING SERVICES	
Ensure adequate internal controls are in place	
<ul style="list-style-type: none"> The bank account reconciliation process will be corrected such that unresolved differences are adequately identified, researched, and either resolved or reported to management. 	<ul style="list-style-type: none"> √ As of March 31, 2006, Accounting Services staff had researched, identified, and resolved all City bank account reconciliation differences that had not been properly addressed during the flawed reconciliation process. The differences identified and resolved included the receipt of the pension investment cash distributions from an external manager that were incorrectly deposited into the City's operating bank account.

<ul style="list-style-type: none"> • Review of the bank account reconciliation process will be enhanced. 	<ul style="list-style-type: none"> √ Accounting Services enhanced the bank account reconciliation process by reassigning certain responsibilities to more experienced and knowledgeable staff. In addition, supervisory staff is more involved in the reconciliation process.
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Table Legend:

- Issue addressed in the original audit
- ◊ On-going activities
- √ Issue addressed and resolved
- ◆ Issue reconsidered by T/C's Office and decision made to accept identified risk based on circumstances and other mitigating controls
- X Issue not addressed

Conclusion

The T/C's Office and Accounting Services have been successful in completing and resolving 20 of the 25 action plan steps that were due for completion as of March 31, 2007. Progress has been made by T/C staff in the completion of three of the remaining five steps assigned to the T/C's Office.

Significant actions completed include:

- Establishing a separate investment policy for the City's defined contribution plans;
- 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;
- 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;
- Sending updated authorization instructions to the custodian and third party administrator; and
- Establishing written procedures for various processes and practices.

Significant actions due as of March 31, 2007, and remaining to be 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;

- Determining if the undercharge reported by the custodian is accurate in amount and sufficient to offset the overcharge identified in the initial audit;
- Requiring an external manager to reinvest City assets (held in unallowable securities) in allowable securities;
- Using recently established checklists to ensure that external managers comply with key policy and contractual provisions and requirements; and
- Consistently providing IAC meeting minutes to T/C management and the IAC for their formal review and approval.

T/C staff is in the process of completing many of these actions.

Other actions remaining to be completed that were not due as of March 31, 2007, include:

- Making revisions to the investment policy for the City's defined benefit plan based on recommendations made in the initial audit;
- Establishing an efficient method to ensure the validity and reasonableness of trade transactions billed by the City's custodian; and
- Requiring external managers to periodically certify that they are reconciling their records with records maintained by the City's custodian.

We will determine and report on the status of those action plan steps, as well as the outstanding action plan steps noted previously, in our subsequent follow up engagement.

We appreciate the assistance provided by T/C and Accounting Services staffs during this follow up.

Appointed Officials' Responses

City Treasurer-Clerk:

The Office of the City Treasurer-Clerk agrees with your follow up report that 20 of the 25 action plan steps for March 31, 2007, were completed and that progress had been made on three of the five remaining steps. Staff had worked to address the two additional steps; however, they had not been completed as of March 31, 2007. We anticipate each of the five remaining steps being completed prior to the next follow up report. The City Treasurer-Clerk thanks the City Auditor's staff for their professionalism and congratulates them on receiving the "2006 Knighton Bronze Award" for their work on this audit. We are pleased that we

could be a part of the process to make improvements to the City's strong pension program.

City Manager:

I am pleased that staff has completed the action plan steps that were developed to address issues identified in audit report #0621. In addition, I appreciate the cooperation between the City Auditor's staff and our staff to complete this process.

Copies of this audit follow up 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).

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