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OFFICE OF THE CITY AUDITOR Audit Report

SYSTEM EVALUATION: INVESTMENTS

October 2007



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CITY OF STOCKTON

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October 12, 2007

Stockton City Council

AUDIT SUMMARY - SYSTEM EVALUATION: INVESTMENTS

In accordance with our 2006-2007 audit plan, we have completed our audit of the processes to manage City investments.

Our audit objectives were to determine whether management of the City's investment portfolio was in compliance with applicable statutes, and City policies and procedures. In addition, we assessed the adequacy of internal controls.

Based on the results of our work, we conclude that the City's investment portfolio is being managed in compliance with applicable statutes and the City's Investment Policy. Internal controls are adequately designed and functioning as intended. We did observe that improvements in cash flow projection procedures could have a positive impact on investment results. Taking corrective action on the condition will place the City in a better position to make investment management decisions.

Additional information is presented in the Audit Report.

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SYSTEM EVALUATION: INVESTMENTS

In accordance with our 2006-2007 audit plan, we have completed an audit of the processes to manage City investments.

BACKGROUND

As of June 30, 2007, the City maintains an investment portfolio valued at more than \$280 million. The California Government Code (Code) provides guidance in an effort to safeguard public funds entrusted to local governments. The Code limits the types of investments that a local government entity can hold, and describes the prudent investor standards as: the investment manager's objectives are to safeguard the principal, meet the liquidity needs of the entity, and to achieve a return on the funds under its control.

In addition to compliance with the Code, the City maintains an Investment Policy, which is reviewed and approved by City Council on an annual basis. The Investment Policy incorporates the Code and City rules and regulations in describing how the City's portfolio is to be managed.

Historically, a staff person in the Administrative Services Department was designated as the City's Investment Officer, performing the function on a part time basis. The Investment Officer was authorized to make investment decisions and negotiate investment security transactions that best met the needs and obligations of the City. With the retirement of the Investment Officer, alternate approaches to managing the portfolio were investigated. This retirement highlights the need to ensure stability of portfolio management by providing appropriate resources in investment management.

The City Council concluded that contracting out a portion of the investment management function was the preferred alternative to ensure that adequate resources were in place. In July 2007, the City contracted with an outside firm to provide investment consultant services.

Regardless of who is managing the City's investments, accurate cash flow information from departments is critical to making efficient investment decisions. Administrative Services gathers cash flow information from City departments and trend analysis from previous year's data to project when cash inflows and outflows may occur. Use of this information allows investment managers to time investment maturities to correspond with payment of City obligations. Knowledge of when cash inflows and outflows will occur also allow investment managers to structure the portfolio to achieve optimal returns while maintaining compliance with the City's Investment Policy

OBJECTIVES AND SCOPE

The objectives of our audit were to determine whether management of the City's investment portfolio was in compliance with applicable statutes, and City policies and procedures. In addition, we assessed the adequacy of internal controls.

The scope of our audit focused on the City's investment process during the period July 1, 2006 through March 31, 2007. We reviewed policies and procedures, and selected investment portfolio transactions made during this period.

During the course of the audit, we were aware that the City would be transitioning from an internally managed investment portfolio to contracting with an outside service provider. We worked to determine whether existing investment policies and procedures were adequate to address this structural change.

METHODOLOGY

To gain an understanding of the investment management process, we reviewed applicable California Government Codes, and the City's investment policies and procedures. We interviewed City staff, observed daily operations, and obtained supporting documentation related to selected transactions.

We reviewed a sample of transactions conducted during the period July 1, 2006 through March 31, 2007 to assess compliance with applicable statutes and policy, and assess the adequacy of internal controls.

We made inquiries of City staff regarding the process for establishing cash flow projections to gain an understanding of how information was gathered, what documents were produced, and whether the information was sufficient to manage the portfolio in an optimal manner.

To gain an understanding of how other jurisdictions address the use of outside investment consultants, we conducted a survey of other local government entities.

Where issues were observed, we communicated them to City management with our recommendations for improvement. We also provided management with a list of suggestions for system improvements. Management suggestions are opportunities to make system improvements. Unlike reportable findings, management is not asked to submit corrective action plans related to suggestions, and formal audit follow-up is not performed. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards.

RESULTS

Based on the results of our work, we conclude that the City's investment portfolio is being managed in compliance with applicable statutes and the City's Investment Policy. Internal controls are adequately designed and functioning as intended. We did however; note a condition where the investment process needs improvement. Taking corrective action on the following condition will place the City in a better position to make investment management decisions.

FINDING: DEVELOPMENT OF CASH FLOW INFORMATION

While the Administrative Services Department makes a concerted effort to anticipate and develop cash flow projections, the City lacks formal written policies and procedures regarding how information used in cash flows projections should be gathered and developed. The lack of clear guidance and assignment of responsibilities for the gathering of information and development of projections has resulted in Administrative Services not getting all of the available information from City departments. Incomplete cash flow information limits the City's ability to make optimal investment decisions.

MANAGEMENT ACTION PLAN:

The City Manager's office will take the following steps to support the development and maintenance of a reliable cash flow forecast.

1. Hold a discussion at the Executive Team Meetings at least once per month that covers the major expected inflows and outflows on the horizon.
2. Require that all departments participate in development of a sustainable cash flow model based on the adopted budget, funding sources, and cyclical needs. Projections requested by Administrative Services are for the purpose of identifying short and long-term cash needs that will in turn be used to optimize investment of the City's available funds.
3. Require that all departments meet quarterly with the Administrative Services Department to review their projections and update as required.

Target Date for Corrective Action: June 30, 2008

CITY AUDITOR MISSION STATEMENT

The Office of the City Auditor independently promotes ethical, efficient and effective governance for the citizens of Stockton. We provide the City Council, management, and employees with objective analyses, appraisals, and recommendations for improvements to City systems and activities. The department maintains independence and objectivity by reporting directly to the City Council and by not exercising direct authority over any department, system, or activity subject to audit.

