

RON GALPERIN
CONTROLLER

August 4, 2017

The Honorable Eric Garcetti, Mayor
The Honorable Michael Feuer, City Attorney
Honorable Members of the Los Angeles City Council

We are releasing the Controller's report on the "Condition of All Funds in the City Treasury as of June 30, 2016." Based on our review, we found the Office of Finance's investment activities to be in compliance with the California State Government Code and the City's Investment Policy.

A copy of this report was provided to the Office of Finance.

Sincerely,

A handwritten signature in black ink that reads 'Georgia Mattera'. The signature is written in a cursive, flowing style.

GEORGIA MATTERA
Chief Deputy Controller





RON GALPERIN
CONTROLLER

August 4, 2017

Claire Bartels, Director
Office of Finance
200 North Spring Street, Suite 220
Los Angeles, CA 90012

Dear Ms. Bartels:

Enclosed is an audit report entitled "Condition of All Funds in the City Treasury as of June 30, 2016."

If you have any questions or comments, please contact me at alfred.rodas@lacity.org or (213) 978-7392.

Sincerely,

A handwritten signature in black ink that reads 'Alfred Rodas'.

ALFRED RODAS, CPA, CIA, CIG, CIGI
Director of Auditing

Enclosure

cc: Ana Guerrero, Chief of Staff, Office of the Mayor
Matt Szabo, Deputy Mayor
Richard H. Llewellyn, Interim City Administrative Officer
Sharon Tso, Chief Legislative Analyst
Holly L. Wolcott, City Clerk
Independent City Auditors

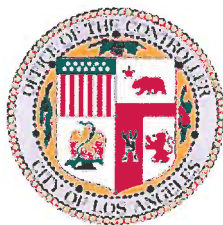


A U D I T

City of Los Angeles

Condition of All Funds in
the City Treasury as of
June 30, 2016

August 4, 2017



RON | GALPERIN

Los Angeles City Controller

controller.lacity.org



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SUMMARY

Section 261(f) of the Los Angeles City (City) Charter requires the Controller to periodically verify the condition of all City funds in the City Treasury and to report the results to the Mayor and Council.¹ A related Charter implementation ordinance amended the Los Angeles Administrative Code to include provisions directing the Controller to audit the accounts, funds and securities of the City.²

The City Treasury is the official depository of the City, which is under the direction and control of the Treasurer, who is appointed and removed by the Mayor, subject to confirmation by the City Council. The City Charter establishes the powers and duties of the Treasurer, which include serving as the custodian of all money deposited in the City Treasury and custodian of all securities bought by the City. The Treasurer manages the City's cash management program and the City's investment pool. Treasury functions are performed by the Office of Finance (Finance), and the Director of Finance serves as the City Treasurer.

The Controller's Audit Division has completed an audit of cash and investment activities at the Office of Finance. The primary objectives of the audit were:

1. To verify and report on the condition of cash and investments in the City Treasury at June 30, 2016.
2. To determine whether banking activities have incorporated adequate internal controls.
3. To determine whether investment activities complied with the California State Government Code and the City's Statement of Investment Policy.

I. Overall Assessment

We determined that Finance maintained a system of adequate internal controls to give reasonable assurance that cash and investment activities were carried out properly, and that City funds as of June 30, 2016, as reported in Appendix II: Schedule of Cash and Investments, were invested in accordance with established policies and procedures.

¹ "The Controller shall: . . . from time to time, verify the condition of all City funds in the City Treasury, and report to the Mayor and Council thereon;" CITY CHARTER; Vol I; Article II; Section 261 (f).

² "In addition to the powers and duties of the Controller as provided in Charter Section 261 and approvals of demands on the Treasury as provided in Charter Section 262, the Controller shall also inspect and audit the books, accounts, funds and securities of every person charged in any way with the safe-keeping and disbursement of public money or securities." LAAC Division 20; Charter 3, Article 1; Section 20.55; Ordinance No. 173337.

Although the current audit did not identify reportable findings, we noted that a prior audit recommendation remains outstanding. Specifically, the prior audit included an observation that the information system used by Finance to track and manage its investments does not identify or segregate sources of funds used to purchase investments, which risked non-compliance with the State Government Code with respect to maturity restrictions for medium-term notes.³

While Finance has not yet implemented a new Treasury Management System or a method to segregate the sources of funds used to purchase specific investments; it has updated the City's Statement of Investment Policy to prohibit new purchases of private securities that exceed a five-year maturity.⁴

Finance management has indicated that they have had challenges in obtaining funding necessary to implement a new Treasury Management System, but anticipated that a new system will be acquired in 2020.

