

OFFICE OF AUDITOR-CONTROLLER

File No. 2309

August 5, 1993

NOT FOR BOARD AGENDA

INDEPENDENT AUDITOR'S REPORT

Honorable Board of Supervisors
County of Orange
Santa Ana, California

Honorable Board Members:

We have completed an audit of the Treasurer-Tax Collector, Treasurer Division (Treasurer), for the year ended December 31, 1991. Our audit involved the review of existing operating procedures and accounting practices for the purpose of studying and evaluating the reliability and integrity of financial and operating information; compliance with policies, plans, procedures, laws and regulations; internal control over County assets and resources; and accomplishment of established goals and objectives. Our audit did not include an appraisal of the economy and efficiency with which the Treasurer's resources are employed. Our study and evaluation was made in accordance with professional internal auditing standards and, accordingly, included such auditing procedures as we considered necessary in the circumstances.

Management of the Treasurer is responsible for establishing and maintaining an appropriate internal control structure for its operations. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly.

Because of inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

We noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions. These are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to conduct its operations consistent with management's expectations. These conditions are discussed in the Findings and Recommendations section of this report, along with our suggestions for improvement.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities that would be material in relation to the operating procedures and accounting practices being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our audit, made for the limited purpose described above, would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, item II of the Findings and Recommendations section is believed to be a material weakness.

The absence of complimentary comments in the following recommendations does not mean that such comments could not be made but rather that we have limited our recommendations to those items upon which management may want to take action.

This report was discussed with representatives of the Treasurer on July 13, 1993.

In accordance with County Administrative Procedure No. 0112-03, Section 2, a response to this report must be filed with the Board of Supervisors within 30 days from the report issuance date, with copies provided to the County Administrative Officer and the Auditor-Controller.

We appreciate the cooperation and assistance extended to us by the Treasurer's personnel during our audit.

Respectfully submitted,

Steven E. Lewis
Auditor-Controller

VA:lr

<u>Audit Manager</u>	- E. Law
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FINDINGS AND RECOMMENDATIONS

TREASURER-TAX COLLECTOR

TREASURER DIVISION

REPORT ON AUDIT

YEAR ENDED DECEMBER 31, 1991

FINDINGS AND RECOMMENDATIONS

Introduction

The Treasurer Division (Treasurer) of the Treasury-Tax Collector manages the money of over 185 agencies, including the County, school districts, special districts, and other local government agencies. The Treasurer's goal is to preserve investment capital while obtaining the highest rate of return possible and meeting agencies' cash flow needs.

We believe the following recommendations will assist the Treasurer in administrating investments under its fiduciary responsibility for managing public funds.

We were told that many of our suggestions were being implemented before the issuance of this report.

I. Control Environments

The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of internal controls implemented through specific policies and procedures. Such factors include management's philosophy and operating style, methods of assigning authority and responsibility, and management's control methods for monitoring and following up on work performed. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of internal controls and their emphasis in the entity.

With the exception of item II below, the Treasurer's internal controls and procedures appeared adequate to safeguard assets and to ensure compliance with applicable laws, policies, and regulations. The weaknesses we found seemed to result from the control environment in that management's style and methods for running day-to-day operations reflected inattentiveness to complying with these policies and procedures.

FINDINGS AND RECOMMENDATIONS, CONT'D

For example, the Treasurer was aware of the risk present in wire transfer procedures as discussed in item II below. Immediate actions were not taken to correct the situation because the Treasurer did not consider this to be a significant risk. However, we believe that it is a material weakness in the internal control structure. Also, accounting and clerical functions of the office were often not reviewed with enough attention paid to details, resulting in careless errors that could affect financial decisions going unnoticed.

Additionally, the department head made all day-to-day investment decisions and also executed the transactions without anyone else involved to provide segregation of duties or oversight. An internal investment committee made up of the department head, the assistant department head, and the chief of divisional operations was created to provide input on investment strategy and types of investments that should be considered. This committee functioned in an advisory capacity only. When the department head deviated from investment guidelines established by Government Code or the investment committee, he did so without consulting anyone in the Treasurer's Office or on the committee. The instances of deviation we found during our audit are described in item III below. We were advised that most of these actions were taken to increase yield. However, when they exceed allowable limits established by code or policy, they serve to reinforce the perception of a loose control environment.

