

# Internal Audit Department

O R A N G E C O U N T Y  
6<sup>th</sup> Largest County in the USA

## FIRST FOLLOW-UP AUDIT: ANNUAL AUDIT OF TREASURER'S INVESTMENT COMPLIANCE FOR YEAR ENDED 12/31/09

AS OF JANUARY 25, 2012

Our First Follow-Up Audit found the Treasurer fully implemented eleven (11) recommendations, one (1) recommendation was closed because it is no longer applicable, and two (2) recommendations are in process of implementation from our original audit report dated May 12, 2011.

Our original examination disclosed **two (2) Material Non-Compliance Exceptions** and **one (1) Material Weakness in internal control**. The **two (2) Material Non-Compliance Exceptions** dealt with purchasing prohibited investments. The **one (1) Material Weakness** in internal control relates to the adequacy of internal controls to prevent and detect the purchase of prohibited investments. The recommendations for the two (2) Material Non-Compliance Exceptions and the one (1) Material Weakness in internal control have been fully implemented.

AUDIT NO: 1118-B  
(ORIGINAL AUDIT NO. 2953)

REPORT DATE: FEBRUARY 28, 2012

**Director:** Dr. Peter Hughes, MBA, CPA, CIA  
**Deputy Director:** Eli Littner, CPA, CIA  
**Senior Audit Manager:** Alan Marcum, CPA, CIA  
**Audit Manager:** Lisette Free, CPA, CFE

### RISK BASED AUDITING

GAO & IIA Peer Review Compliant – 2001, 2004, 2007, 2010



American Institute of Certified Public Accountants Award to Dr. Peter Hughes as 2010 Outstanding CPA of the Year for Local Government

GRC (Government, Risk & Compliance) Group 2010 Award to IAD as MVP in Risk Management



2009 Association of Certified Fraud Examiners' Hubbard Award to Dr. Peter Hughes for the Most Outstanding Article of the Year – Ethics Pays



2008 Association of Local Government Auditors' Bronze Website Award



2005 Institute of Internal Auditors' Award to IAD for Recognition of Commitment to Professional Excellence, Quality, and Outreach



*GAO & IIA Peer Review Compliant - 2001, 2004, 2007, 2010*

*Providing Facts and Perspectives Countywide*

### **RISK BASED AUDITING**

**Dr. Peter Hughes**

**Director**

**Ph.D., MBA, CPA, CCEP, CITP, CIA, CFE, CFF**

Certified Compliance & Ethics Professional (CCEP)

Certified Information Technology Professional (CITP)

Certified Internal Auditor (CIA)

Certified Fraud Examiner (CFE)

Certified in Financial Forensics (CFF)

E-mail:

[peter.hughes@iad.ocgov.com](mailto:peter.hughes@iad.ocgov.com)

---

**Eli Littner**

Deputy Director

**CPA, CIA, CFE, CFS, CISA**

Certified Fraud Specialist (CFS)

Certified Information Systems Auditor (CISA)

**Michael Goodwin**

Senior Audit Manager

**CPA, CIA**

**Alan Marcum**

Senior Audit Manager

**MBA, CPA, CIA, CFE**

**Autumn McKinney**

Senior Audit Manager

**CPA, CIA, CISA, CGFM**

Certified Government Financial Manager (CGFM)

### **Hall of Finance & Records**

12 Civic Center Plaza, Room 232  
Santa Ana, CA 92701

Phone: (714) 834-5475

Fax: (714) 834-2880

To access and view audit reports or obtain additional information about the OC Internal Audit Department, visit our website: [www.ocgov.com/audit](http://www.ocgov.com/audit)



**OC Fraud Hotline (714) 834-3608**

# Letter from Dr. Peter Hughes, CPA

## Transmittal Letter



**Audit No. 1118-B February 28, 2012**

**TO:** Members, Treasury Oversight Committee

**FROM:** Dr. Peter Hughes, CPA, Director  
Internal Audit Department

**SUBJECT:** First Follow-Up Audit: Annual Audit of  
Treasurer's Investment Compliance for  
Year Ended December 31, 2009,  
Original Audit No. 2953, Issued May 12,  
2011

We have completed a First Follow-Up Audit of Treasurer's Investment Compliance for the year ended December 31, 2009. Our audit was limited to reviewing, as of January 25, 2012, actions taken to implement the **fourteen (14) recommendations** from our original audit. We conducted this First Follow-Up Audit in accordance with the *FY 11-12 Audit Plan and Risk Assessment* approved by the Audit Oversight Committee and Board of Supervisors (BOS).

