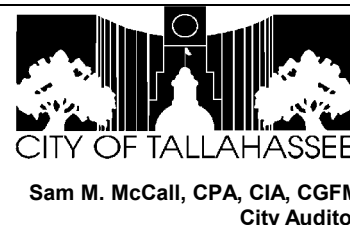


Audit

Follow Up

As of May 23, 2002



“Investment Reconciliations”

Report #0221

May 23, 2002

Summary

Accounting Services, in conjunction with the City Treasurer-Clerk’s Office, has addressed investment reconciliation issues identified by the City’s external auditors and the City Auditor’s Office. We have subsequently identified additional issues for which corrective action has been taken.

Accounting Services has taken steps to address investment reconciliation issues identified by the City’s external auditors in their audit of the City’s financial statements. The City’s external auditors expressed those concerns as a reportable condition in their Independent Auditor’s Report on Compliance and on Internal Control Over Financial Reporting, dated March 5, 2002.

Accounting Services, in conjunction with the City Treasurer-Clerk’s Office, has addressed the issues identified and recommendations made in the City Auditor’s Assistance and Guidance Report on Investment Reconciliations (#0211), dated January 24, 2002. During our follow-up work, we identified additional issues, and Accounting Services and the Treasurer-Clerk’s Office initiated corrective actions to address those issues as well.

Scope, Objectives, and Methodology

The scope of our follow-up review included investment reconciliations completed for all City investment accounts for the month ended February 28, 2002, or the quarter ended December 31, 2001. Those represent reconciliations completed subsequent to Accounting Services being made aware of the issues identified by the City’s external auditors and by the Office of the City Auditor in our Assistance and Guidance Report.

The primary objective of this follow-up is to determine and report on the adequacy of actions taken to address the issues identified by the City’s external auditors and to implement recommendations made by the City Auditor’s Office.

To make our determinations, we reviewed the investment reconciliations for the previously noted month and quarter and interviewed key staff within Accounting Services (AS) and the Treasurer-Clerk’s (T/C) Office.

This audit was conducted in accordance with Generally Accepted Government Auditing Standards and Standards for the Professional Practice of Internal Auditing, as applicable.

Background – City Investments

The City maintains both pension and non-pension investment accounts with assets valued in excess of \$1.34 billion. These accounts are comprised of the following:

- Four investment accounts for the City’s defined benefit pension plan. Investment decisions for these accounts are made by various contracted external managers. State Street Bank is the City’s custodian for applicable assets within each of these accounts.
- Four investment accounts for the City’s defined contribution and deferred compensation pension plans. Prudential Financial is the third party administrator for these plans. Investment decisions are made by individual employees within the parameters established by the plans. Included within one of those four plans is the City’s “DEFRA” account maintained for purposes of funding additional pension benefits payable to eligible retiring employees. Investment decisions for that account are made by Treasurer-Clerk staff.
- Twenty-two non-pension investment accounts consisting primarily of investments of excess

available cash, bond reserve accounts, and sinking fund accounts. Treasurer-Clerk staff makes investment decisions for some of these accounts while contracted external managers make investment decisions for the other accounts. The administrators for these accounts include State Street Bank, the State Board of Administration, First Union National Bank, Nations Funds, and Florida League of Cities.

The account custodians/administrators submit monthly or quarterly statements to the City reflecting activity and balances within the respective accounts. Because of the amount and volume of City investments, it is essential that activity per the statements be reconciled to investment activity recorded in the City's general ledger records. Staff other than the T/C's Office that executes transactions for those accounts should perform such reconciliations. If done properly, the independent reconciliations will detect:

1. Errors by T/C or AS staff in preparing journal entries or recording transactions,
2. Errors by account custodians/administrators in recording transactions and activity in the City's account or otherwise safeguarding City funds, and
3. Fraudulent activity by either City staff or account custodians/administrators.

AS staff is assigned responsibility for conducting independent reconciliations of the City's investment accounts. To ensure successful and timely reconciliations, applicable T/C staff must prepare accurate and timely journal entries reflecting activity in the City investment accounts.