II. Review of Report

On June 29, 2017, a draft of this report was provided to Finance management and they expressed general agreement with this audit's results.

We would like to thank Finance management and staff for their cooperation and assistance during the audit.

³ State Code 53601(m) provides an exception for investments over the five-year period if they were purchased with bond proceeds and provisions governing the bond issuance allows it. The City's funds used to buy investments is composed of all sources of revenues including taxes and bond proceeds.

⁴ Though Finance no longer purchases corporate notes in excess of five years, it kept private securities in its portfolio that were purchased prior to January 1, 2015. We noted that at June 30, 2016, Finance held 19 medium-term notes totalling \$190 million, whose maturity goes beyond five years, which is significantly less than the 31 medium-term notes totaling \$295 million that it held at June 30, 2015.

BACKGROUND & CONCLUSIONS

City Treasurer Authority

Through its Treasury Operations function, the Office of Finance serves as the custodian of all money deposited in the City Treasury. This includes ensuring sufficient availability of cash for the City's day-to-day operations through monies on deposit with the City's custodial bank, and managing investments. As provided by California State Government Code Section 53600, the City Council delegated to the City Treasurer the authority to invest or reinvest the temporarily idle funds of the City.

The Government Code and the City's Statement of Investment Policy specifies that, when investing and managing public funds, the City Treasurer shall act with care, skill, prudence and diligence. The City's investment objectives are described in the Statement of Investment Policy and ranked in the order of importance below:

- 1) **Safety of Principal** - The City's first objective is to protect the portfolio's value by instituting prudent practices to manage portfolio risk and by instituting a system of controls that are adequate to protect against fraud or mismanagement.
- 2) **Liquidity** - The second objective is to have sufficient funds to ensure the City Treasurer can meet all operating requirements of the City that may be reasonably anticipated (e.g. daily cash flow requirements).
- 3) **Rate of Return** - The third objective is to attain a market rate of return through budgetary and economic cycles consistent with the risk limitations, prudent investment principles, and cash flow characteristics identified herein. For comparative purposes, the City will compare its performance to the performance of market benchmarks of similar duration and sector allocation.

Investment Balances as of June 30, 2016

Other than amounts held as currency, or the cash balance within the City's custodial bank account that is required for daily operations, substantially all funds in the City Treasury are pooled and invested to maximize investment earnings, though safety and liquidity still take precedence.

Together, as of June 30, 2016, the combined market value of the investment pool totaled \$9.8 billion, with the General Pool representing 88% (\$8.6 billion), the Special Pool representing 10% (\$959 million), and the newly created Mutual Fund Pool representing 2% (\$250 million) of the total investments of the City Treasury. Appendix II shows the schedule of Cash and Investments as of June 30, 2016.

Condition of All City Funds in the City Treasurer as of June 30, 2016

Background & Conclusions

It should be noted that investments held outside of the City Treasury are not managed by the Office of Finance, though they are considered City assets and included as such on the City's Comprehensive Annual Financial Report (CAFR). These include those held by the City's three retirement systems (\$48 billion) and restricted assets with fiscal agents and trustees (\$1.6 billion).

Additionally, certain City Departments maintain standalone bank accounts that are not controlled by Finance. Departments are required to report and certify the amounts to Finance quarterly. For our audit period, we found that all City Departments that maintained outside bank accounts had submitted certifications and/or reconciliations. Finance reported to the Controller, as of June 30, 2016, that there were 232 standalone bank accounts with cash balances totalling \$317 million.

The following exhibits provide a breakdown by investment type, for each of the investment pools, as of June 30, 2016.

Exhibit 1: General Pool Investments at June 30, 2016

General Pool – Investment Type	Fair Market Value ¹	%
US Treasury Notes	\$ 4,615,715,012	53.6%
Commercial Paper	1,414,244,455	16.4%
Medium Term Notes	1,321,557,313	15.4%
US Sponsored Agency Issues	833,146,152	9.7%
US Treasury Bills	206,761,522	2.4%
Supranational Coupons	141,952,300	1.6%
Municipal Bonds	60,884,836	0.7%
Negotiable Certificates of Deposit (CDs)	10,000,000	0.1%
Total General Pool	\$ 8,604,261,590	100%

(1) Investments are stated at fair value based on quoted market prices except for investments that have remaining maturities of one year or less at time of purchase, which are noted at amortized cost. Those account for approximately 18% of the total included in the categories above.