The results of our First Follow-Up Audit are discussed in the **OC Internal Auditor's Report** following this transmittal letter. Our First Follow-Up Audit found the Treasurer **fully implemented eleven (11) recommendations, one (1) recommendation was closed because it was no longer applicable, and two (2) recommendations are in process of implementation.**

Each month I submit an **Audit Status Report** to the BOS where I detail any material and significant audit findings released in reports during the prior month and the implementation status of audit recommendations as disclosed by our Follow-Up Audits. Accordingly, the results of this audit will be included in a future status report to the BOS.

Other recipients of this report are listed on the **OC Internal Auditor's Report** on page 7.

# Table of Contents



***First Follow-Up Audit: Annual Audit of Treasurer's Investment  
Compliance for Year Ended December 31, 2009  
Audit No. 1118-B***

As of January 25, 2012

|                                     |          |
|-------------------------------------|----------|
| <b>Transmittal Letter</b>           | <b>i</b> |
| <b>OC Internal Auditor's Report</b> |          |
| <b>Scope of Review</b>              | <b>1</b> |
| <b>Background</b>                   | <b>1</b> |
| <b>Results</b>                      | <b>2</b> |

# OC Internal Auditor's Report



Audit No. 1118-B

February 28, 2012

TO: Members, Treasury Oversight Committee

FROM: Dr. Peter Hughes, CPA, Director  
Internal Audit Department

A handwritten signature in blue ink, reading "Peter Hughes", is placed over the printed name and title of the Director of the Internal Audit Department.

SUBJECT: First Follow-Up Audit: Annual Audit of Treasurer's Investment Compliance for  
Year Ended December 31, 2009, Original Audit No. 2953, Issued May 12, 2011

---

## Scope of Review

We have completed a First Follow-Up Audit of Treasurer's Investment Compliance for the Year Ended December 31, 2009. Our audit was limited to reviewing, as of January 25, 2012, actions taken to implement **fourteen (14) recommendations** from our original audit.

## Background

We conducted an examination of the Treasurer's Investment Compliance for year ended December 31, 2009 in accordance with the attestation standards established by the American Institute of Certified Public Accountants. The original audit disclosed two (2) Material Non-Compliance Exceptions and one (1) Material Weakness in internal control. The two (2) Material Non-Compliance Exceptions dealt with purchasing prohibited investments. The one (1) Material Weakness in internal control relates to the adequacy of internal controls to prevent and detect the purchase of prohibited investments.

California Government Code, Sections 27000.1, 27000.3, and 53600.3 grant a county board of supervisors, not a county treasurer, with authority for investing public funds. Thus, under California law, county boards of supervisors generally have primary responsibility for investment of public funds in a county treasury. The authority of the board to invest or reinvest funds deposited in a county treasury may be delegated for a one-year period by the board. Subject to review, such a delegation may be renewed annually (Government Code Section 53607). It is common practice for the board of supervisors for counties in the State to delegate its investment responsibility.

California law requires the Treasurer to prepare an annual investment policy statement. The County's Investment Policy Statement (IPS) is reviewed by the County's Treasury Oversight Committee (TOC) and approved by the Board of Supervisors on an annual basis. The IPS, to the extent consistent with the restrictions of state law, establishes the legal parameters by which the Treasurer, or other qualified party to which investment authority is delegated, may invest monies deposited and held within the County treasury.

Historically, the Board of Supervisors performs an annual review of the Treasurer's performance and has delegated its investment authority to the County Treasurer. The most recent renewal of investment authority was January 10, 2012 for calendar year 2012.

On March 16, 2010, the Board of Supervisors revoked its investment authority from the County Treasurer-Tax Collector, Chriss W. Street, and directed the County Chief Financial Officer to exercise the Board of Supervisors' investment authority.

# OC Internal Auditor's Report



On November 2, 2010, a new County Treasurer-Tax Collector, Shari L. Freidenrich, was elected and on December 14, 2010, the Board of Supervisors delegated the Board's investment authority, effective January 14, 2011, to the new County Treasurer-Tax Collector.

## Results

Our First Follow-Up Audit indicated the Treasurer **implemented eleven (11) recommendations, one (1) recommendation was closed because it is no longer applicable, and two (2) recommendations are in process of implementation.** We believe the remaining two (2) recommendations are still appropriate and efforts should be made to fully implement them. Based on the Follow-Up Audit we conducted, the following is the implementation status of the **fourteen (14) original recommendations:**

**1. Finding No. 1 – Controls Were Not Adequate to Prevent and Detect Overrides and Noncompliance with the IPS for Investment Purchases – Noncompliance with IPS Section XVI – INTERNAL CONTROLS (Material Weakness in Internal Control)**

Recommendation No. 1 – We recommend that the Treasurer-Tax Collector reconfigure the pre-trade parameters in the Bloomberg Investment System to include the requirement to purchase only investments with two current credit ratings and issued by entities organized within the United States.

