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# **2004 Investment Compliance**

(Internally Managed Fund Portfolio)

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## (Internally Managed Fund Portfolio)

### Introduction

In 2003, the Office of the City Auditor (OCA) completed an investment process review project. This project focused primarily on compliance and governance issues and was designed to provide assurance that the investment processes and methodologies employed were consistent with a reasonable system of internal controls. One of the recommendations identified a need for further independence on the reporting of the internally managed funds. Management agreed that the OCA would conduct a compliance review of the internally managed investment portfolio in 2004. This report provides the outcome of this review.

### Background

Corporate Services Department, Treasury Management Section, Investment Management Unit is responsible for administering the investment portfolio in accordance with City Policy C212B, *Investment*, the Municipal Government Act of Alberta, and other established regulations and mandates. An investment committee appointed by the City Manager is responsible for ensuring prudent investment of the City's funds. The committee is responsible for reviewing the appointment and termination of investment managers, recommending changes to the investment policy and monitoring investment results and policy compliance. City Council, as the governing fiduciary body, periodically receives reports and recommendations from the City Manager and approves the investment policy and any amendments to it.

The City averages approximately \$200 million in short-term and \$1.6 billion in long-term investments. The City's Investment Management Unit internally manages approximately \$750 million of the investment portfolio with external investment managers managing the balance. These investments are made either on behalf of the citizens of Edmonton or for designated beneficiaries of pension or trust funds. Tables A and B present a summary of internally and externally managed investment portfolios.

The Investment Management Unit's role in relation to the externally managed funds is to monitor investment activities and to build and maintain working relationships with external investment managers. This includes compliance testing and ensuring that any deviations from policy and regulations are acted upon immediately to minimize risk exposure, evaluating adherence to stated management style and investment process guidelines, and maintaining awareness of staffing and firm changes.

The Investment Management Unit is responsible for managing three funds (Money Market Fund, Short-term Bond Fund, and Sinking Fund) and reporting on its compliance activities. In the 2003 investment review, the OCA observed that compliance reporting and managing the internal investments were not segregated. In order to ensure

objectivity in the reporting process, independence and segregation of duties is necessary.

In 2003, the City of Edmonton Reserves and Working Capital Funds were restructured to ensure that the City's investment program better matched investment objectives and time horizons with respect to fund asset mixes by maximizing returns while ensuring that investments are consistent with the funds' stated purposes.

**Table A: Investment Funds Managed Externally (in millions)**

Fund	Market Value – Dec 31, 2002	Market Value – Dec 31, 2003
Balanced Fund (Reserves Fund in 2002)	\$336	\$369
Ed Tel Endowment Fund	\$561	\$604
Pension Fund	\$107	\$117
<b>Total</b>	<b>\$1,004</b>	<b>\$1,090</b>

A brief description of each fund follows:

- The **Balanced Fund** has a time horizon of greater than five years and is a long term investment vehicle for operating and capital reserve funds, deferred revenue accounts and other similarly mandated funds.
- The **Ed Tel Endowment Fund** was created in 1995 and holds the financial assets generated by the sale of Edmonton Telephones to the Telus Corporation. The purpose of the fund is to provide an income source to the City and a financial legacy for future generations.
- The **Pension Fund** consists of the Firefighters Supplementary Pension Plan and the Fire Chiefs and Deputy Fire Chiefs Supplementary Plan.

**Table B: Investment Funds Managed Internally by City Staff (in millions)**

Fund	Market Value – Dec 31, 2002	Market Value – Dec 31, 2003
Sinking Fund	\$555	\$556
Money Market Fund* (General fund in 2002)	\$111	\$96
Short Term Bond Fund (Transportation & General Funds in 2002)	\$102	\$98
Ed Tel Defeasance	\$16	\$0
<b>Total</b>	<b>\$784</b>	<b>\$750</b>

\*Note: The Money Market fund reaches a peak each July of approx. \$375 million.

