

Investment Management Financial Audit

Report No. 96-05 -- Report Summary

Mac Fletcher, Principal Financial Auditor
Paul Walker, Financial Auditor

TABLE OF CONTENTS

▶ [Introduction and Background](#)

▶ [Objective and Scope](#)

▶ [Summary Statement of Findings](#)

▶ Major Findings:

- ▶ [Finding](#) - The enhancement of some policies and updating of procedures in the Cash Management Section is necessary.
 - ▶ [Finding](#) - The legal basis for the investment management fee charged to pool participants by the County has not been clearly established.
 - ▶ [Finding](#) - Oversight of investments is provided through the Executive Finance Committee.
 - ▶ [Finding](#) - Investment instruments purchased by the County appear to be in accordance with state statutes and further safety is provided through the provisions of investment policies.
 - ▶ [Finding](#) - An additional degree of safety over investments can be achieved through monitoring the securities dealers used by the County.
-

INTRODUCTION AND BACKGROUND

The financial audit of County investment management policies and procedures was authorized by the Metropolitan King County Council in the 1996 Auditor's office work program.

The Cash Management Section within the Treasury Division of the Department of Finance is responsible for management of an investment portfolio which approached \$2.3 billion on December 31, 1995. Of the total investment amount, about \$1.2 billion are investments of various County funds. The remainder, about \$1.1 billion, are funds of approximately 110 special

purpose districts for whom the County, under State law, is required to act as ex-officio treasurer.

The County investment process is primarily governed by RCW Chapter 36.29. The statute defines the duties of county treasurer, including the treasurer's duties to the county's subjurisdictions, and requires that monies not needed for immediate expenditure be invested. The statute also specifies authorized investment instruments and authorizes the pooling of county and other governmental entities' funds for investment purposes.

OBJECTIVE AND SCOPE

The general objective of the audit was to determine whether the County's investment activities achieved adequate levels of safety, liquidity, and profitability in accordance with existing mandates. The audit focused primarily on the investment of County funds. However, the audit reviewed investment performance and statutory compliance of all funds under the County's custody, i.e., both the County's and special purpose districts' idle cash.

SUMMARY STATEMENT OF FINDINGS

The general conclusion of the audit was that the investment management activities provided by the Cash Management Section achieve adequate degrees of safety, liquidity, and profitability for the funds of the County and the special purpose districts, and that the investment program complies with existing mandates. However, the audit did raise concern regarding the lack of a clearly established legal basis for the investment management fee charged to investment pool participants. Additionally, while the audit found the Cash Management Section's investment manual to be generally adequate, it identified some policies and procedures currently utilized by the section that need to be enhanced and/or updated.

MAJOR FINDINGS AND RECOMMENDATIONS

Finding 1. The Cash Management Section has developed adequate investment policies and procedures. However, the enhancement of some policies and updating of procedures is necessary.

The Cash Management Section has developed an investment manual which appears to adequately address key aspects of the investment management process. However, in audit

staff's opinion, some policy provisions in the manual need to be enhanced and/or updated to address recent developments in the investment market and to formalize the investment process currently used by Cash Management Section staff.

First is the section on the investment pool which, as of December 31, 1995, encompassed substantially all County funds and funds of 45 special purpose districts. While the investment manual addresses certain broad criteria, such provisions as requirements for participation by County and special purpose districts have not been developed into written policy. Other specifics, such as the definition of investment balances, interest allocation procedures, and fees charged also need to be developed as formal written policy.

Second, due to the current interest in derivatives, a policy statement which defines and limits allowable derivatives that the County may invest in, if any, and relevant internal control criteria need to be developed.

Third, the audit found that additional services may be provided to the districts. For example, the County may purchase investment instrument(s) held by the district or interest-bearing warrants to allow the district to meet unexpected cash needs. However, the investment manual does not include such formal policy provisions as an interest rate requirement or a limit on such purchases.

Lastly, the audit noted that the investment manual requires a general update to reflect current procedures, such as the PC-based cash management/investment management system, on-line market information system, and investment pool with district participation.

