

**REPORT  
ON ANNUAL AUDIT OF  
TREASURY INVESTMENT COMPLIANCE  
FOR THE  
YEAR ENDED DECEMBER 31, 2000**

**Issued: April 18, 2002**

**Audit Number 2107**

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**COUNTY OF ORANGE  
INTERNAL AUDIT DEPARTMENT**

**REPORT  
ON ANNUAL AUDIT OF  
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FOR THE  
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## **INTERNAL AUDIT DEPARTMENT**

File No. 2107

April 18, 2002

County of Orange  
Treasury Oversight Committee  
12 Civic Center Plaza, Room G-76  
Santa Ana, CA 92701-4521

### INTERNAL AUDITOR'S REPORT

We have examined the Treasury management's assertions in the accompanying Summary of Investment Compliance Requirements which was included in the representation letter dated December 28, 2001, that Orange County Treasurer complied with California Government Code Sections 27130 through 27137 and related provisions of the Orange County Treasurer Investment Policy Statement for the Money Market and the Extended Funds during the year ended December 31, 2000. Treasury management is responsible for compliance with those requirements. Our responsibility is to express an opinion on Treasury management's assertions about Orange County Treasurer's compliance based on our examination.

Our examination was made in accordance with the attestation standards established by the American Institute of Certified Public Accountants, and accordingly included examining on a test basis evidence about the County Treasury's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on the County Treasury's compliance with specified requirements.

As described in the accompanying schedule of Findings, Recommendations and Responses, Orange County Treasurer did not comply with some of the requirements regarding authorized investments, compensation agreement and voluntary participants that are applicable to its Investment Policy Statement for the Money Market and the Extended Funds.

In our opinion, except for the noncompliance described in the preceding paragraph, management's assertions that Orange County Treasurer complied with the aforementioned requirements during the year ended December 31, 2000, are fairly stated, in all material respects.

*County of Orange  
Treasury Oversight Committee  
April 18, 2002*

This report is intended solely for the information and use of the County Treasury Oversight Committee and is not intended to be and should not be used by anyone other than the party specified. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

Dr. Peter Hughes, CPA  
Director, Internal Audit

Other recipients of this audit report:

Members, Board of Supervisors  
Members, Audit Oversight Committee  
Michael Schumacher, Ph.D., County Executive Officer  
Foreman, Grand Jury  
John M.W. Moorlach, Treasurer-Tax Collector  
Richard G. Hilde, Assistant Treasurer  
Paul Gorman, Treasurer Accounting/Compliance Manager  
Darlene Bloom, Clerk of the Board

**COUNTY OF ORANGE**

**SUMMARY OF INVESTMENT COMPLIANCE REQUIREMENTS**

**SCHEDULE I**

**For Year-Ended 12/31/00**

The investment compliance requirements presented in the California Government Code Sections 27130 through 27137 and related provisions of the Orange County Treasurer Investment Policy Statement are as follows:

**Government Code Sections 27130 through 27137**

1. The Legislature finds and declares that local agencies, including school districts, should participate in reviewing the policies that guide the investment of those funds. (Section 27130)
2. The Board of Supervisors in each county shall, if the county is investing surplus funds, establish a county treasury oversight committee that consists of from three to eleven members. (Section 27131)
3. The county treasury oversight committee shall consist of members appointed from the following: county treasurer; county auditor, auditor-controller or finance director; a representative appointed by the county board of supervisors; the county superintendent of schools or designee; a representative selected by a majority of the presiding officers of the governing bodies of the school or community college districts; a representative selected by a majority of the presiding officers of the legislative bodies of the special districts; up to five other members of the public who either have expertise or academic background in finance or are economically diverse and bipartisan in political registration. (Section 27132)
4. Committee members may not be employed by an entity that has contributed to the campaign of a candidate for the office of local treasurer, or contributed to the campaign of a candidate to be a member of a legislative body of any local agency that has deposited funds in the county treasury, in the previous three years or during the period that the employee is a member of the committee. (Section 27132.1)
5. Committee members may not directly or indirectly raise money for a candidate for local treasurer or a member of the governing board of any local agency that has deposited funds in the county treasury while a member of the committee. (Section 27132.2)
6. Committee members may not secure employment with bond underwriters, bond counsel, security brokerages or dealers, or with financial services firms with whom the treasurer is doing business during the period that the person is a member of the committee or for one year after leaving the committee. (Section 27132.3)
7. Committee meetings shall be open to the public and subject to the Ralph M. Brown Act. (Section 27132.4)
8. The county treasurer shall annually prepare an investment policy that will be reviewed and monitored by the county treasury oversight committee. The investment policy shall include the following: a listing of authorized securities or other instruments in which the treasurer may invest; maximum security terms; criteria for the selection of brokers and dealers; limits on the receipt of gifts; investment reporting requirements; cost calculation and apportionment policy for managing funds; deposit terms and conditions for voluntary participants; and funds withdrawal criteria. (Section 27133)

