



PERFORMANCE AUDIT REPORT

**Reviewing Operations of the
Pooled Money Investment Board
Fiscal Year 2008**

**A Report to the Legislative Post Audit Committee
By Allen Gibbs & Houlik, an audit firm under contract with the
Legislative Division of Post Audit
State of Kansas
December 2008**

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 \$13 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. Government Accountability 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. Legislators

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.

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Barbara J. Hinton, Legislative Post Auditor

DO YOU HAVE AN IDEA FOR IMPROVED GOVERNMENT EFFICIENCY OR COST SAVINGS?

The Legislative Post Audit Committee and the Legislative Division of Post Audit have launched an initiative to identify ways to help make State government more efficient. If you have an idea to share with us, send it to ideas@lpa.state.ks.us, or write to us at the address above.

You won't receive an individual response, but all ideas will be reviewed, and Legislative Post Audit will pass along the best ones to the Legislative Post Audit Committee.

The Legislative Division of Post Audit supports full access to the services of State government for all citizens. Upon request, Legislative Post Audit can provide its audit reports in large print, audio, or other appropriate alternative format to accommodate persons with visual impairments. Persons with hearing or speech disabilities may reach us through the Kansas Relay Center at 1-800-766-3777. Our office hours are 8:00 a.m. to 5:00 p.m., Monday through Friday.



LEGISLATURE OF KANSAS

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December 12, 2008

To: Members, Legislative Post Audit Committee

Senator Derek Schmidt, Chair
Senator Les Donovan
Senator Anthony Hensley
Senator Nick Jordan
Senator Chris Steineger

Representative Virgil Peck, Jr., Vice-Chair
Representative Tom Burroughs
Representative John Grange
Representative Peggy Mast
Representative Tom Sawyer

This report contains the findings and conclusions from the completed performance audit, *Reviewing the Operations of the Pooled Money Investment Board*. The audit covers fiscal year 2008, and was conducted by Allen Gibbs & Houlik, 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.


Barbara J. Hinton
Legislative Post Auditor

READER'S GUIDE

<i>The Big Picture</i>		<i>The Details</i>	
Executive Summary	Provides an overview of the questions we asked and the answers we found	“At-a-Glance Box”	Used to describe key aspects of the audited agency; generally appears in the first few pages of the main report
Conclusions and Recommendations	Located at the end of the report sections, and referenced in the Executive Summary	Side Headings	Point out key issues and findings
Agency Response	Included as the last Appendix in the report	Charts, Tables, and Graphs	Visually help tell the story of what we found
List of Figures	Lists all figures used in the report and their location (as shown at the end of the Executive Summary)	Narrative Text Boxes	Highlight interesting information or provide detailed examples

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: page 1

- *establishes investment policies in accordance with K.S.A. 75-4232*
- *establishes the applicable market rate and awards State deposits to requesting banks in accordance with K.S.A. 75-4237*
- *follows Board policies for safety and liquidity in its investments*
- *provides monthly investment summary reports, including comparison to the adopted performance benchmark*

The audit reviewed each of the above areas of responsibility for fiscal year 2007, and found no deficiencies.

This audit was conducted by Allen Gibbs & Houlik, an audit firm 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.

December 10, 2008

Legislative Post Audit Committee Members:

The performance audit report on Reviewing the Financial Management Practices of the Pooled Money Investment Board for the year ended June 30, 2008 is enclosed. This work was performed in accordance with *Government Auditing Standards* for performance audits.

Please do not hesitate to contact Mr. Mark Dick at the undersigned if you have any questions.

Allen, Gibbs & Houlik, L.C.

POOLED MONEY INVESTMENT BOARD

PERFORMANCE AUDIT REPORT REVIEWING
FINANCIAL MANAGEMENT PRACTICES
FOR THE YEAR ENDED JUNE 30, 2008

POOLED MONEY INVESTMENT BOARD
PERFORMANCE AUDIT REPORT
Reviewing Financial Management Practices
For the Year Ended June 30, 2008

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POOLED MONEY INVESTMENT BOARD
Reviewing Financial Management Practices

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 \$10.7 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.