Background – Audit Issues

As part of the audit of the City's financial statements for the fiscal year ended September 30, 2001, the City's

external auditors issued an Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting. In that report, the City's external auditors stated that certain investment accounts were not being reconciled on a timely basis. On other accounts, they stated there were unresolved reconciling items in addition to reconciling items that were not timely corrected. They also stated there were instances where correcting entries were posted in error and without appropriate review and approval, and that some reconciliations appeared to lack proper review and approval.

Because of the concerns being expressed by the external auditors during their audit fieldwork, the director of the Department of Management of Administration requested the City Auditor's Office to review the investment reconciliation process. That review resulted in the issuance of the Assistance and Guidance Report on Investment Reconciliations (#0211) dated January 24, 2002. Within that report, the City Auditor's Office identified specific areas where improvements should be made in regard to internal controls over the investment reconciliation process.

The City's Audit Committee requested the City Auditor's Office to follow up on the issues and concerns noted by the external auditors and in the Assistance and Guidance Report.

Previous Issues and Current Status

Table 1 provides a summary of the issues identified by the City's external auditors, and the status of those issues as determined during our review of the investment reconciliations completed for the month of February 2002 and quarter ended December 31, 2001.

**Table 1
Issues Identified by the City's External Auditors and Current Status**

Previous Issues	Current Status
<ul style="list-style-type: none"> • Significant account balances were not being reconciled on a timely (quarterly or monthly) basis during the year. 	<ul style="list-style-type: none"> ✓ All monthly reconciliations for the month ended February 28, 2002, were completed by March 20, 2002. All quarterly reconciliations for the quarter ended December 31, 2001, were completed by March 4, 2002 (i.e., prior to the end of the subsequent quarter). Completion included review and approval by AS managerial or senior staff.
<ul style="list-style-type: none"> • Investment reconciliations contained unresolved reconciling items. 	<ul style="list-style-type: none"> ✓ In the 31 reconciliations reviewed, all reconciling items were resolved and adequately documented or explained.
<ul style="list-style-type: none"> • Reconciling items were not corrected on a timely basis. This included instances 	<ul style="list-style-type: none"> ✓ In the 31 reconciliations, all reconciling differences were timely and properly resolved. Timely resolution included

where correcting entries were made in error.	any necessary corrections (e.g., correcting journal entries) by City staff and/or requests by City staff for corrective actions by investment custodians.
<ul style="list-style-type: none"> Documentation did not always show that reconciliations and related correcting entries were timely reviewed and approved by appropriate supervisory staff. 	<ul style="list-style-type: none"> ✓ Each of the 31 reconciliations was timely reviewed and approved by senior or managerial staff. The reviews and approvals were documented on the reconciliations. All correcting or adjusting journal entries also reflected timely review and approval by senior or supervisory staff.

Table Legend:

- Issue addressed by the external auditors in the reportable condition
- ✓ Action taken by Accounting Services and issue resolved

Table 2 provides a summary of the issues identified and recommendations made in the City Auditor's Assistance and Guidance Report on Investment Reconciliations (#0211), dated January 24, 2002,

and the current status of efforts by AS and the T/C's Office in implementing those recommendations.

