
Secretary of State

State of Oregon

OREGON STATE TREASURY

Administrative Accounts

January 1, 1995 to June 30, 1996



Audits Division

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Auditing for a Better Oregon

The Honorable John Kitzhaber
Governor of Oregon
State Capitol Building
Salem, Oregon 97310

The Honorable Jim Hill
State Treasurer
159 State Capitol
Salem, Oregon 97310

This report encompasses a review of administrative accounts of the Oregon State Treasury for the period January 1, 1995, to June 30, 1996.

The objectives of our audit were to 1) evaluate the Treasury's internal controls over selected financial activities, including charges for services, disbursements, and fixed assets; 2) evaluate the Treasury's compliance with state laws, rules, and regulations material to the administrative accounts; and 3) follow up on significant findings and recommendations included in the previous report on the Treasury for the period of January 1, 1994, to December 31, 1994.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. In this regard, we interviewed Treasury personnel, observed procedures, and examined documents related to our audit objectives. We limited our audit to the tests and procedures we considered necessary in the circumstances.

OREGON AUDITS DIVISION

John N. Lattimer
Director

Fieldwork completion date:
September 30, 1996

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SUMMARY

The Oregon State Treasury (Treasury) is the custodian of most of the state's cash and investments. The treasurer receives and disburses state funds, deposits state money with banks, and invests money not immediately needed for state expenditure. With an operating budget of \$16.7 million for the 1995-97 biennium, Treasury's primary funding sources are fees based on investment balances and charges for services performed.

This audit evaluated the Treasury's internal controls over selected financial activities, including charges for services, disbursements, and fixed assets. In addition, we reviewed Treasury's compliance with selected laws and regulations, and followed up on the recommendations contained in the previous Treasury audit.

During our audit, we noted that Treasury could improve accounting and internal control for its fixed assets. In particular, Treasury needs to take annual physical inventories and improve accounting for computer software.

We also reviewed the status of recommendations made in our 1994 administrative accounts audit and determined that our recommendations for two findings were fully implemented. Treasury:

- Has established procedures to review limited partnership investment fees.
- Is providing information on earnings and brokerage-related services from soft dollar arrangements to the Oregon Public Employees Retirement System (PERS).

Treasury and the Oregon Investment Council have partially implemented the recommendations concerning derivative financial instruments, but Treasury has not established a system or procedure to accumulate consolidated information on the types and amounts of derivative holdings to facilitate preparation of financial statement disclosures.

INTRODUCTION

ORGANIZATION AND FUNCTIONS

The Office of State Treasurer was established in Article VI of the Oregon Constitution. The Treasurer is the state's banker and investment officer. In this regard, the Treasurer receives and disburses state funds, deposits state money with banks, and invests money not immediately needed for state expenditure. In addition, the Treasurer coordinates and approves the issuance of all state bonds.

The Treasurer is also a member of the Oregon Investment Council, which establishes and reviews Oregon's investment policies and hires the state's outside investment managers. In addition to the State Treasurer, the council includes four members appointed by the Governor, subject to Senate confirmation.

Oregon State Treasury staff carries out the responsibilities of the State Treasurer. The State Treasurer serves as the chief executive officer and appoints a deputy to assist in overseeing Treasury operations. The Treasury is organized into four operating divisions and one support unit, all of which report to the Deputy State Treasurer.

Investment Division

This division is responsible for the productive and prudent investment of state and local government funds placed with the Treasury. The division also provides staff support for the Oregon Investment Council.

The division invests funds for the Oregon Public Employees Retirement System (PERS), the State Accident Insurance Fund (SAIF), and other state trust funds and constitutional bond funds. In addition, it invests excess state and local government moneys in a short-term investment fund. The market value of all funds invested by Treasury was approximately \$32 billion on June 30, 1996.

Finance Division

This division provides banking and cash management services for all state agencies. The division also accounts

for all Treasury investments and financial activities, manages collateral pools securing public funds deposited in banks, redeems state general obligation bonds, and administers the Local Government Investment Pool.

Debt Management Division

This division coordinates and approves the issuance of all state agency bonds. The division also provides information and assistance to local governments in the issuance of bonds. The division provides staff support to the Municipal Debt Advisory Commission and the Private Activity Bond Committee.

Information Systems Division

In addition to developing and maintaining Treasury's automated information and telecommunications systems, this division operates and maintains Treasury's information management center and information networks.

Employee Services

This unit administers the Treasury's personnel and training functions, as well as being responsible for various support services including purchasing, facilities management, and mail.

Treasury also has an internal auditor, who organizationally reports directly to the state treasurer.