Audit Objective, Scope and Methodology

K.S.A. 46-1106(a) requires a written audit report on the financial management practices of the Pooled Money Investment Board for each fiscal year. The objective of the following report is to address five specific questions. We have addressed those questions and have included a summary of each area and our conclusions and recommendations regarding those questions.

To accomplish our objective, we reviewed State Statutes, policies and procedures; interviewed PMIB personnel; reviewed records; and tested samples of transactions when applicable. Statistical sample sizes were determined based on combined inherent and control risk assessment of low and a 70% confidence level. Samples were chosen on a random basis. Accordingly, statistical sample results can be projected to the intended population with a 70% reliability factor. When Statistical Numeric Sampling is considered inefficient because of the small size of the population, the engagement team may judgmentally determine and select the number of items it should test.

We conducted this performance audit in accordance with *generally accepted government auditing standards*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

It should be emphasized that this performance audit is not a financial performance audit; the performance audit questions set forth below relate to performance in the context of compliance with applicable statutes and policies, and compliance with statutes and policies does not provide a guarantee of financial performance, as there are no such guarantees.

1. Did the PMIB establish investment policies in accordance with KSA 75-4232?

Per KSA 75-4232, such policies and procedures shall address the following key elements:

1. Liquidity
2. Diversification
3. Safety of principal
4. Yield
5. Maturity
6. Quality and capability of investment management
7. Such investment policy shall specify when or under what circumstances securities may be disposed of prior to maturity.
8. Such investment policies and procedures shall be reviewed annually by the pooled money investment board.

Summary of PMIB Investment Policy:

The policy statement of the PMIB, as stated in the Investment Policy document revised September 2007, 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 scope of the investment policy applies to all moneys in the treasury of the State or coming lawfully into the possession of the STO, 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 PMIB's investment activities, are as follows:

Safety. Safety of principal is the foremost objective of the investment program. The investments are undertaken in a manner that seeks to ensure preservation of capital in the overall portfolio. This includes mitigating credit and interest rate risk.

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 of secondary importance compared to the safety and liquidity objectives described above.

It is the policy of the PMIB to diversify its investments portfolio so as to protect state moneys from material losses due to issuer defaults, market price changes, technical complications leading to temporary lack of liquidity, or other risks resulting from an over-concentration of assets, a specific maturity, a specific issuer, a specific geographical distribution, or a specific class of securities.

Following the primary objective of preservation of capital, investment portfolios shall be actively managed to take advantage of market opportunities. In so doing, negotiable securities may be sold prior to their maturity to provide liquid funds as needed for cash flow purposes, to enhance portfolio returns, or to restructure maturities to increase yield and/or decrease risk. In practice, however, it is generally a hold to maturity portfolio.

AGH Procedures:

We read the published Investment Policy of the PMIB and compared it to the required elements of Kansas Statute 75-4232; including:

1. Liquidity – section III. B.
2. Diversification – section VIII.
3. Safety of principal –section III. A and section VI.
4. Yield – section III. C and IV.
5. Maturity – section VII.
6. Quality and capability of investment management – section IX and section X.
7. Such investment policy shall specify when or under what circumstances securities may be disposed of prior to maturity – section IX.
8. Such investment policies and procedures shall be reviewed annually by the pooled money investment board – section XI.

Conclusion: No exceptions were noted in connection with these procedures.

2. Did the PMIB establish the market rate and award the investment account to the requesting bank at the established market rate per the provisions of KSA 75-4237?

Requirements per KSA 75-4237:

1. Subsection (a)
The director of investments shall accept requests from banks interested in obtaining investment accounts of state moneys. Such requests may be submitted any business day and shall specify

the dollar amount and maturity. The director of investments is authorized to award the investment account to the requesting bank at the market rate established by subsection (b). Awards of investment accounts pursuant to this section shall be subject to investment policies of the pooled money investment board. When multiple requests are received and are in excess of the amount available for investment that day for any maturity, awards shall be made available in ascending order from smallest to largest dollar amount requested, subject to investment policies of the board.

2. Subsection (b)

The market rate shall be determined each business day by the director of investments, in accordance with any procedures established by the pooled money investment board. Subject to any policies of the board, the market rate shall reflect the highest rate at which state moneys can be invested on the open market in investments authorized by subsection (a) of K.S.A. 75-4209, and amendments thereto, for equivalent maturities.