**Table 2
Issues Identified in Assistance and Guidance Report #0211 and Current Status**

Previous Issues/Recommendations	Current Status
<ul style="list-style-type: none"> For the defined contribution and deferred compensation plans, AS staff should reconcile contributions shown on Prudential statements to the contributions recorded in the City's general ledger. 	<ul style="list-style-type: none"> ✓ In the reconciliations for the quarter ended December 31, 2001, AS reconciled contributions per the Prudential statements to the contributions recorded in the City's general ledger.
<ul style="list-style-type: none"> The T/C's Office should revise current procedures to require documented approval of two T/C staff to establish or change the bank or account to which repetitive wire transfers are sent (i.e., either of two employees within the T/C's Office, other than the City Treasurer-Clerk, could independently change the bank or account to which certain pension contributions were sent). 	<ul style="list-style-type: none"> ✓ In a letter dated January 15, 2002, T/C staff confirmed to First Union Bank that the only individuals that can authorize the setup or change of a repetitive wire transfer are signers on the City's bank account, who are presently the City Treasurer-Clerk, City Manager, and Mayor. The letter stated that any requests to establish or change wire transfer instructions without signatures of an authorized signer will (should) be refused by the bank.
<ul style="list-style-type: none"> AS should continue their recently implemented reconciliations of the City's DEFRA account. Any unexplained differences should be timely pursued and resolved. 	<ul style="list-style-type: none"> ✓ AS timely reconciled the DEFRA account for the quarter ended December 31, 2001. Differences were timely identified and explanations provided.
<ul style="list-style-type: none"> AS staff should record complete and current activity of the defined contribution plan in the general ledger. That information should then be used to report applicable information within the City's financial statements. To do this, AS staff needs to obtain a sufficient understanding of the activity recorded on the periodic Prudential account statements. 	<ul style="list-style-type: none"> ✓ AS obtained an understanding of the balances and activity reflected on the quarterly Prudential statements. That understanding was used to accurately report defined contribution plan activity in the City's financial statements for the fiscal year ended September 30, 2001. Subsequent to that fiscal year end, AS selected an alternative method for reporting activity of the City's defined contribution plans. That option, which is provided by applicable accounting and reporting standards, allows the City to exclude that activity from the City's financial statements. Under the alternative disclosure, the City will continue to report activity of the City's DEFRA account (one component of the City's defined contribution plan) as

	<p>part of the financial statements. However, significant activity relating to the other components of the defined contribution plan (e.g., overall plan description, number of participants, required contributions) will be disclosed within the notes to the financial statements. AS is consulting with the City's external auditors in regard to this alternative method.</p>
<ul style="list-style-type: none"> The T/C's Office should request remaining account custodians to send their periodic statements directly to Accounting Services. Good internal controls provide that the statements be delivered unopened directly to or accessed directly by the reconciler to avoid tampering by parties executing transactions (i.e., T/C's Office). 	<ul style="list-style-type: none"> ✓ The statements used in the defined contribution and deferred compensation account reconciliations for the quarter ended December 31, 2001, were initially received by the T/C's Office and then given to AS staff. Those statements were received prior to corrective action taken by the T/C's Office. Based on the corrective action taken by the T/C's Office, a separate set of statements was sent directly to AS by the administrator (Prudential) for the quarter ended March 31, 2002. <p>Also, for one non-pension account, the statement was received by the T/C's Office but delivered unopened (sealed envelope) to AS. The account statement was addressed to T/C staff. Notwithstanding the statement was delivered to AS unopened, it would be more appropriate for the statement to be addressed to and received directly by AS. Subsequent to discussions on this matter, T/C staff requested the applicable investment custodian to submit the statements directly to AS.</p> <p>For all other account reconciliations reviewed, the custodians/administrators submitted statements directly to AS based on corrective actions taken by the T/C's Office.</p>
<ul style="list-style-type: none"> AS should establish and distribute to staff written procedures for completing independent reconciliations of the City's investment accounts. 	<ul style="list-style-type: none"> ✓ Comprehensive written procedures for each type of investment account were prepared by AS and distributed to staff that performed the reconciliations.
<ul style="list-style-type: none"> Applicable providers (custodians and/or administrators) should be requested to submit sufficient information and explanations to enable useful and meaningful reconciliations. 	<ul style="list-style-type: none"> ✓ Based on discussions during our audit follow up, AS obtained explanations from applicable custodians/administrators of the information reflected on their statements. A determination was made that the statements were sufficient to allow proper and complete reconciliations. For one administrator, this determination and subsequent review of applicable accounting standards resulted in a change to the methodology in valuing the account balance recorded in the general ledger on an interim basis. Specifically, while this account had been properly valued at year-end for financial statement purposes, the value recorded throughout the remainder of the year within the general ledger was understated by \$400,502.77. The revised methodology will now result in recording of the proper value (market value pursuant to accounting standards) in the general ledger on an on-going basis.

Table Legend:

- Issue addressed (recommendation made) in Assistance and Guidance Report #0211
- ✓ Action taken by Accounting Services or Treasurer-Clerk's Office and issue resolved

New Issues and Current Status

during our follow up work and the status of the efforts by AS and the T/C's Office to resolve those issues.

