



PERFORMANCE AUDIT REPORT

**Reviewing the Operations of the
Pooled Money Investment Board
Fiscal Year 2001**

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
January 2002**

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$9 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the Representatives, three are appointed by the Speaker of the House and two are appointed by the Minority Leader.

Audits are performed at the direction of the Legislative Post Audit Committee. Legisla-

tors or committees should make their requests for performance audits through the Chairman or any other member of the Committee. Copies of all completed performance audits are available from the Division's office.

LEGISLATIVE POST AUDIT COMMITTEE

Representative Lisa Benlon, Chair
Representative Richard Alldritt
Representative John Ballou
Representative Dean Newton
Representative Dan Thimesch

Senator Lynn Jenkins, Vice-Chair
Senator Anthony Hensley
Senator Dave Kerr
Senator Derek Schmidt
Senator Chris Steineger

LEGISLATIVE DIVISION OF POST AUDIT

800 SW Jackson
Suite 1200
Topeka, Kansas 66612-2212
Telephone (785) 296-3792
FAX (785) 296-4482
E-mail: LPA@lpa.state.ks.us
Website:
<http://skyways.lib.ks.us/ksleg/PAUD/homepage.html>
Barbara J. Hinton, Legislative Post Auditor

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LEGISLATURE OF KANSAS
LEGISLATIVE DIVISION OF POST AUDIT

800 SOUTHWEST JACKSON STREET, SUITE 1200
TOPEKA, KANSAS 66612-2212
TELEPHONE (785) 296-3792
FAX (785) 296-4482
E-MAIL: lpa@lpa.state.ks.us

January 4, 2002

To: Members, Legislative Post Audit Committee

Representative Lisa Benlon, Chair	Senator Lynn Jenkins, Vice-Chair
Representative Richard Alldritt	Senator Anthony Hensley
Representative John Ballou	Senator Dave Kerr
Representative Dean Newton	Senator Derek Schmidt
Representative Dan Thimesch	Senator Chris Steineger

This report contains the findings, conclusions, and recommendations from the completed performance audit, *Reviewing the Operations of the Pooled Money Investment Board*. The audit was conducted by Berberich Trahan & Co., an audit firm under contract with the Legislative Division of Post Audit.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials.

A handwritten signature in black ink that reads "Barbara J. Hinton". The signature is written in a cursive, flowing style.

Barbara J. Hinton
Legislative Post Auditor

EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

Reviewing the Operations of the Pooled Money Investment Board

As part of its responsibilities, the Pooled Money Investment Board does the following:

- *helps ensure that cash flow needs of State agencies for moneys in the State Treasury are met*
- *manages State idle funds and municipal investment moneys in accordance with the requirements of State law*
- *ensures that investment income is received and properly credited to the appropriate accounts*
- *maintains custodial accountability for moneys for which it is responsible*

The audit reviewed each of the above areas of responsibility, and found no deficiencies.

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This audit was conducted by the joint venture of Allen Gibbs & Houlik and Berberich Trahan & Company, certified public accounting firms, under contract with the Legislative Division of Post Audit. If you need any additional information about the audit's findings, please contact Randy Tongier at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

Reviewing the Financial Management Practices of the Pooled Money Investment Board

Introduction

The Pooled Money Investment Board (PMIB) was created by the 1974 Legislature and came into being on January 13, 1975, assuming all powers, duties and functions of the then-abolished State Board of Treasury Examiners. The organization, primary functions and duties of the Board may be found under the State Moneys Law, K.S.A. 75-4201 *et seq.* During the 1992 Legislative Session, Senate Bill 480 increased the membership of the Board from three to five members; four were appointed by the Governor and the fifth, the State Treasurer, served as the chairperson of the Board as defined by the statute. Senate Bill 476, Session Laws of 1996, further changed the composition of the Board. The membership increased to six, comprised of four gubernatorial and two statutory appointments. Both the State Treasurer and the State Securities Commissioner were members per statute. Additionally, the Governor would now be responsible for appointing the Chairman. The State Securities Commissioner served as a non-voting member. As part of the 1997 Legislative Session, the membership was reduced to five with the passage of Senate Bill 282 which eliminated the non-voting member position occupied by the State Securities Commissioner. No additional structural changes have been made to the Board since 1997.

