SUBJECT: Audit Report 2007-06 – Corporate Services - Investments (CM07025) (City Wide)

RECOMMENDATION:

(a) That Report CM07025 respecting Audit Report 2007-06, Corporate Services – Investments, be received; and

(b) That the management actions plans as detailed in Appendix “A” of Report CM07025 be approved and the General Manager of Finance and Corporate Services direct the appropriate staff to have the plans implemented.

Ann Pekaruk
Director, Audit Services
City Manager's Office

EXECUTIVE SUMMARY:
The 2007 Internal Audit work plan approved by Council included the audit of the City’s management of investments. The results of the audit are included in a formal audit report containing observations, recommendations and management responses, attached as Appendix “A” of Report CM07025.

BACKGROUND:
The Investments Section of Corporate Services is responsible for investing the assets of the City’s reserve/revenue funds and trust accounts. As of December 31, 2006, the investments of the reserve fund had a book value of approximately $534 million and a market value of over $545 million. Investments of the Hamilton Future Fund, with a book value of $101 million, had a market value of over $103 million. In order to assess the adequacy of controls in the system as well as the effectiveness of various other investment-related tasks (accounting, compliance with policies, third party portfolio manager relationships, reporting, etc.), the audit was recommended for inclusion in the work plan.
BACKGROUND: The audit work commenced in March and was completed in June, 2007. The audit reviewed the processes and procedures relating to initiating, tracking and maintaining the investments of the reserve/revenue funds and Hamilton Fund account and the accounting methods used for purchases, sales, capital gains/losses and interest income. The audit also determined whether current processes/controls in place were sufficient to ensure the completeness, accuracy and legitimacy of the investment activities as well as the safe custody of the assets of the funds. Compliance with relevant legislation and City policies was assessed. Areas for improvement in regard to financial and administrative controls as well as effective and efficient operations were identified.

The Audit and Administration Committee receives and approves final audit reports and reviews as part of its responsibilities for the oversight of governance and control.

ANALYSIS/RATIONALE:

The audit resulted in the issuance of a formal audit report containing observations, recommendations and management responses, attached as Appendix “A” of Report CM07025.

The main areas for improvement noted in the audit report include:

- The review of Finance and Administration procedures annually to ensure they remain current;
- The consideration of an alternate to the antiquated Focus software used to track investment records and generate monthly investment journal entries;
- A review of Finance and Administration staff responsibilities for appropriate resourcing in this area;
- A cost-benefit analysis for the internal preparation of the Treasurer’s report with regard to investments; and
- A review of the investment holdings on a regular basis to ensure proper reconciliation and adequate follow up of any variances.

Management and staff have already taken action or have agreed to take measures in the near future in order to implement all of the five (5) formal recommendations. Specific action plans can be found in the attached audit report.

ALTERNATIVES FOR CONSIDERATION:

Not applicable.
FINANCIAL/STAFFING/LEGAL IMPLICATIONS:

Financial
There may be costs associated with replacing the Focus software application. Minimal cost savings may be realized with the preparation of a Treasurer’s Report being assumed internally.

Staffing
None.

Legal
None.

POLICIES AFFECTING PROPOSAL:
The Statement of Investment Policies and Procedures (SIP&P) provides the investment framework. Recent amendments to sections in the Municipal Act increased municipalities’ investment opportunities so the SIP&P was revised and approved by Council in February, 2007.

RELEVANT CONSULTATION:
The attached report includes management action plans which reflect the responses of staff in the Budgets & Finance Division in the Corporate Services Department responsible for the investment of the City’s reserve/revenue funds and Hamilton Fund account.

CITY STRATEGIC COMMITMENT:
By evaluating the “Triple Bottom Line”, (community, environment, economic implications) we can make choices that create value across all three bottom lines, moving us closer to our vision for a sustainable community, and Provincial interests.

Community Well-Being is enhanced. ☐ Yes ☑ No

Environmental Well-Being is enhanced. ☐ Yes ☑ No

Economic Well-Being is enhanced. ☑ Yes ☐ No

City Council’s strategic commitment to “Best Practices – Best Value” under “A City That Spends Wisely and Invests Strategically” is addressed through audits and reviews and their subsequent follow up to ensure controls are in place to protect the assets of the City and promote efficient, effective and economic services and programs.