The audit recommended that the Cash Management Section develop and formalize additional investment policies to reflect current developments, including a formal policy on the investment pool, allowable use of derivatives, and a policy on allowable services provided to the County's jurisdictions. *The audit further recommended* that the investment manual be updated to incorporate newly-instituted investment procedures.

Finding 2. While investment pool participants obtained a higher net return than previously earned, the legal basis for the investment management fee charged to pool participants by the County has not been clearly established.

Audit staff found that the County charges 15 basis points (.15%) on the average daily cash balance of each participant's funds in the County's investment pool. The underlying basis of the fee and its applicability to the existing State statute were not found to be clearly established and documented. Investment staff noted, and audit staff concurs, that pooling results in administrative benefits to both the County and pool participants. Moreover, the Cash Management Section contended that the higher fee is justified based on additional services provided, and also, participants earn higher income than previously available net of the fee since

all cash is "swept" into the pool and earns income for the participants' benefit.

Audit staff tested the contention that pool participants earn higher levels of net income. The result of the analysis showed that while the service fee charged the participants was substantially higher, the income distributed to the participants was also significantly higher. Specifically, the sample tested in the audit showed that pooling resulted in net additional income of 6.2% to 46.3% higher than previously available for the funds. However, the relevant State statute stipulates that "... the county treasurer may deduct the amounts necessary to reimburse the treasurer's office for the actual expense the office incurs..."

In 1995, the County collected approximately \$1.22 million in service fees from the pool participants, while the total of all costs for the Cash Management Section was \$730,000 (although it is contended that there are additional "opportunity costs" to the County from lost Current Expense Fund earnings previously available to the County). In the final analysis, however, audit staff found this lack of clarity regarding the new fee in relation to current law could pose potential issues and hinder effective conduct of the pool.

The audit recommended that the Cash Management Section should seek a formal written opinion from the Prosecuting Attorney's Office regarding the appropriateness of the investment pool service fee as it applies to the statutory requirement expressed in RCW 36.29.024.

Finding 3. Oversight of investments is provided through the Executive Finance Committee, thus providing additional administrative control over the investment management function.

The Executive Finance Committee, under a provision in King County Code Chapter 4.10, provides oversight over the Cash Management Section and the investment process through approval of investment policies and review of various reports provided to them. Based on audit staff review, the committee appears to function as intended, thus contributing to the safety of the County's investments.

Finding 4. Investment instruments purchased by the County appear to be in accordance with state statutes and further safety is provided through the provisions of investment policies.

Investment instruments purchased by the County are limited to those allowed under State statutes. Additionally, the County provides further safety of investments through policies implemented, such as collateralization and safekeeping arrangements for securities underlying repurchase agreements, and limiting the purchases of bankers acceptances and commercial paper to the secondary -- open -- market. The audit found that the Cash Management Section purchases authorized investments in accordance with relevant statutes and County policies.

Finding 5. An additional degree of safety over investments can be achieved through monitoring the securities dealers used by the County.

The audit found that the dealer selection policies and procedures, which included a questionnaire on the dealer's profile and submission of the dealer's latest financial report, to be adequate. However, subsequent to selection, the Cash Management Section does not monitor the dealers' financial condition on an ongoing basis. While it is recognized that investments are substantially safeguarded through collateralization and safekeeping of securities, the possibility exists that financial difficulties experienced by a securities dealer could result in delayed access to the County's funds, and potentially, to the loss of funds.

Requiring that the dealers submit audited annual financial statements, and/or the reports submitted to regulatory agencies, and notifying the County of any change in status, such as key personnel and operating condition, would provide an additional degree of safety over the County's investments. Such policies and procedures are recommended by the Government Finance Officers Association.

The audit recommended that the Cash Management Section should monitor the financial and operating conditions of the County's securities dealers, at least annually, through a review of audited financial statements and regulatory reports. *The audit further recommended* that, if deemed feasible, annual evaluation of dealer performance should be conducted.

Updated: 06/24/02