Current Status: **Implemented.** The Bloomberg Investment system pre-trade compliance parameters were reconfigured on January 6, 2011 to include an additional rule for all purchases of municipal debt requiring approval by either the Chief Portfolio Manager or Accounting/Compliance Manager to purchase local agency debt issued within Orange County where the security purchased has less than two (2) credit ratings. All other purchases of municipal debt are required to meet the credit rating restrictions set forth in the IPS. Any purchases of municipal debt from agencies in Orange County appear as a compliance error; if approved, a memo is prepared by the Accounting/Compliance Manager and approved by the Chief Assistant Treasurer-Tax Collector and is placed with the trade packet showing override of the pre-trade rule as the investment meets IPS guidelines.

In addition, on February 10, 2010, the Treasurer added a pre-trade compliance rule within the Bloomberg Investment System. This rule ensures that all purchases are domiciled within the United States and the rule cannot be overridden.

**2. Finding No. 2 – Treasurer Overrode the IPS and Purchased Debt Securities with Less Than the Required Two Credit Ratings – Noncompliance with IPS Section VII – INVESTMENT RESTRICTIONS (Material Compliance Exception)**

Recommendation No. 2 – We recommend that the Treasurer-Tax Collector ensure that purchases of debt securities have the minimum required rating by at least two Nationally Recognized Statistical Rating Organizations at the time of purchase as required by the Investment Policy Statement. Additionally, the Treasurer-Tax Collector's staff be formally informed that neither management nor the investment officers are to override the Investment Policy Statement.

# OC Internal Auditor's Report



Current Status: **Implemented.** The Bloomberg Investment system pre-trade compliance parameters were reconfigured on January 6, 2011 to include an additional rule for all purchases of municipal debt requiring approval by either the Chief Portfolio Manager or Accounting/Compliance Manager to purchase local agency debt issued within Orange County where the security purchased has less than two (2) credit ratings. All other purchases of municipal debt are required to meet the credit rating restrictions set forth in the IPS. Any purchases of municipal debt from agencies in Orange County appear as a compliance error; if approved, a memo is prepared by the Accounting/Compliance Manager and approved by the Chief Assistant Treasurer-Tax Collector and is placed with the trade packet showing override of the pre-trade rule as the investment meets IPS guidelines.

**3. Finding No. 3 – Treasurer Improperly Purchased Commercial Paper and Medium Term Notes from Prohibited Issuers Organized Outside of the United States – Noncompliance with Government Code Section 53601 and IPS Section VI – AUTHORIZED INVESTMENTS (Material Compliance Exception)**

Recommendation No. 3 – We recommend that the Treasurer-Tax Collector ensure that purchases of commercial paper and medium term notes are only from issuers organized within the United States.

Current Status: **Implemented.** On February 10, 2010, the Treasurer added a pre-trade compliance rule within the Bloomberg Investment System. This rule ensures that all purchases are domiciled within the United States and the rule cannot be overridden.

**4. Finding No. 4 – Treasury Oversight Committee did not Review as Required \$6 Million Administrative and Overhead Fees Charged to Pool Participants – Noncompliance with IPS Section XVI – COMPENSATION AGREEMENT**

Recommendation No. 4 – We recommend that the Treasury Oversight Committee ensure that administrative and overhead fees charged to pool participants are reviewed annually as required by the Investment Policy Statement.

Current Status: **Closed.** A summary of the 2006-2009 annual treasury cost allocation study was included on the Treasury Oversight Committee's (TOC) Agenda for October 26, 2011 as a new business item of "Receive & file 2006-2009 Treasury Administration Fee". The item was reviewed and filed by the TOC as required per the Investment Policy Statement.

The 2010 and 2011 Treasury Administration Fees reviews are in process, but have not yet been completed. However, on January 10 2012, the Board of Supervisors approved the Investment Policy Statement removing the requirement for the TOC to annually review the administrative and overhead fees.

# OC Internal Auditor's Report



## 5. Finding No. 5 – TOC did not Provide a Required Annual Report to the BOS – Noncompliance with Resolution No. 95-946, Establishment of New Treasury Oversight Committee Pursuant to Provisions of SB 866, Clause 6

Recommendation No. 5 – We recommend that the Treasury Oversight Committee ensure that they provide both an oral and written report at least once a year to the Board of Supervisors during open session as required by resolution.