Does the option you are recommending create value across all three bottom lines? ☐ Yes ☑ No

Do the options you are recommending make Hamilton a City of choice for high performance public servants? ☑ Yes ☐ No

Attachment
<table>
<thead>
<tr>
<th>#</th>
<th>OBSERVATIONS OF EXISTING SYSTEM</th>
<th>RECOMMENDATION FOR STRENGTHENING SYSTEM</th>
<th>MANAGEMENT ACTION PLAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td><strong>Access Database</strong>&lt;br&gt;The responsibility of investing the assets of the City’s Reserve Fund and the Hamilton Future Fund (Funds) is delegated to the Investments Section of the Corporate Services Department. The custody over the assets of the Funds is outsourced to a third party custodian (Custodian) who provides financial statements and reports as required.&lt;br&gt;The investment details, as determined by the Chief Investment Officer (CIO) or the Senior Investment Fund Manager (SIFM), are entered into an Access database by the Investment Assistant (INA) on a daily basis and two trade tickets are produced. One ticket is sent to the Custodian who then contacts the brokers to complete the transaction. A photocopy of the other trade ticket is forwarded to Finance &amp; Administration (F&amp;A) where the information is entered into Focus, a system used to track the investments and as a basis for journal entries to be posted in the general ledger (GL).&lt;br&gt;The audit observation has identified that the information included in the above two trade tickets is basically identical. Hence, printing out both is not economical.&lt;br&gt;Also, there have been instances in which a few trade tickets went missing during transition or were misplaced. As a result, the investment records in both Focus and GL would be incomplete.&lt;br&gt;In addition, all investment performance reports such as the Investment Compliance Report and Issuer Exposure Report are currently prepared by the Custodian for an extra charge to the City. It has been discovered that some of the reports could be generated from the Access database since all the investment details (such as cost, interest rate, maturity date, rating, etc.) have been keyed in by the INA.&lt;br&gt;At the time of audit, the City’s IT Services Division was working on updating the Access database currently in use by the INA.</td>
<td>That the users’ needs be communicated effectively to the IT Services Division while the functionality of the Access database is under review. For example, the new Access database should enable the investment details entered into it to be exported and sent to the F&amp;A staff electronically so that manual errors could be minimized and duplicate entry is not necessary. A reporting function should be added to accommodate the requests from the CIO. The function of producing redundant printouts should be eliminated.</td>
<td>Agreed. The access database will be ready by June 30, 2007 for the purpose of entering trades. The reporting functionality will be available December 31, 2007. The database will be used to verify transactions against the RBC data, and used for the purpose of generating journal entries.</td>
</tr>
<tr>
<td>#</td>
<td>OBSERVATIONS OF EXISTING SYSTEM</td>
<td>RECOMMENDATION FOR STRENGTHENING SYSTEM</td>
<td>MANAGEMENT ACTION PLAN</td>
</tr>
<tr>
<td>----</td>
<td>--------------------------------</td>
<td>----------------------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>2.</td>
<td><strong>Treasurer’s Report</strong></td>
<td>That a cost-benefit analysis be conducted before deciding on whether to prepare the Treasurer’s report internally. The qualification of the designated internal staff should be evaluated based on the content and requirements of the report.</td>
<td>Agreed. A cost-benefit analysis will be completed by March 2008, before the next Treasurer’s Report is due. If found to be of benefit, an internal procedure will be put into place for April 2008.</td>
</tr>
<tr>
<td></td>
<td>An annual Treasurer’s report with regard to investments is required by the Municipal Act as reflected by the Statement of Investment Policies &amp; Procedures (SIP&amp;P). The report is currently prepared by an external investment consultant, James P. Marshall (JPM) for a fee. The overall objective of the report is to ensure the Funds are managed in accordance with existing legislation and the SIP&amp;P as well as to provide an independent third party review of the Funds’ performance. The most recently revised SIP&amp;P now allows the Treasurer’s report to be produced internally. However, it has not been determined if internal staff have the expertise or appropriate database to produce the report. The independence of the opinion could also be challenged as a result of internal staff involved in the investment processes commenting on their own work.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td><strong>Investment Holdings Review</strong></td>
<td>That the comparison between the SOM and the ADR be performed on a monthly basis by the F&amp;A staff and reviewed by the Business Administrator (BA) to ensure the process has been completed properly. Evidence of review and follow up should be indicated on both the SOM and the ADR.</td>
<td>Agreed. Since more than one employee worked on completing the reconciliations in 2006, inconsistent methods were used. However, the holdings were reconciled. A consistent method has been implemented, effective June 2007, including Business Administrator review and sign-off. Trades are entered into the database by investments. F&amp;A staff are verifying the data from the database to the Custodial Statement of Transactions, effective June 2007.</td>
</tr>
<tr>
<td></td>
<td>At the end of each month, a list of investments, namely Schedule of Maturity (SOM), is printed out from Focus which details the current investment holdings of the Funds as recorded in Focus. To ensure completeness and accuracy of the investment records, the SOM is reviewed against a list of investments (which is called the Asset Detail Report (ADR)) provided by the Custodian. At the time of audit, the review of investment holdings was not performed on a regular basis. It was noted from the audit samples that a few variances between the SOM’s and ADR’s had been identified but were not subsequently followed up. There was no evidence of review by the F&amp;A staff on some of the SOM’s and ADR’s. Further, none of the SOM’s or the ADR’s indicate evidence of a supervisory review. Consequently, there is a risk that the review and the corresponding follow up might not have been done properly or at all. As a result, the effectiveness of the monthly review may be compromised.</td>
<td>If the SOM is not available, an alternative review should be conducted by the F&amp;A staff. For example, the Statement of Transaction (SOT) received from the Custodian can be reviewed against the trade tickets received from the INA to ensure completeness and accuracy. In this case, evidence of review and follow up should be indicated on both the SOT and the trade tickets.</td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td><strong>Finance &amp; Administration Procedures</strong></td>
<td>That F&amp;A procedures be reviewed annually to ensure that they remain current and are appropriately and consistently applied.</td>
<td>Agreed. A process with specific dates and responsibilities for reviewing F&amp;A procedures will be developed for implementation by September 30, 2007.</td>
</tr>
<tr>
<td></td>
<td>F&amp;A staff set up a number of procedures pertaining to investments in 2005 with an intention to review them annually. No such review was done in 2006 and the procedures have not been updated to reflect the change of staff nor changes in some of the procedures followed in the process currently in place. When the procedures are not up to date, confusion can result in inefficiency.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## System Development