3. Subsection (c) (1)

Notwithstanding the provisions of this section, linked deposits made pursuant to the provisions of K.S.A. 2-3703 through 2-3707, and amendments thereto, shall be at an interest rate which is 2% less than the market rate determined under this section and which shall be recalculated on the first business day of each calendar year using the market rate then in effect.

4. Subsection (c) (2)

Notwithstanding the provisions of this section, agricultural production loan deposits made pursuant to the provisions of K.S.A. 2007 Supp. 75-4268 through 75-4274, and amendments thereto, shall be at 2% less than the market rate provided by this section and which shall be recalculated on the first business day of each calendar year using the market rate then in effect.

AGH Procedures:

We reviewed the daily procedures of the PMIB office and staff in relation to the required elements of Kansas Statute 75-4237 noted above. This review included interviewing staff, reading the published PMIB Procedures Manual and testing a sample of transactions for the rate awarded per the daily rate sheet for compliance with Kansas Statute 75-4237.

Randomly selected 12 business days and compared to the Procedures Manual revised October 10, 2006 which states that "rates for which Kansas Banks will be able to obtain State money will be set by the Investment Officer on each business day no later than 8:30 a.m. The amount of dollars available for investment, as well as the specific maturity date(s), will be based on the States current cash flow forecast. These rates will be based upon current market rates, which can be obtained for statutorily defined investments. The statutorily defined investments include U.S. Treasury & Federal Agency Securities, as well as high grade (A1/P1 or better) Commercial Paper. Rates for maturity dates ranging between 30 – 270 days will be based on the current Commercial Paper market. Rates for maturity dates beyond 270 days (2 year maximum maturity) will be based primarily on the current Federal Agency market."

Randomly selected 12 business days and determined the interest rate awarded for the Agricultural Production Loan Deposits (Linked Deposits) was 2% less than the determined market rate for selected issue date in accordance with KSA 75-4237; based on the daily rate sheet for each selected date.

Randomly selected 12 business days and determined the interest rate awarded to the requesting bank was for funds available to Kansas banks on the effective (issue) date in accordance with KSA 75-4237; based on the daily rate sheet for each selected effective (issue) date.

Conclusion: No exceptions were noted in connection with these procedures.

3. Does the PMIB follow their policies for safety and liquidity as stated in parts IIIA and IIIB of the PMIB Investment Policy?

Per PMIB Investment Policy:

Section III. A.

Safety of principal is the foremost objective of the investment program. Investments by the Board shall be undertaken in a manner that seeks to ensure preservation of capital in the overall portfolio. This includes mitigating credit and interest rate risk.

In regards to **Safety** (Credit Risk), PMIB shall limit investments to the safest types of securities per policy. The PMIB written Investment Policy identifies permitted investments as certificates of deposit in Kansas banks, which are fully collateralized; direct obligations of the US or any federal agency; securities of US sponsored enterprises that under federal law may be accepted as security for public funds, excluding mortgage-backed securities; repurchase and reverse repurchase agreements with a bank or primary government securities dealer for direct obligations of the U.S. government or governmental agencies; commercial paper less than 270 days to maturity which is rated in the top two rating categories by a nationally recognized rating firm; corporate bonds with less than 2 years to maturity which are rated in the top two rating categories; loans pursuant to legislative mandates; and investments in SKILL act projects and bonds, and investments in any state agency bonds or bond projects. By not being allowed to invest in lower quality credits—particularly commercial paper and corporate bonds—the PMIB Board has limited investments to the safest types of fixed income investments. The monthly portfolio reports for FY 2008 provide verification of the types of securities held in the portfolio, as well as their credit quality.