FINANCIAL ACTIVITIES

The Oregon State Treasury functions as a self-sustaining business operation and accounts for its financial activities in a proprietary fund. Treasury's revenues come primarily from fees assessed on investment balances and charges for services. The 1995-1997 biennium operating budget for Treasury placed a limitation of approximately \$14.4 million on expenditures of "other funds" which are comprised of these charges and fees. However, the budget exempted certain cash management and investment services

expenditures estimated at \$2.3 million from the limitation.
The approved budget is summarized below:

	Other Funds Expenditure <u>Limitation</u>	Expenditures Not Subject <u>To</u> <u>Limitation</u>	<u>Totals</u>
Personal Services	\$8,435,183	\$ 0	\$8,435,183
Services and Supplies	4,513,954	2,300,000	6,813,954
Capital Outlay	<u>1,493,000</u>	<u>0</u>	<u>1,493,000</u>
Totals	<u>\$14,442,137</u>	<u>\$2,300,000</u>	<u>\$16,742,137</u>
Percentage of Total:	86.3%	13.7%	100.0%

During the fiscal year ending June 30, 1996, Treasury's revenues totaled approximately \$9.6 million, while expenditures were approximately \$6.9 million. Approximately \$5.8 million of these expenditures were charged to Treasury's other funds expenditure limitation, and the remaining \$1.1 million expenditures were not subject to the limitation.

Cash and investments held by Treasury for state agencies and local governments had a book value of approximately \$20 billion at June 30, 1996. For most of the investments, book value reflects cost. Stated at market value, the cash and investments totaled approximately \$32 billion.

SCOPE AND METHODOLOGY

The audit encompassed a review of selected financial activities of the Oregon State Treasury for the period of January 1, 1995, to June 30, 1996. Our objectives were to:

- Evaluate the Treasury's internal controls over selected financial activities and processes, including charges for services, disbursements, and fixed assets.

- Evaluate the Treasury's compliance with state laws, rules, and regulations material to the administrative accounts.
- Follow up on significant findings and recommendations included in the previous report on the Treasury for the period of January 1, 1994, to December 31, 1994.

In this regard, we interviewed Treasury personnel, observed procedures, examined supporting documentation, reviewed authoritative literature, and tested accounts.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Our review was limited to the areas specified in this section of the report.

AUDIT RESULTS

FINDINGS AND RECOMMENDATIONS

Fixed Assets

As of June 30, 1996, Treasury owned fixed assets with an original cost of approximately \$1.6 million, including significant computer equipment and leasehold improvements. Controls could be improved as follows:

- Treasury has not regularly completed required annual physical inventories of fixed assets. The agency took complete inventories in fiscal years 1993 and 1996. In fiscal year 1994, no inventory was taken. In fiscal year 1995, a spot check was taken, rather than a complete inventory.

Treasury's Administrative/Employee Services Manual requires it to arrange for a temporary independent employee to conduct a complete physical inventory of all fixed assets each June 1 to verify their existence and location. If an asset cannot be located, Treasury's internal auditor is to be notified. The internal auditor then investigates to determine the status of unlocated assets and decides whether write-off of the assets is warranted.

Physical inventories reduce the risk that fixed asset records will be incomplete or inaccurate by identifying unrecorded losses, dispositions, and relocation of fixed assets. Regular inventories also act as a deterrent against theft and misuse of state property.

- The fixed-asset records relating to software were incomplete. Specifically, we could not locate copies of certain software packages as described on Treasury's fixed asset ledger. The incomplete records limit Treasury's ability to manage and control software assets.

One way to help control software would be to maintain a separate ledger with a description of each software package, locations of installed software and software copies, dates of installation or purchase, and the assigned fixed asset number. The records should include the vendor's name and the voucher number, date, and cost for each purchase.

This software ledger should serve as a subsidiary to the complete fixed asset ledger and would include all software having a cost exceeding the state's capitalization threshold of \$5,000. Software having a cost of less than \$5,000 could also be included in the ledger for purposes of monitoring and control.

On June 30, 1996, software on Treasury's fixed asset records was valued at \$210,000, representing approximately 13 percent of the total value of fixed assets.

We recommend that Treasury:

- Annually complete a physical inventory of fixed assets and retain a record to document inventory results.
- Develop and maintain a ledger of capitalized software.

AGENCY RESPONSE:

The net book value of our fixed assets at June 30, 1996 was \$293,000, on a cost basis of approximately \$1.6 million. Most of Treasury's assets were fully depreciated as of June 30, 1996. In fact, at June 30, 1996, only 18 assets had a net book value greater than zero. The \$210,000 of capitalized software mentioned in your comment was fully depreciated, with a net book value of zero at June 30, 1996.