F&A staff use Focus to track investment records and to generate monthly investment journal entries to be posted in the GL. This is an antiquated application whose results require some manual adjustments monthly due to the system’s limited functionality. In addition, the amortization of discounts/premiums follows a methodology different from that adopted by the Custodian and widely used in the industry. This results in differences between internal records and the Custodian’s statements which need to be reviewed to ensure these are the only exceptions.

At present, a review for an alternative is being conducted by the City’s IT Services Division. The intent is to replace Focus with an investment sub-ledger built into PeopleSoft enabling the sub-ledger to automatically post the monthly investment journal entries to the GL and to generate reconciliation reports between the Custodian and PeopleSoft balances. Meanwhile, the F&A staff have completed an external Request for Information (RFI) and are planning to proceed with a Request for Proposal (RFP) for replacement to the Focus system.

### Observations of Existing System

<table>
<thead>
<tr>
<th>#</th>
<th>System Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.</td>
<td>F&amp;A staff use Focus to track investment records and to generate monthly investment journal entries to be posted in the GL. This is an antiquated application whose results require some manual adjustments monthly due to the system’s limited functionality. In addition, the amortization of discounts/premiums follows a methodology different from that adopted by the Custodian and widely used in the industry. This results in differences between internal records and the Custodian’s statements which need to be reviewed to ensure these are the only exceptions.</td>
</tr>
</tbody>
</table>

### Recommendation for Strengthening System

That a decision for a new system (either developed in house or purchased externally) be made in the immediate future after the users’ needs are clarified and a cost-benefit analysis is performed. The irresolution of this issue could result in inefficient use of resources.

In either case, the F&A staff should coordinate with the selected party and monitor the progress closely in order to ensure the new system is implemented efficiently and in a timely manner.

### Management Action Plan

Agreed. A decision has been made not to implement a sub-ledger system. Procedures will be developed to ensure the accuracy of the custodial reports by September 30, 2007.
ADDENDUM

The following item was noted during the course of the audit. Although it does not present an internal control deficiency, it is indicated in this Addendum so management is aware of the issue and can address it as necessary.

1. In accordance with the most recent departmental organizational chart provided by the Manager, Finance & Administration (F&A), there is one employee (FA1) designated exclusively to the Investments area. Currently, a review of the Access database and a review aimed at replacing the Focus application are being conducted. Thus, the entries to Focus, monthly posting to the general ledger (GL) and the reconciliation of various investment accounts which represent a considerable portion of the duties originally assigned to this designated staff person have not been carried out at all for the 2007 fiscal year. Once the system review is completed, the current accounting process pertaining to investments will likely change.

   It is recommended:
   That the responsibilities of the designated staff person be reviewed now and after the new process is implemented to ensure an appropriate allocation of staff resources.

   Management Response:
   Agreed. Staff responsibilities are currently under review.