In regards to **Safety** (Credit Risk), PMIB pre-qualifies the financial institutions, brokers/dealers, intermediaries, and advisers with which PMIB will do business. In accordance with the written Investment Policy statement, PMIB only conducts investment transactions with qualified institutions, which include depository banks, any Federal Reserve Bank, primary government securities dealers, or broker-dealers engaged in the business of selling government securities that are registered in compliance with Section 15 or 15C of the Securities Exchange Act of 1934 and registered pursuant to KSA 17-1254, and direct dealers and issuers of qualified commercial paper. PMIB maintains a list of Approved Broker/Dealers and require all institutions who want to become qualified to do business with PMIB to provide: audited financial statements; proof of NASD certification; proof of registration with the state of Kansas; a completed broker/dealer questionnaire, if they are not a primary dealer; the resume of the representative assigned to the PMIB account; and certification that they have read and understood and agree to comply with PMIB's investment policy. PMIB establishes and maintains broker/dealer relationships, maintains documentation files on each broker/dealer, and performs the annual review.

In regards to **Safety** (Credit Risk), PMIB diversifies the investment portfolio so that potential losses on individual securities will be minimized. The PMIP portfolio is diversified by type of investment, and by investment maturity date. The PMIB Investment Policy limits CDs to 10%, commercial paper and corporate bonds combined to 50%, and loans pursuant to legislative mandates to 10% of the portfolio. The portfolio reports provided for FY 2008 show how the portfolio was actually diversified by type of investment. In addition, the portfolio is diversified by maturity to provide maturities as needed to meet cash flow needs, based on the State Treasurer's Office (STO) cash flow forecast.

In regards to **Safety** (Interest Rate Risk), PMIB structures the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity. PMIB uses the STO's cash flow forecast to project when cash will be needed, and purchases securities with maturities which are designed to meet those cash needs.

In regards to **Safety** (Interest Rate Risk), PMIB invests in operating funds primarily in shorter-term securities. "Operating funds" are those funds which might be needed on a daily basis, and which are therefore invested in overnight repurchase agreements.

AGH Procedures:

Randomly selected a sample of 12 investment files in which we observed for all the required elements of the safety objectives for credit risk and interest rate risk outlined in the PMIB Investment Policy:

- Limiting investments to the safest types of securities
- Pre-qualifying the financial institutions, brokers / dealers, intermediaries, and advisers with which the PMIB does business
- Diversifying the investment portfolio so that potential losses on individual securities will be minimized
- Structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities on the open market prior to maturity
- Investing operating funds primarily in shorter-term securities

Conclusion: No exceptions were noted in our review of this area, as described above.

Per PMIB Investment Policy:

Section III. B.

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.

This is best demonstrated by the fact that PMIB did not have to sell any securities to meet operating requirements during the fiscal year.

AGH Procedures:

Randomly selected a sample of 12 investment files in which we observed for all of the required elements of the liquidity objectives outlined in the PMIB Investment Policy:

- Structuring the portfolio so that securities mature concurrent with the cash needs to meet anticipated demands

Conclusion: No exceptions were noted in our review of this area, as described above.

4. Did the Director of Investments provide monthly performance summary reports using the S & P Rated GIP Invest/General Purpose Taxable as the current benchmark as required by part IV of the PMIB Investment Policy?

Per PMIB Investment Policy:

Section IV.

Investment performance is continually monitored and evaluated by the Director of Investments using investment strategies developed under the investment principles referred to in K.A.R. 122-3-1 and this policy. Investment performance statistics and activity reports are generated by staff. The Director of Investments will provide summary reports on a monthly basis for the Board and annually for the Legislature.

The current benchmark is the S&P Rated GIP Index/General Purpose Taxable. External comparative performance reviews will be conducted as the Board deems necessary.

AGH Procedures:

We read all 12 monthly performance summary reports and compared them to the S&P Rated GIP Invest/General Purpose Taxable to page 2 of each report. The year end S&P Rated GIP Index/General

Purpose Taxable benchmark is the average of each month as reported in the monthly performance reports.

Conclusion: No exceptions were noted in our review of this area.

5. How did the investment performance compare to the S & P Rated GIP Index/General Purpose Taxable benchmark for the year ended June 30, 2008?

AGH Procedures:

We read the June 2008 Performance Summary Report which indicated the FY 2008 Total Return was 4.28% and the S & P Rated GIP Index/General Purpose Taxable benchmark was 4.35%, which is a difference of (.07%).

Conclusion: The portfolio's return was comparative to that of the benchmark.

Summary

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