Current Status: **Implemented.** The Treasury Oversight Committee presented the 2007, 2008, 2009, and 2010 annual reports to the Board of Supervisors at their July 26, 2011 regular meeting.

In addition, the Treasury Oversight Committee at their October 26, 2011 regular meeting approved an amendment to their Bylaws by adding the following provision to be aligned with the original 1995 Board Resolution:

Rule 30. In accordance with Resolution 95-946, clause 6, of the County of Orange Board of Supervisors the Committee shall present an oral and written report to this Board during open session no less frequently than annually. In all instances, the Committee shall be required to immediately report to this Board any substantial concern relative to the Treasurer's compliance with applicable law, County policy or treasury policy, if such shall come to the attention of the Committee.

On January 10, 2012, the Board of Supervisors approved the revised Bylaws. The Annual TOC Report for 2011 was approved as amended at the regular meeting of the TOC on January 25, 2012.

## 6. Finding No. 6 – Policies and Procedures were not Documented for the Treasury Oversight Committee's Required Investigation of Alleged Irregularities in the Treasury Operation

Recommendation No. 6 – We recommend that the Treasury Oversight Committee develop and document policies and procedures to fulfill their responsibilities for investigating and reporting upon any and all irregularities in the treasury operation which become known to the Committee as required by the Board of Supervisors' Resolution No. 95-946.

Current Status: **Implemented.** The Treasury Oversight Committee at their regular meeting of October 26, 2011 approved a formal policy for investigating and reporting upon any and all irregularities in the treasury operation which become known to the Committee.

Furthermore, the Treasury Oversight Committee at their October 26, 2011 regular meeting approved an amendment to their Bylaws by adding the following provision to be aligned with the original 1995 Board Resolution:

Rule 31. In accordance with Resolution 95-946, clause 4(c), of the County of Orange Board of Supervisors the Committee shall investigate any and all irregularities in the treasury operation which become known to the Committee. The Committee will develop and document policy and procedures to investigate and report such irregularities.

# OC Internal Auditor's Report



On January 10, 2012, the Board of Supervisors approved the revised Bylaws.

## **7. Finding No. 7 – Investment Policy Statement does not Clearly Define “Organized and Operating in the United States”**

Recommendation No. 7 – We recommend that the Treasurer-Tax Collector review the Investment Policy Statement Section VI – AUTHORIZED INVESTMENTS to determine if the phrase “organized and operating in the United States” needs to be clarified.

Current Status: **Implemented.** The Treasurer-Tax Collector reviewed the referenced IPS section and determined the phrase “organized and operating in the United States” does not need further clarification as it is directly out of California Government Code 53601. We verified that “organized and operating in the United States” was a direct quote from the California Government Code.

## **8. Finding No. 8 – Treasurer Does Not Use a Commonly Accepted Municipal Benchmark for the County’s Portfolio – Government Code Section 27134**

Recommendation No. 8 – We recommend that the Treasurer-Tax Collector reevaluate the investment portfolio’s performance standards and consider the appropriateness of benchmarking an index consisting of U.S. Treasury notes and bonds as recommended by the California Debt and Investment Advisory Committee and revise the Investment Policy Statement as appropriate for review by the Treasury Oversight Committee and approval by the Board of Supervisors.

Current Status: **In Process.** The Treasurer-Tax Collector has hired a consultant, PFM, to review the County’s portfolio and provide input on overall investment strategy.

### **Planned Action:**

Until the Treasurer-Tax Collector considers PFM’s recommendations, no action will be taken on changing the benchmark.

## **9. Finding No. 9 – One Designated Employee did not File the Required Statement of Economic Interests Disclosure – Noncompliance with IPS Section X – ETHICS AND CONFLICT OF INTEREST**

Recommendation No. 9 – We recommend that the Treasurer-Tax Collector have the Accounting and Compliance Manager complete and submit a State of California Form 700 – Statement of Economic Interests Disclosure to the Clerk of the Board of Supervisors.

Current Status: **Implemented.** On December 30, 2010, the Accounting/Compliance Manager filed late copies of her Form 700 for calendar years 2008 and 2009 which was received and stamped by the Clerk of the Board.



## **10. Finding No. 10 – Continuous Review of Qualified Institutions was not Completed and Approved – IPS Section XI – AUTHORIZED FINANCIAL DEALERS AND QUALIFIED INSTITUTIONS**

Recommendation No. 10 – We recommend that the Treasurer-Tax Collector: (a) improve policy and procedures to be followed in reviewing and reporting political contributions from qualified institutions; (b) ensure that qualified and systematic supervisory review is provided and documented to the integrity of the review of qualified institutions; and (c) ensure that the review of qualified institutions is complete.