Senate Bill 480 made sweeping changes to the state moneys law in 1992. Investment authority was broadened to include investments in U.S. Government securities (U.S. Treasury and Federal Agency instruments). High grade commercial paper was added during the 1996 Legislative Session via Senate Bill 476. It is estimated that the use of commercial paper has accounted for an additional \$ 6.4 million in investment income (over comparable Federal Agency investment alternatives) since its inception in fiscal year 1996. Late in fiscal year 1996 (6/3/96) the Board combined the investment portfolio of the Municipal Investment Pool (MIP) with the Pooled Money Investment Portfolio (PMIP) in order to more effectively manage and closely match cash flow needs thereby reducing liquidity risk. The operating account, formally known as the active account, continues to be maintained in one bank.

With the passage of Senate Bill 480, investment accounts replaced the former inactive accounts, offering Kansas banks two investment options - apportioned and competitively bid. The apportionment process was administered in much the same manner as former inactive accounts. Approximately one-half of the investable state moneys (after setting aside funds for liquidity purposes) were prorated to Kansas banks on the basis of equity capital. Interest rates paid on the apportioned offering were revised to reflect yield rather than the discount rate of current U.S. Treasury securities with a similar maturity. The remaining investable state moneys were offered to Kansas banks on a competitive bid basis, at interest rates based on U.S. Treasury and Federal Agency securities of similar terms. During the 1997 Legislative Session (Senate Bill 132) the apportionment process was eliminated, and funds offered to Kansas banks were then available at interest rates based upon the current market.

The PMIB is also subject to the requirements of K.S.A. 75-4264 which established that a comparative investment performance review and an audit of the PMIB investment program be conducted. The results of the most recent review was submitted to the PMIB on September 13, 2001.

Objective and Scope of Work

K.S.A. 46-1106(a) requires a written audit report on the financial management practices of the Pooled Money Investment Board. The following report addresses four specific questions and includes a summary of each area and our conclusions and recommendations regarding those questions.

The audit work was performed in accordance with *Government Auditing Standards* for performance audits.

Did the Pooled Money Investment Board's procedures help ensure that cash flow needs of State Agencies for moneys in the State Treasury were met?

PMIB has established policies and procedures to help ensure the cash flow needs are met. These policies are in effect for the daily and the longer-term needs of the agencies.

The daily cash flow needs analysis is performed at PMIB in close communication with the State Treasurer's Office (STO). An initial cash calculation is performed at approximately 8:00 a.m. This calculation considers items such as:

- Current collected bank balance
- Repurchase agreement maturities
- ACH clearings
- Estimated bank clearings
- Idle fund maturities (including interest)
- Idle fund purchases
- Municipal Investment Pool (MIP) Deposit and Withdrawals
- CD Maturities
- KDOT purchases and maturities
- HCSF purchases and maturities
- Linked deposits
- ACH and wire bonds

This provides information to determine funds available for the initial repurchase agreement purchase. A final cash calculation is prepared later in the day when more agency information becomes available. This provides for more substantial information on collected funds and bank clearings from the STO. This final calculation then provides the basis to ensure that idle state funds are invested to the maximum level. A daily liquidity analysis is also performed to ensure that adequate funds could be made available if liquidation would be requested from day-to-day deposits. Scenarios depicting various levels of withdrawals (25%, 50% and 75%) are also built into the analysis to provide information regarding the availability of funds under those environments.