Implementing the recommendations that follow in the rest of this report will help to correct specific weaknesses we identified. However, management needs to also reassess the control environment along with the implementation of specific recommendations. This will help reduce the risk, or the perception of risk, that compliance with laws, policies, and regulations may deteriorate to a degree that creates additional material weaknesses.

Considering the trust assigned to the Treasurer for managing public funds, management should have a heightened awareness of appearances in carrying out its duties. Consequently, it should hold itself accountable to high expectations for establishing and complying with internal controls and to enough formality in performing procedures to reasonably demonstrate the fulfillment of the Treasurer's fiduciary responsibility.

We recommend that management reassess its control environment to determine where changes in philosophy, style, and methods for performing the Treasurer's fiduciary responsibility may be appropriate.

FINDINGS AND RECOMMENDATIONS, CONT'D

II. Wire Transfers

We found that controls over wire transfers appeared adequate except for those from Security Pacific National Bank (SPNB). SPNB accepted fax requests to initiate wire transfers to new accounts. Because of the use of fax messages, it appears that falsification of an authorizing signature would not be difficult. As an important internal control, the Treasurer's procedures require daily reconciliations of cash; therefore, a loss should not go undetected for more than one day. However, it appears that the County is at risk for a one-time cash loss as described below.

Wire transfers of \$2.5 million and less are made based on only the fax request without any other verification that the request was properly authorized. For wire transfers of more than \$2.5 million, SPNB is required to verify the request by calling the requester's supervisor. The supervisor may have the opportunity to falsify the authorizing signature, fax the request to SPNB, and confirm the wire transfer request if the amount exceeds \$2.5 million. Therefore, we believe the Treasurer is at a significant risk that an unauthorized transfer could be made.

The Treasurer was aware of the weakness in using faxes for new accounts and, during our fieldwork, began working with SPNB to establish a procedure that would replace the use of faxes in those circumstances. Because SPNB has now merged with Bank of America, the Treasurer may be able to use the computerized, on-line request and approval capabilities that are already established with Bank of America for wire transfers from SPNB. Access to these capabilities is controlled by unique, secret passwords for each user that would help prevent a fraudulent wire transfer.

We recommend that the Treasurer pursue the development of procedures for wire transfers to new accounts that eliminate the use of faxes.

III. Investments

Government Code Sections (GCs) 53601, 53635, 53637, 53638, and 53651 mandate guidelines for investments and depositories that the Treasurer can use for the County's monies. We found that the Treasurer adequately monitored its investments for compliance, however, our testing revealed some violations of the GCs. We were told that the instances were conscious decisions made to maximize returns. These types of management decisions exemplify the effects of the control environment discussed in item I above and could compromise the Treasurer's credibility and the appearance of fulfilling its fiduciary responsibilities.

FINDINGS AND RECOMMENDATIONS, CONT'D

The following summarizes the noncompliance with GCs that we found during testing:

- The Treasurer held \$125 million in Chrysler Corporation medium-term notes that Moody rated Ba1/Baa3 and Standard and Poor rated BB-/BB. GC 53635 requires that medium-term notes be rated A or better.
- The Treasurer invested \$80 million in two-year, medium-term notes issued by GPA Holland, a corporation organized in the Netherlands. Moody rated these notes Baa1, and Standard and Poor did not rate them. According to GC 53635, investments in medium-term notes are permitted only if issued by corporations organized and operating within the United States and only if rated A or better.
- For 10 of 12 months, we found that the percentage of surplus money invested in medium-term notes ranged from 31.50 to 44.63 percent. GC 53635 allows only up to 30 percent of surplus money to be invested in these instruments.
- According to GC 53635, not more than 30 percent of surplus money may be invested in negotiable certificates of deposit. We found that for 3 of 12 months, the Treasurer had invested from 33.72 to 36.75 percent of surplus money in these certificates.