Exhibit 2: Special Pool Investments at June 30, 2016

Special Pool – Investment Type	Fair Market Value ¹	%
Federal Agency Issues	\$ 528,960,388	55.1%
Commercial Paper	203,753,741	21.2%
Superanational Coupons	100,229,322	10.4%
US Treasury Notes	79,781,855	8.3%
Sweep Account	46,755,276	4.9%
Total Special Pool	\$ 959,480,582	100%

(1) Investments are stated at fair value based on quoted market prices, except for investments that have remaining maturities of one year or less at time of purchase, which are noted at amortized cost. Those account for approximately 36% of the total included in the categories above.

In addition, in 2015 the Office of the Chief Administrative Officer requested that the Treasurer invest approximately \$250 million of outstanding bond proceeds in tax free obligations to comply with IRS tax law. This created a new Mutual Fund Pool, which is invested in U.S. Treasury Demand Deposit State and Local Government Securities (SLGS), that had a fair value of \$250,138,015 at June 30, 2016.

Rates of Return

The General Pool is comprised of a Core Portfolio and a Reserve Portfolio. The Core Portfolio, in conjunction with tax receipts and departmental deposits, is managed to help meet the City's daily cash flow needs. The State Code requires local agencies to denote that the agency (City) has the ability to meet its pool's expenditure requirements for the next six months; which is the City's "cash flow horizon". As such, the City's Core Portfolio consists of short-term investments and the City's Statement of Investment Policy dictates that the effective duration of investments held within this portfolio may not exceed six months. In contrast, the Reserve Portfolio is invested to maximize return, without exposing the monies to excessive market risks. Thus, the Reserve Portfolio maintains investments with longer durations.

For Fiscal Year 2015-16, the Core Portfolio's annualized rate of return was 0.40%, which was higher than the 3-month Treasury Bill Index rate of return (0.19%).⁵ Further, the Reserve Portfolio's rate of return was 2.56%, which was higher than the 1-5 Year Govt/Corp Index rate of return (2.51%).⁵ At June 30, 2016, the effective yield of the General Pool (both portfolios) was 1.16%.

Restrictions on Investments

Minimum Credit Ratings. The City's Statement of Investment Policy (which is based on the Government Code) establishes the minimum credit rating requirements for investments.

- There is no credit quality requirements for Local agency bonds, U.S. Treasury Obligations, State of California Obligations, California Local Agency Obligations, and U.S. Sponsored Agencies (U.S. government sponsored enterprises) securities.

- **Medium-term notes** must be issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any

⁵ Per the City's Investment Report dated June 30, 2016.

state and operating within the United States. Medium-term notes must have at least an “A” rating.

- **Commercial paper** issuances must have a minimum of “A-1” or equivalent rating. If the issuer has issued long-term debt, it must be rated “A” without regard to modifiers. Issuing corporations must be organized and operating within the United States and have assets in excess of \$500 million.
- **Mutual Funds** must receive the highest ranking by at least two nationally recognized rating agencies.

Concentration of Credit Risk. The City’s Statement of Investment Policy restricts the concentration of investments for common types of investment instruments, as follows:

- Commercial Paper – up to 40% of portfolio;
- Certificates of Deposit – up to 30% of portfolio; and,
- Medium-term Notes – up to 30% of portfolio.

Further, the City’s Statement of Investment Policy prohibits more than 10% of the portfolio to be invested in securities of a single issuer including its related entities, excluding “Treasuries and Agencies” investments.

Maturities. The City’s Statement of Investment Policy and the State of California Government Code 53601 establishes the maximum maturity for certain types of investments. For example, medium-term notes must mature within five years, commercial paper must mature within 270 days, and security lending agreements must mature within 92 days. Moreover, California Government Code 53601 specifies that “Where this section does not specify a limitation on the term or remaining maturity at the time of the investment, no investment shall be made in any security.....that at the time of the investment has a term remaining to maturity in excess of five year unless the legislative body grants express authority.”

Custody Services and Securities Lending

The City Treasurer contracts with Bank of New York to provide custody services and to manage a securities lending program. Under the City’s securities lending program, and in accordance with California Government Code Section 53601, the City may lend up to 20% of the City’s investment portfolio to qualified institutions on a short-term basis; however, these agreements must be collateralized with either US Treasuries or Agencies at 102%

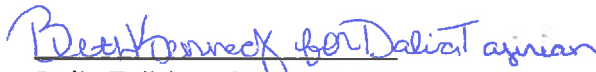
of the market value. The City can sell collateral securities only in the event of borrower default. The lending agent provides indemnification for borrower default.