A brief description of each fund follows:

- The ***Sinking Fund*** has existed since the incorporation of the City of Edmonton and was established to fulfill the requirements of various public debenture issues (borrowings).
- The ***Money Market Fund*** (a working capital fund) represents the excess or shortfall in the daily operating requirements of the City. The purpose of this fund is to ensure that sufficient cash and liquid assets are available to cover the City's short-term obligations.
- The ***Short Term Bond Fund*** was created in December 2003 as part of the Reserves and Working Capital Funds restructuring. This fund provides an investment vehicle for working capital that is not currently required to fund City operations, but has a time horizon of less than five years.

### **Audit Objective**

The OCA's objective was to conduct an independent review of the internally managed investment portfolio activities in 2003 to ensure compliance with governing legislation and City Policy C212B, *Investment*.

### **Audit Scope**

The scope of the review was limited to the internally managed investment activities that occurred in 2003.

### **Methodology**

The OCA:

1. Developed and applied an investment audit program to determine whether internal investments were made in accordance with investment policies and mandates.
2. Conducted compliance testing as required to determine whether the internally managed investment process is providing reliable and adequate information for accountability and decision-making purposes.

### **Summary of Results**

The OCA assessment of the internally managed investment reporting in 2003 resulted in two observations that were identified and communicated to the Administration.

### **Compliance Monitoring of Internally Managed Funds (Segregation of Duties)**

During the 2003 Investment Process Review Project, the OCA recommended that funds managed by the Investment Management Unit be subject to independent compliance reviews. For 2004, the OCA agreed to complete an independent review of the internally managed fund portfolio.

The OCA reviewed two randomly sampled reporting periods for 2003 and found the following:

- All funds were managed in compliance with the Asset Mix Policy for Sinking fund and Working Capital funds.
- All fixed income investments were managed in accordance with the fixed income credit quality-rating requirements specified in the MGA and its regulations.
- The fixed income maximum percent weights were in compliance with applicable policies and legislation. Not more than 10% of the market value of the total fixed income portfolio is invested in a single corporate issue; not more than 20% of market value is denominated in non Canadian currencies; and not more than 20% of the market value is invested in CMHC insured mortgages or mortgage-backed securities.
- All Canadian fixed income position sector limits comply with the Sinking Fund mandate in place for 2003. The working capital sector and Canadian fixed income individual issuer limits were also in compliance with applicable policies and legislation.

Currently, the Investment Management Unit internally manages three funds and reports on its own compliance activity. Implementation of Recommendation 1 (segregation of investment and compliance duties) from the OCA's June 2003 Investment Review report is still underway. The Administration is currently exploring options for having compliance reporting or verification performed by an independent entity. The Administration has indicated that implementation will be complete by December 31, 2004.

### **Reconciliation of Holdings**

The OCA reviewed the internal holdings reconciliation reports to determine if the investments held by the City balance to City Accounting records (SAP Treasury System). However, since the SAP Treasury System does not record past holdings that were subsequently sold, the OCA was unable to reconcile the Royal Trust statements with the SAP Treasury System records. Pending automation of a reconciliation system, the Administration needs to implement a manual system on a go forward basis to ensure that fund balances are regularly verified. Records should be verified against Royal Trust statements of Par Value Holdings.

**Recommendation:** That monthly reconciliations of the Royal Trust statements to the SAP Treasury System continue to be processed manually with added supporting documentation on a go forward basis until such time as modifications to automate reconciliations are implemented.

**Management's Response:** *The Administration accepts the OCA recommendation and has already taken the necessary steps to incorporate the proposed action into the reconciliation process.*

## **Conclusion**

The OCA believes that implementation of the above recommendation and completion of the outstanding recommendation from June 2003 will enhance the internal control processes of the Investment Management Unit.

The OCA would like to acknowledge the cooperation we received from the Investment Management Unit during this review.