Table 3 provides a summary of new issues identified

**Table 3
New Issues Identified During Follow Up Fieldwork and Current Status**

New Issues	Current Status
<ul style="list-style-type: none"> • For six non-pension accounts, the T/C's Office obtained a copy of the account statements, through facsimile or through the investment custodians' websites, prior to AS receipt of statements directly from the investment custodians. To facilitate timely completion of the February reconciliations for those six non-pension accounts, AS obtained copies of the statements (not sealed) received by T/C staff and used them to do the reconciliations. However, AS staff did not follow up and verify those statements to the statements subsequently received directly (by AS) from the custodians. (Good internal controls provide that the statements used for independent reconciliations be delivered unopened directly to or accessed directly by the reconciler [i.e., AS] to avoid tampering by parties executing transactions [i.e., T/C's Office].) 	<ul style="list-style-type: none"> ✓ After discussions of this matter, AS indicated that when T/C statements are used to facilitate future reconciliations, they will be verified to the statements subsequently obtained directly (by AS) from the investment custodians. Evidence of those verifications will be included as part of the reconciliation records. We noted that for subsequent months (March and April 2002), AS used account statements received directly from the investment custodians when completing their reconciliations.
<ul style="list-style-type: none"> • For each of three non-pension investment accounts, all monthly transactions were accumulated and recorded on a single end-of-month journal entry by T/C staff. For one of those three accounts, only the net changes in account balances were recorded on the end-of-month journal entry (i.e., individual transactions were not reflected). This practice does not ensure that the City's general ledger is timely updated to reflect investment activity. In addition, for the one account, the general ledger does not provide evidence of specific transactions impacting that account. 	<ul style="list-style-type: none"> ✓ In April 2002, T/C staff started preparing and submitting journal entries for individual transactions (e.g., sales, purchases, deposits, withdrawals, etc.) as they occurred, instead of accumulating transactions and preparing journal entries only at the end of each month.
<ul style="list-style-type: none"> • Journal entries for certain transactions were prepared by T/C staff based on activity reflected on the monthly account statements instead of independent determinations/authorizations by T/C staff. Specifically: <ul style="list-style-type: none"> o For the City's internally managed bond portfolio, journal entries for interest payments were prepared from the account statements. It would more appropriate for T/C staff to prepare journal entries based on their independent determinations of the interest payments using the bonds' par values, interest rates, and payment dates. o For the City's defined benefit plan investment accounts, journal entries for custodian fees were prepared from the monthly statements. It would be more appropriate for T/C staff to prepare journal entries based on T/C letters authorizing the fees to be deducted from the account. <p>Preparing journal entries based on independent determinations and authorizations by T/C staff would allow the account reconciliations by AS staff to detect instances where interest or custodian fees as recorded by the investment custodians are incorrect.</p> 	<ul style="list-style-type: none"> ✓ In April 2002, T/C staff started preparing and submitting journal entries for interest and custodian fees for the applicable accounts based on independent determinations and authorizations.