**COUNTY OF ORANGE**

**SUMMARY OF INVESTMENT COMPLIANCE REQUIREMENTS**  
**SCHEDULE I (Continued)**  
**For Year-Ended 12/31/00**

9. The county treasury oversight committee shall cause an annual audit to be conducted to determine the county treasury's compliance with the investment compliance requirements presented in the California Government Code Sections 27130 through 27137. (Section 27134)
10. The costs of complying with this article shall be county charges and may be included with those charges enumerated under Section 27013. (Section 27135)
11. Local or public agencies that have funds on deposit in the county treasury pool and seek to withdraw funds for the purpose of investing or depositing those funds outside the county treasury pool shall first submit the request for withdrawal to the county treasurer. The county treasurer shall evaluate each proposed withdrawal for its consistency with the criteria adopted pursuant to Section 27133. Prior to approving a withdrawal, the county treasurer shall find that the proposed withdrawal will not adversely affect the interests of the other depositors in the county treasury pool. (Section 27136)
12. The county treasury oversight committee shall not direct individual investment decisions, select individual investment advisors, brokers, or dealers, or impinge on the day-to-day operations of the county treasury. (Section 27137)

**Orange County Treasurer Investment Policy Statement (IPS)**

13. Investments maintained in the portfolios shall be consistent with those authorized per Government Code Sections 53601 et seq., 53631.5, and 53635, as stated in IPS Sections IV and V.
14. Investments maintained in the portfolios shall comply with investment criteria as stated in IPS Sections IV, V and VI, including the maximum allowable percentage by type of security, allowable percentage per issuer, maximum term limits and credit ratings requirements.
15. Treasurer, investment personnel, and Treasury Oversight Committee members shall annually complete the Statement of Economic Interests Disclosure (State of California Form 700) and must comply with the Orange County Gift Ban Ordinance which prohibits the receipt of specified gifts, as stated in IPS Section VII.
16. All security transactions must be executed through brokers/dealers and financial institutions that meet the selection criteria specified in IPS Section VIII and are placed on the list of qualified institutions.
17. All security transactions entered into by the Treasurer shall be conducted on a delivery-versus payment basis and a third party custodian, as stated in IPS Section X, shall hold securities.
18. Repurchase agreements are required to be collateralized by securities authorized under Government Code Section 53601 at a minimum of 102% of market value of the principal and accrued interest, and shall be adjusted no less frequently than weekly. Collateral is to be held by an independent third party with whom the treasurer has a current custodial agreement. Evidence of ownership must be supplied to the Treasurer and retained as stated in IPS Section XI.

**COUNTY OF ORANGE**  
**SUMMARY OF INVESTMENT COMPLIANCE REQUIREMENTS**  
**SCHEDULE I (Continued)**

**For Year-Ended 12/31/00**

19. The Treasurer will charge all pool participants for administrative and overhead costs of investing, depositing, banking, auditing, reporting, or otherwise handling or managing the funds as authorized by Government Code Section 27013, as stated in IPS Section XIV.
20. Local agencies that voluntarily deposit monies with the Treasurer must provide to the Treasurer a resolution adopted by its governing board stating that excess funds are available for investing, in compliance with requirements stated in IPS Section XV.
21. Withdrawal of participant funds shall require prior written approval from the Treasurer. Prior to approving the withdrawal request, the Treasurer shall make a finding of the effect of the withdrawal on the stability and predictability of the investments, as stated in IPS Section XVI.
22. The Treasurer shall provide monthly report and any audit report in accordance with Government Code Sections 53646 and 53686, as stated in IPS Section XIX.

## **FINDINGS, RECOMMENDATIONS, AND RESPONSES**

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### **I. Noncompliance noted with Investment Policy Statement Section IV – Authorized Investments**

Section IV.10 of the Treasurer’s Investment Policy Statement effective as of January 2000 and July 2000 requires that medium-term notes eligible for investment “...shall be rated “A” or better by at least two of the following nationally recognized rating agencies: Standard and Poor’s, or Moody’s, or Fitch.”

We tested 97 purchases made during our audit period (1/1/00 to 12/31/00) for investment compliance. Of those 97 investments, we determined that 22 were medium-term notes. Of the 22 medium-term notes, we identified one note, SMM Trust 2000-B, purchased on 3/15/00 with a par value and cost of \$20,000,000 did not have an “A” rating or better by at least two nationally recognized rating services. The investment matured on 12/13/00 and the Treasurer received all principal and earned interest for the investment.