In addition to the above, we noted that the Treasurer invested \$75 million in a negotiable certificate of deposit from Columbia savings and Loan and \$7.5 million in a time deposit from Fidelity Federal Savings and Loan. Ratings for these types of institutions are not specified by GCs. The Treasurer lost no money with either institution, but we found that Fidelity was rated by Thompson Bank Watch as D/Z and that Columbia went bankrupt in 1991. Because of the fiduciary responsibility that the Treasurer has for the County's monies, it should only invest with institutions maintaining high ratings. However, if risks such as these are taken, reasons for the decisions should be documented by the internal investment committee.

During our testing, we also found that \$25 million of medium-term notes were sold on June 28, 1991, and that similar amounts and, types of notes, were purchased on July 2, 1991. We were told that the department head entered into these transactions at the request of the broker, Merrill Lynch, to help the broker meet financial statement ratios required by the Securities and Exchange Commission. We reported a similar finding to the Treasurer in a letter dated December 23, 1991, concerning transactions with Merrill Lynch in late December 1990 and early January 1991. In that letter we recommended that the Treasurer request County Counsel to investigate the possible liability, if any, in which such transactions could result. Also, as this is an unusual transaction, the decision to

FINDINGS AND RECOMMENDATIONS, CONT'D

enter into it should be made by the investment committee, and the reasons for it should be documented.

In our last audit report, dated October 20, 1987, we found that the County's investment strategy was designed and carried out by only the department head. Over the past few years, investment policies have involved more participation from management other than the department head through the formation of the internal investment committee. Also, subsequent to our fieldwork, the Treasurer hired an investment officer who, we were told, is beginning to perform routine investing, such as overnight repurchase agreements. We were also told that the Treasurer plans to gradually train the investment officer in the more complex transactions. This decentralization needs to continue to ensure prudent oversight and safeguards for the County's monies.

We recommend that the Treasurer continue to decentralize investing, establishing a chain of command that helps to promote adequate review of decisions. We also recommend that risky or unusual transactions be prudently entered into with documented decisions made by the investment committee and with advice from County Counsel, if appropriate. We further recommend that the Treasurer comply with government code requirements for investments.

IV. Supervisory Reviews

Our audit of various financial analyses, such as for cash flow projections and for interest apportionment, found careless errors in worksheets that had been reviewed by supervisors. The mistakes were computational and posting errors that should have been easily caught and corrected by these reviews. Although the results of the errors we found were not financially material, lack of adequate supervisory reviews increases the risk that errors affecting financial decisions or mistakes embarrassing to the County could occur and not be detected timely.

We recommend that supervisors adequately review work performed to reasonably ensure its accuracy.

V. Documentation

We found that critical decisions made, information obtained from outside sources, and routine work performed were not always adequately documented. For example, decisions of the investment committee were not documented to record changes to plans, strategies, and policies. Other tasks, such as explaining items on reconciliations and obtaining information over the phone for cash flow forecasting, were not documented consistently. A lack of adequate documentation could result in the failure to carry out operations according to

FINDINGS AND RECOMMENDATIONS, CONT'D

management's policies and/or the inability to verify the accuracy of information used for financial decisions.

We recommend that critical decisions made, information obtained from outside sources, and routine work performed be adequately documented.

VI. Policies and Procedures

The Treasurer documented policies and procedures as an on-going task with a low priority. Although we recognize that management must prioritize work and weigh the cost-benefit of how resources are used, we found errors in the preparation of financial analyses and reconciliations that were attributable to either the lack of written procedures or the incompleteness of procedures that were documented. We also noted that critical policies for ensuring adequate controls over wire transfers and computer system passwords were not yet written. Written policies and procedures help to ensure that operations are performed consistently, correctly, and in accordance with the Treasurer's fiduciary responsibility.

We recommend that the Treasurer review its policies and procedures to determine a timetable and priority order for ensuring all are adequately documented.