The STO provides to PMIB, on approximately a quarterly basis, an anticipated cash flow analysis for the upcoming 15 to 24 months. The Performance Audit Report - Reviewing the Operations of the State Treasurer's Office for the year ended June 30, 2001 provides additional information on this longer-term analysis. This report provides the anticipated cash receipt and disbursements over the upcoming 15 to 24 months on a daily basis.

From the STO cash flow analysis, a report is prepared by PMIB which provides the daily cash flow and investment analysis for the upcoming 15 to 24 months. This report, titled “PMIB Investment Portfolio Exposure Report (Cash Flow Forecast Model),” provides information on cash inflows and outflows for state operations, maturity of MIP deposits, investment maturities as they are currently scheduled to occur and actual investment purchases. Finally and most importantly, the report indicates the amount of variance between outflows and inflows. If the variance is positive then adequate maturities are providing for anticipated cash flow needs. A negative variance indicates that additional maturities need to be available for that date. The overnight repo balance is indicated which provides for the current projected balance without consideration for future investment of funds.

These efforts provide a strong framework to ensure that the cash flow needs for the state agencies are met for the near and long terms. It also provides a method to provide for a reasonable maximization of invested funds. The statutory requirement states that “the PMIB shall adopt rules and regulations . . . with a primary emphasis on safety and liquidity”.

No exceptions were noted to these requirements.

Did the Pooled Money Investment Board manage State idle funds and municipal investment moneys in accordance with the requirements of State Law?

The policy of the PMIB as stated in their Investment Policy document revised March 21, 2001, is “ to invest the Pooled Money Investment Portfolio in a manner which will provide a reasonable rate of return with the maximum security while meeting the daily cash flow demands of the State and conforming to all statutes governing the investment of state moneys. The standard of prudence to be used by investment officials shall be the prudent person standard, which shall be applied in the context of managing an overall portfolio. This standard states that investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital, as well as the probable income to be derived.”

The investment policy applies to all moneys in the treasury of the state or coming lawfully into the possession of the treasurer, pursuant to K.S.A. 75-4201, *et seq.*, including the Municipal Investment Pool. The moneys are accounted for in the Board's annual financial report to the Legislature and include investment account moneys, as specified in K.S.A. 75-4209, as amended. The board specifically manages the Pooled Money Investment Portfolio (PMIP), Health Care Stabilization Fund, and Special Funds. The PMIB performs transaction execution, investment accounting, and provides investment advice for the Kansas Department of Transportation (KDOT). KDOT, however, retains responsibility for the investment decisions on the KDOT investments. The PMIB also administers the Municipal Investment Pool.

The primary objectives, in priority order of the Board's investment activities, are as follows:

Safety. Safety of principal is the foremost objective of the investment program.

Liquidity. The pooled money investment portfolio will remain sufficiently liquid to meet all operating requirements that might be reasonably anticipated. This is accomplished by structuring the portfolio so that securities mature concurrent with cash needs to meet anticipated demands.

Return on Investment. The pooled money investment portfolio shall be designed with the objective of attaining a reasonable rate of return throughout budgetary and economic cycles, taking into account investment risk constraints and the cash flow characteristics of the portfolio. Return on investment is a secondary importance compared to the safety and liquidity objectives described above.

The composition of assets at June 30, 2001 in the combined portfolios is as follows:

	Assets (In Millions)	
	\$	
Cash		13.298
Deposits in Transit		26.609
Investment (at amortized cost):		
U.S. Government Agency Securities	\$ 456.243	
Kansas Bank CDS	153.507	
Commercial Paper	771.492	
Repurchase Agreements	488.400	
Loan Refunding Securities	<u>41.344</u>	
Total investments		1,910.986
PMIB Loans		10.519
Agriculture Production Loans		49.871
Interest receivable		<u>3.637</u>
Total PMIP		2,014.920
KDOT		887.307
Health Care Stabilization Fund		198.454
Special Funds		10.047
Elimination Entry		<u>(2.403)</u>
Total assets		<u>\$ 3,108.325</u>

No exceptions were noted in our review of this area.