Upon review of the trade ticket, it was determined that the Assistant Investment Officer, who is no longer employed by the Treasurer, placed the trade and the trade ticket was signed by the Investment Officer.

#### **Recommendation No. 1**

We recommend that the Treasurer only purchase medium-term notes meeting the requirements of Section IV.10 of the Treasurer’s Investment Policy Statement.

#### **Treasurer Response:**

Partially Concur. We concur with the above recommendation however we do not concur with Internal Audit’s finding that the subject investment did not have an “A” rating or better by at least two nationally recognized rating services.

The subject investment in SMM Trust 2000-B (Trust) was secured by a total return swap agreement with Morgan Guaranty Trust Company of New York (MGT), Swap Counterparty. MGT provides the primary source of principal and interest payment to investors holding the securities. The guarantee and demand feature diversification standards of Section 2a-7(a)(3)(iii) of the Investment Company Act of 1940 state that a money market fund can rely on the credit quality of a guarantee in determining the credit quality of the underlying security.

As a result of the swap agreement, this security represents exposure to AAA/Aa1 (long-term) rated Morgan Guaranty Trust Company of New York. The Offering Memorandum states that ratings on the SMM securities will change with the short-term or long-term rating of the Swap Counterparty.

#### **Internal Audit Response:**

While we disagree with the Treasurer’s characterization and interpretation of this complex investment instrument, we found that the Treasurer has not continued to purchase any further securities offered by SMM Trust 2000-B. Since there have been no further purchases of SMM Trust 2000-B and since all interest and principal payments were received when the subject investment matured on 12/13/00, no further work is required.



**II. Noncompliance noted with Investment Policy Statement Section XIV – Compensation Agreement**

Section XIV of the Treasurer’s Investment Policy Statement effective as of January 2000 and July 2000 requires that “The Treasurer shall annually prepare a proposed budget revenue estimate, providing a detailed itemization of all estimated costs which comprise the administrative fee charged in accordance with California Government Code Section 27013...the administrative and overhead fee will be reviewed by the Treasury Oversight Committee on an annual basis.”

During our review of the Treasury Oversight Committee meeting minutes during our audit period (1/1/00 to 12/31/00) we determined that the administrative and overhead fee for fiscal year 2000 was not presented to the Treasury Oversight Committee for review.

**Recommendation No. 2**

We recommend that the Treasurer comply with their Investment Policy Statement and California Government Code Section 27013 and annually submit the administrative and overhead costs for the pool participants to the Treasury Oversight Committee for review.

**Treasurer Response:**

Concur. The Treasury Oversight Committee, in their January 16, 2002 meeting, reviewed the administrative and overhead costs for 2000 and 2001.

**III. Noncompliance noted with Investment Policy Statement Section XV – Voluntary Participants**

Section XV of the Treasurer’s Investment Policy Statement effective as of July 2000 states “Monies deposited by local agencies approved for entry into the Treasurer’s Investment Pool will be invested in the Money Market Fund. To participate in the Extended Fund, the local agency must sign a waiver indicating their understanding of the possible NAV (Net Asset Value) risk involved.”

Treasury staff informed us that all monies deposited into the Orange County Investment Pool are commingled between the Money Market and Extended funds. Individual deposits into the pool are not identified as deposits into one specific fund. In effect, any pool participant with monies invested in the Orange County Investment Pool after July 2000 (when the Extended Fund was established) has a percentage of their holdings invested in the Extended Fund. Therefore, all voluntary participants are participating (investing) in the Extended Fund.

Since the Extended Fund was not established until July 2000 and the Investment Policy Statement requirement did not become effective until that time, we determined any participant established subsequent to that date should have signed a waiver indicating their understanding of the possible NAV risk. Of the two new voluntary participants established during calendar year ended 12/31/00, we found that one participant, Mesa Consolidated Water District, was subject to this requirement. However we were unable to locate a signed waiver form in the participants file indicating their understanding of the possible NAV risk related to participating in the Extended Fund.

**Recommendation No. 3**

We recommend that Treasurer include a standard section in their voluntary participant agreements stating that the agency is aware of the possible NAV risk related to participating in the Extended Fund.

**Treasurer Response:**

Concur. The Treasurer will include a standard section in their voluntary participant agreements stating that agency is aware of the possible NAV risk related to participating in the Extended Fund.

**Recommendation No. 4**

We recommend that Treasurer request that Mesa Consolidated Water District sign a waiver form indicating their understanding of the possible NAV risk related to participating in the Extended Fund.