As of June 30, 2016, the City had a total cash collateral holding balance of \$166,278,452 as noted in Appendix II. During Fiscal Year 2015-16, collateralizations on all loaned securities were compliant with the required 102% of the market value. The total earnings for Fiscal Year 2015-16 was \$656,488 related to the security lending program with the City receiving \$525,194 and the Bank of New York receiving \$131,294 (or 20%) commission.


Condition of Cash and Investments


The Schedules included on Appendix II show the condition of cash and investment activities as of June 30, 2016. For the Special Pools, amounts are presented by the designated Fund number as recorded in the City's Financial Management System.

Respectfully submitted,


Dalia Tajirian, CPA
Internal Auditor II


Siri A. Khalsa, CPA
Deputy Director of Auditing


Beth Kennedy, CPA, CFE
Chief Internal Auditor


Alfred Rodas, CPA, CIA, CIG, CIGI
Director of Auditing

APPENDIX I: SCOPE AND METHODOLOGY

We evaluated the Finance's compliance with the City's Statement of Investment Policy for a one-year period, July 1, 2015 to June 30, 2016. Audit fieldwork was conducted between January - March, 2017.

In performing our audit, we:

- a. Interviewed Finance staff and management to obtain an understanding of processes for authorizing, approving, recording, and monitoring cash and investment activities.
- b. Reviewed City's Statement of Investment Policy and pertinent laws and regulations, such as section 261(f) of the City Charter and California State Government Code Section 53601 and identified key compliance requirements.
- c. Tested bank account and investment reconciliations.
- d. Reviewed bank account reconciliations and quarterly certifications for accounts that are not controlled by the Treasurer.
- e. Reviewed internal controls over wire transfers, including verification that the wire transfers were properly approved.
- f. Tested for compliance with key requirements of the California State Government Code and the City's Statement Investment Policy. For example, we verified, on a sample basis, that investment purchases/sales were the best bid based on a competitive bidding process and that investments were rated at or above Standard and Poor's A-1/A or Moody's P-1/A2. We also verified that the Treasurer complied with the maximum allowable concentration percentages. (e.g., not more than 40% in commercial paper, not more than 30% in medium-term corporate notes, not more than 30% in negotiable certificates of deposit or time deposits, etc.).
- g. Reconciled the total of cash and investments on hand, and cash and investments held by banks and other safekeeping agents as of June 30, 2016 to the total shown on the books and records of the Treasurer and the Controller.

This audit was performed 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 the evidence obtained provides reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX II: SCHEDULE OF CASH AND INVESTMENTS

CITY OF LOS ANGELES - OFFICE OF FINANCE Schedule of Cash and Bank Balance As of June 30, 2016

		Balance
Cash	\$	69,720
Wells Fargo Master Concentration Account		82,375,736
Total Cash and Bank Balance	\$	82,445,456

CITY OF LOS ANGELES - OFFICE OF FINANCE Schedule of Investments As of June 30, 2016

		Market Value ⁽¹⁾
GENERAL POOL		
Core and Reserve Portfolios	\$	8,604,261,590
Total General Pool	\$	8,604,261,590
MUTUAL FUND POOL		
Mutual Funds	\$	250,138,045
Total Mutual Fund Pool	\$	250,138,045
SPECIAL POOLS		
Harbor - Fund 751	\$	47,607,739
Harbor - Fund 72W		6,032,133
Harbor - Fund 70L		561,469
MICLA Funds - 26A		4,990
Wastewater - Fund 208		413,294,755
MICLA Lease Revenue - Fund 26J		982,553
MICLA Lease Revenue - Fund 26K		491,774
MICLA Street Lights - 26U		22,980,606
MICLA Lease Revenue - Fund 26X		37,615,000
Water Short Term Revenue - M1E		15,634
Water Systems Revenue - M1L		294,701,444
Water Systems Revenue - M1N		130,192,484
Power Systems Revenue - J7D		5,000,000
Total Special Pools	\$	959,480,582
Cash Collateral Security Lending	\$	166,278,452
Total Investment Pool	\$	9,980,158,669

⁽¹⁾ Investments are stated at fair value based on quoted market prices except for investments that have remaining maturities of one year or less at time of purchase, which are noted at amortized cost.