<ul style="list-style-type: none"> For the reconciliation of the City's DEFRA account maintained at Prudential, one of the reconciling items (\$2,741.02) was not adequately verified. The reconciling item pertained to a correcting entry made by Prudential for an error that occurred in a prior period. That correcting entry reduced the City's asset balance in that account. While AS staff obtained a reasonable explanation for the correcting entry from Prudential, they did not trace to the original entry recorded in error to validate the propriety of the correcting error. 	<ul style="list-style-type: none"> ✓ AS indicated that in future circumstances, any similar entries will be verified back to the original documents (e.g., errors on prior statements) to validate the propriety of the correction or adjustment. Evidence of that validation will be included as part of the reconciliation records.
<ul style="list-style-type: none"> The reconciliation for the City's DEFRA account properly addressed the most critical activity – contributions and payouts to and forfeitures from employees/retirees. However, the reconciliation did not address beginning and ending account balances. That should be done to ensure that Prudential accurately reflects the balance of assets in the City's account. 	<ul style="list-style-type: none"> ✓ After discussions on this matter, AS revised the reconciliation for the quarter ended March 31, 2002, to address beginning and ending account balances.
<ul style="list-style-type: none"> The 13 external managers contracted to manage portions of the City's investments provide periodic statements to T/C staff reflecting investment activity and account balances based on their records. For 11 of these managers, State Street Bank is the custodian of the applicable assets. (Custodians are not used for the other two accounts due to the nature of the assets.) Reconciliations of the activity and balances per the external manager statements to the account statements of the custodian (i.e., State Street Bank) should provide assurance that the custodian is safeguarding and accurately accounting for the related investments. Such reconciliations could be done by either T/C or AS staff. Alternatively, the City could require that the external managers perform those reconciliations and report any unresolved items to the City. We noted that City staff has not been reconciling the external manager statements to the custodian statements. Our review of the contracts with the 11 external managers showed that only two of those managers were expressly required to reconcile their records to the records of the custodian. While the remaining nine external managers may be performing such reconciliations at their own discretion, T/C staff did not routinely obtain assurances that such reconciliations were done. To ensure that the City's account custodian is properly and accurately safeguarding and accounting for City investments, T/C staff should either (1) reconcile the external manager statements to the custodian statements or (2) require each external manager to reconcile their records to the custodian statements and report any unresolved items to the City. 	<ul style="list-style-type: none"> ✓ T/C staff made inquiries of each of the 11 external managers to determine if they reconcile their records to the records of State Street Bank. All 11 managers responded that they do such reconciliations. These external managers will be requested to report any unresolved reconciling items to the City. All subsequent contracts with external managers will contain provisions requiring (1) reconciliations to the custodian's records, (2) the reporting of unresolved reconciling items to the T/C Office, and (3) evidence of such reconciliations to be made available to the City upon appropriate requests.
<ul style="list-style-type: none"> Appropriate controls should exist to ensure that funds withdrawn from custodians (e.g., sale proceeds, earnings, etc.) are placed only in authorized City bank accounts. Such controls should also include provisions that designate the City staff authorized to make such requests. Due to the recent retirements of T/C staff, the T/C's Office should submit written instructions to applicable custodians (1) designating the T/C staff authorized to make withdrawal and other requests and (2) specifying that the funds can only be transferred to the City's official bank account. 	<ul style="list-style-type: none"> ✓ In May 2002, T/C staff issued written instructions to the four applicable custodians/administrators stating that all transfers of City funds pursuant to withdrawal requests must (1) be approved by the named designated staff/officials and (2) be placed in the designated City bank account.

Table Legend:

- New Issue identified during follow up work

- ✓ Appropriate efforts taken and/or planned/initiated to resolve the issue.

Conclusion

As noted above, AS and the T/C's Office have taken corrective actions that address issues identified by the City's external auditors and by the Office of the City Auditor in our Assistance and Guidance Report (#0211). In addition, AS and T/C staff have taken or planned and initiated appropriate corrective actions for additional issues identified during the follow up process.

We would like to acknowledge the importance and priority that AS and the T/C's Office have placed on reviewing and improving internal controls, including proper independent reconciliations of investment account statements. Consistent with this recognition, both offices assisted and proactively participated in identifying additional issues and proposing solutions throughout the follow up process. We appreciate the cooperation and team approach.

Response from Appointed Officials

City Manager Response:

I want to thank the City Auditor's staff for their assistance in improving this process. I believe that Accounting Services, the Treasurer-Clerk's Office, and the City Auditor's Office have worked diligently and cooperatively in these efforts. All recommendations have been completed.

City Treasurer-Clerk Response:

I have reviewed the "Investment Reconciliations" audit, and believe that implementing the audit recommendations will strengthen and improve the reconciliation process. All recommendations have been implemented, and I want to thank the City Auditor's staff for the professional manner in which they conducted the review, and for the insight they brought to the reconciliation process.

Copies of this Audit Follow Up or report #0211 may be obtained from the City Auditor's web site (<http://talgov.com/citytlh/auditing/index.html>), or via request 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 (dooleym@talgov.com).

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