**Treasurer Response:**

Concur. The Treasurer will comply with this request by May 31, 2002.

**IV. Noncompliance noted with Investment Policy Statement Section XV – Voluntary Participants**

Section XV of the Treasurer’s Investment Policy Statement effective as of January 2000 and July 2000 requires that voluntary participants “...comply with the requirements of Section 53684 of the California Government Code and provide to the Treasurer a resolution adopted by its governing board stating that excess funds are available for the purpose of investment. The resolution shall specify that the local agency authorizes the investment of excess funds pursuant to Section 53684...”.

Of the two new voluntary participants established during calendar year ended 12/31/00, we found that the Treasurer accepted one resolution, 99-628 adopted by the Board of Directors of the Costa Mesa Sanitary District, that did not contain the verbiage required by Section 53684 and the Investment Policy Statement Section XV stating that excess funds are available for the purpose of investment.

**Recommendation No. 5**

We recommend that the Treasurer obtain from the Costa Mesa Sanitary District a revised resolution that contains the required verbiage that excess funds are available for the purpose of investment.

**Treasurer Response:**

Concur. The Treasurer will comply with this request by May 31, 2002.

**APPENDIX  
TREASURER MANAGEMENT RESPONSE**

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COUNTY OF ORANGE  
**OFFICE OF THE TREASURER-TAX COLLECTOR**  
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April 17, 2002

RECEIVED  
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Dr. Peter Hughes, CPA  
Director, Internal Audit  
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**INTERNAL AUDIT**

Dear Dr Hughes:

Pursuant to Audit Oversight Committee Administrative Procedure No. 1, we have prepared our response to the draft results of your examination of the investment compliance requirements presented in California Government Code Sections 27130 through 27137, and related provisions of the Orange County Treasurer Investment Policy Statement, for the year ended December 31, 2000. The recommendation numbers used in your report references our response.

**Recommendation No. 1:**

We recommend that the Treasurer only purchase medium-term notes Meeting the requirements of Section IV.10 of the Treasurer's Investment Policy Statement.

**Treasurer-Tax Collector response:**

Partially Concur. We concur with the above recommendation however we do not concur with Internal Audit's finding that the subject investment did not have an "A" rating or better by at least two nationally recognized rating services.

The subject investment in SMM Trust 2000-B (Trust) was secured by a total return swap agreement with Morgan Guaranty Trust Company of New York (MGT), Swap Counterparty. MGT provides the primary source of principal and interest payment to investors holding the securities. The guarantee and demand feature diversification standards of Section 2a-7(a)(3)(iii) of the Investment Company Act of 1940 state that a money market fund can rely on the credit quality of a guarantee in determining the credit quality of the underlying security.

As a result of the swap agreement, this security represents exposure to AAA/Aa1 (long-term) rated Morgan Guaranty Trust Company of New York. The Offering Memorandum states that ratings on the SMM securities will change with the short-term or long-term rating of the Swap Counterparty.

**APPENDIX**  
**TREASURER MANAGEMENT RESPONSE (cont'd)**

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Dr. Peter Hughes, CPA  
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**Recommendation No. 2:**

We recommend that the Treasurer comply with their Investment Policy Statement and California Government Code Section 27013 and annually submit the administrative and overhead costs of the pool participants to the Treasury Oversight Committee for review.

**Treasurer-Tax Collector response:**

Concur. The Treasury Oversight Committee, in their January 16, 2002 meeting, reviewed the administrative and overhead costs for 2000 and 2001.

**Recommendation No. 3:**

We recommend that Treasurer include a standard section in their voluntary participant agreements stating that the agency is aware of the possible NAV risk related to participating in the Extended Fund.

**Treasurer-Tax Collector response:**

Concur. The Treasurer will include a standard section in their voluntary participant agreements stating that agency is aware of the possible NAV risk related to participating in the Extended Fund.

**Recommendation No. 4:**

We recommend that Treasurer request that Mesa Consolidated Water District sign a waiver form indicating their understanding of the possible NAV risk related to participating in the Extended Fund.

**Treasurer-Tax Collector response:**

Concur. The Treasurer will comply with this request by May 31, 2002.

**Recommendation No. 5:**

We recommend that the Treasurer obtain from the Costa Mesa Sanitary District a revised resolution that contains the required verbiage that excess funds are available for the purpose of investment.

**Treasurer-Tax Collector response:**

Concur. The Treasurer will comply with this request by May 31, 2002.

If you have additional questions or follow-up comments, please contact Paul Gorman, Treasury Accounting/Compliance Manager at 834-2288.

Very truly yours,



John M. W. Moorlach, C.P.A., CFP™  
Treasurer-Tax Collector