We agree that regular inventories act as a deterrent against theft and misuse of state property. Accordingly, we will complete a physical inventory of our fixed assets annually and will retain the related documentation. We have just completed our physical inventory of fixed assets for 1997.

Currently, all our PC computer hardware is maintained on a separate database independent of the general fixed asset system housed on the WANG. A separate database affords us the ability to include more detailed information such as: location, serial number, model, manufacturer, memory, etc. We use this database as our subsidiary ledger and control document since PC hardware is generally most susceptible to theft. Likewise, we currently maintain a ledger of software independent of the WANG fixed asset report since it only captures software with an original cost greater than \$5,000. As mentioned above, the \$210,000 in capitalized software is fully depreciated with the majority of the software purchased over five years ago. As we migrate to a client/server environment, we will continue to monitor our software and the related licenses and enhance our tracking of software.

**FOLLOW UP ON
PRIOR AUDIT FINDINGS**

This section briefly summarizes the status of findings presented in the audit comments section of our report on Treasury for the period January 1, 1994, to December 31, 1994.

Prior Audit Findings	Disposition
<p>1. <i>Treasury did not obtain detail information showing how \$8.2 million in limited partnership investment fees were calculated.</i></p> <p>We recommended:</p> <ul style="list-style-type: none"> • Treasury require a detailed statement of fee calculations to be submitted for approval before any fees are paid with state investment funds. • Treasury implement a review process to ensure fees are not deducted from investment earnings without explicit approval. 	<p>Resolved. Treasury now requires all general partners to send fee billings or fee assessment worksheets to an investment consulting firm. The firm maintains the fee structure for each limited partnership on its computer system. Each quarter, the firm independently calculates the fees and compares the results to the general partner billings or worksheets. The results of the comparison analysis are provided to Treasury. Any exceptions found by the consulting firm are followed up by Treasury.</p>
<p>2. <i>With respect to brokerage transactions, Treasury keeps records of (a) brokerage commissions paid, (b) amounts earned through soft dollar arrangements with brokerage firms, and (c) brokerage-related services provided using amounts earned from soft dollar arrangements. However, information provided by Treasury to the Oregon Public Employees Retirement System (PERS), for use in financial reporting, was limited to the amount of brokerage commissions paid.</i></p> <p>We recommended the information Treasury provides to PERS also include information on amounts earned through soft dollar arrangements with brokerage firms, and brokerage-related services provided using amounts earned from soft dollar arrangements.</p>	<p>Resolved. In fiscal 1996, Treasury provided this information to PERS.</p>

Prior Audit Findings	Disposition
<p>3. <i>Except for a brief clause in the investment managers' contracts, the Oregon Investment Council and the Oregon State Treasury do not have policies for derivative financial instruments (derivatives). In addition, Treasury systems do not consolidate information on derivative holdings for financial reporting and assessment of derivative risks.</i></p> <p>We recommended the Oregon Investment Council:</p> <ul style="list-style-type: none"> • Supplement its investment policies to clarify the use of derivatives. • Explicitly communicate the derivatives policy through agreements with each investment manager. • In developing a derivatives policy, consider listing derivative types permitted, restricted, or prohibited. <p>We also recommended that Treasury accumulate consolidated information on the types and amounts of derivative holdings to facilitate preparation of required financial statement disclosures.</p>	<p>Partially Resolved. The Oregon Investment Council (Council) has not adopted a formal policy concerning the use of derivatives. However, the council's standard contract for equity investment managers includes language prohibiting the use of derivatives without their prior approval. Some external equity managers have received approval from the council to use certain derivatives.</p> <p>No restrictions on derivatives have been established for the internal managers employed by Treasury to make investments for the Oregon Fixed Income Fund and the Oregon Short-Term Fund. The fixed income portfolio currently includes two types of financial instruments, mortgage-backed securities and collateralized mortgage obligations, included in the definition of derivatives used for financial reporting by the state of Oregon.</p> <p>Treasury has not established a system or procedure to routinely accumulate information needed for disclosures in the financial statements of the state of Oregon, or other state entities.</p> <p>We recommend Treasury and the Oregon Investment Council continue their efforts to improve accounting and control for derivatives.</p>

REPORT DISTRIBUTION

This report is a public record and is intended for the information of the Oregon State Treasury management, the governor of the state of Oregon, the Oregon Legislative Assembly, and all other interested parties.

COMMENDATION

The courtesies and cooperation extended by the officials and employees of the Oregon State Treasury during the course of our audit were commendable and sincerely appreciated.

AUDIT TEAM

Stephanie Schutzler, CPA, Audit Administrator
Andy Bromeland, CPA
Brooks Hogle, CPA
Janice Richards