Did the Pooled Money Investment Board ensure that investment income was received and properly credited to the appropriate accounts?

Two primary systems of accountability over investment income are maintained (investments - accrual basis and investments - cash basis). These systems are reconciled to each other monthly.

On the cash basis system, interest income is accounted for as received and investments are stated at cost. The investment balance is agreed to the balance of investments actually being held by the STO and the investment income is reconciled to the Division of Accounts and Reports monthly. Trade tickets, dealer confirmations and interest advice support the balances.

The accrual basis system is obtained primarily from the EVARE Desktop Investment System. The report is agreed to the STO Daily Cash Sheet (cash basis) but also accounts for accrued interest and amortization for each investment. A second system, called IPACS, is used for the MIP and provides a detail accountability for each of the participants in the MIP. The accrual basis reports are provided to the Board monthly.

The Municipal Investment Pool is combined with the PMIP Portfolio for investment purposes. Municipalities invest in the MIP in two ways:

1. Overnight Pool - Municipalities are paid the weighted overnight rate that the PMIP earned less 30 basis points (which is 1/100 of a %, i.e., .3%). This is calculated daily and credited monthly to each municipality. It is also transferred monthly from the General Fund to the MIP fund. The interest earned continues to be interest income and is not invested in principal unless advised by the municipality to do so.
2. Fixed Rate Deposits - Municipalities can invest in fixed rate deposits by choosing their own maturity dates for 30 to 179 days or by choosing the 180 day or 1 year maturity option. The Senior Investment Officer quotes a rate to the municipality, which is the then current commercial paper rate (per Bloomberg) for maturities from 30 day to 180 day and the U.S. Government Agency Rate for 1 year maturities (commercial paper has no maturities beyond 270 days), less 25 basis points. This is credited to the municipality upon maturity, and transferred monthly to the MIP Fund from the State General Fund. The interest income is automatically invested in principal unless withdrawn by the municipality.

PMIB also maintains a system, GAINS, which among other capabilities produces for each day an interest payment report and a maturity report.

The EVARE and GAINS system produce reports which indicate maturities and associated interest or investment earnings. This information is used to post the interest to the appropriate fund.

No exceptions were noted in our review of this area.

Did the Pooled Money Investment Board maintain adequate custodial accountability for moneys for which it was responsible?

As indicated in the previous question various systems are maintained for PMIB investments. The PMIB accounting staff maintains accountability for investments through these systems and their reconciliation to the daily cash report and the State's STARS accounting system. PMIB also prepares an accrual basis report which is provided monthly to the Board.

As established by Statute the State Treasurer's office is the custodian of the investment instruments that consist of safekeeping receipts and certificates of deposits.

No exceptions were noted in our review of this area.

Summary

The PMIB personnel maintain their office in a professional and efficient manner. The individuals effectively performed and communicated their responsibilities.

AGENCY RESPONSE



POOLED MONEY INVESTMENT BOARD

Landon State Office Building
900 S. W. Jackson Street
Suite 209
Topeka, KS 66612-1220

Ph. (785) 296-3701
Fax (785) 296-1085

<http://kansasstatetreasurer.com/pmib>

DIRECTOR OF INVESTMENTS
Derl S. Treff

November 14, 2001

Allen, Gibbs & Houlik, L.C.
301 N. Main, Suite 1700
Wichita, KS 67202-4868

Berberich Trahan & Co., P.A.
800 SW Jackson St., Suite 1300
Topeka, KS 66612-1268

To Whom It May Concern:

I have received the draft of the Financial Management Audit for the year ended June 30, 2001 and agree that your commentary provides a reasonably accurate synopsis of our operations.

I appreciate the professional manner in which the audit was conducted.

Sincerely,

A handwritten signature in black ink, appearing to read "Derl S. Treff".

DERL S. TREFF
Director of Investments

DST:mcg