Current Status: **Implemented.** The written policy for the Broker Dealer Annual Review has been modified to include supervisory review and approval by the Chief Assistant Treasurer-Tax Collector. The broker dealer annual review for the year ended December 31, 2010 was completed and reviewed by the Chief Assistant Treasurer-Tax Collector.

## **11. Finding No. 11 – Documentation was not on File to Support Nomination of the Representative for Special Districts - Government Code Section 27132**

Recommendation No. 11 – We recommend that the Treasury Oversight Committee consult with County Counsel regarding the appointment of the representative of the special districts and to clarify what documentation is necessary to support the candidate selection by the presiding officers of the legislative bodies of the special districts.

Current Status: **Implemented.** The Committee eliminated this provision of the Bylaws in their January 27, 2010 regular meeting and the revised Bylaws were approved by the Board of Supervisors on April 19, 2011.

## **12. Finding No. 12 – Expiration of TOC Public Member's Term – Noncompliance with Bylaws and Rules of Procedures of the County of Orange Treasury Oversight Committee Section III – Chair and Vice Chair Powers and Duties, Rule 9**

Recommendation No. 12 – We recommend that the Treasurer-Tax Collector develop a process to timely identify and nominate qualified candidates subject to term limits for the Board of Supervisors' confirmation as required by Rule 9 in the County of Orange Treasury Oversight Committee Bylaws and Rules of Procedure.

Current Status: **In Process.** The Treasurer-Tax Collector is in the process of drafting the policies and procedures for the Treasury Oversight Committee. It is expected that a process will be developed and implemented by June 2012. The Treasurer-Tax Collector has hired a consultant, PFM, to perform a follow-up review of the TOC's bylaws.

### **Planned Action:**

Once the Treasurer-Tax Collector has received PFM's input on the TOC bylaws, a process will be developed.

# OC Internal Auditor's Report



## **13. Finding No. 13 – One TOC Member Use of a Designee – Noncompliance with Bylaws and Rules of Procedures of the County of Orange Treasury Oversight Committee, Rule 6**

Recommendation No. 13 – We recommend that the Treasury Oversight Committee discuss the use of designees at the meetings and whether the Bylaws and Rules of Procedures of the County of Orange Treasury Oversight Committee should be amended to allow for additional designee(s). If the Bylaws and Rules of Procedure are amended, the proposed procedures should be approved by the Board of Supervisors.

Current Status: **Implemented.** The Committee added this provision of designees into the Bylaws at their January 26, 2011 regular meeting and the Board of Supervisors approved the revised Bylaws at their April 19, 2011 regular meeting.

## **14. Finding No. 14 – The Treasurer-Tax Collector Agenda Lacked Clarity and the Treasury Oversight Committee Meeting Minutes Did Not Provide Adequate Detail Regarding the Discussion of Investment Types Not Specifically Authorized by the IPS**

Recommendation No. 14 – We recommend that the Treasurer-Tax Collector prepare meeting agendas and minutes for the Treasury Oversight Committee that include an adequate description of actions to be taken and whether approval or rejection was conferred.

Current Status: **Implemented.** The Treasurer-Tax Collector now prepares the Treasury Oversight Committee's meeting agendas and minutes with complete descriptions of actions being requested, actions taken, and whether they passed or were rejected.

We appreciate the assistance extended to us by the Treasurer during our Follow-Up Audit. If you have any questions, please contact me directly or Eli Littner, Deputy Director at 834-5899, or Alan Marcum, Senior Audit Manager at 834-4119.

### **Members, Treasury Oversight Committee Distribution List:**

Hon. William Habermehl, County Superintendent, OC Department of Education  
Shaun Skelly, Chief Deputy Auditor-Controller  
Thomas G. Mauk, County Executive Officer  
George Jeffries, Public Member  
William "Andy" Dunn, Public Member

### **Distribution Pursuant to Audit Oversight Committee Procedure No. 1:**

Members, Board of Supervisors  
Members, Audit Oversight Committee  
Thomas G. Mauk, County Executive Officer  
Robert J. Franz, Deputy CEO/Chief Financial Officer  
Shari L. Freidenrich, Treasurer-Tax Collector  
Paul C. Gorman, Chief Assistant Treasurer-Tax Collector  
Foreperson, Grand Jury  
Susan Novak, Clerk of the Board of Supervisors