

Small Government Focus: Best Practices for Investments, Non GAAP/Cash Basis Statements, and Internal Controls

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Agenda

- ☐ Best Practices for Investments
- ☐ Non-GAAP/Cash Basis Statements
- ☐ Internal Controls

Best Practices for Investments

Take – aways

Appreciate how GFOA best practices can be the basis of a sound investment program and provide the first level of internal control.

- ☐ Investment policy
- ☐ Keep a simple cash flow forecast
- ☐ Know who you are doing business with
- ☐ Competitive procurement
- ☐ Third party custody
- ☐ Deposit protection – collateral and FHLB LOCs
- ☐ Diversify


Investment policy

- ☐ Have it!
- ☐ Keep it fresh!
- ☐ It serves as your checklist, guide and protector
 - ✓ Investment program
 - ✓ Investment leadership team

Investment policy

- ❑ Create, and have your governing body approve, a comprehensive investment policy that should stand the test of time. It should serve to guide the entire investment program.
 - ✓ Review annually
 - ✓ Update with date of most recent review
- ❑ Communicate
 - ✓ Be proactive
 - ✓ Embrace transparency

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Investment Policy

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Type: Best Practice

Background:

An investment policy describes the parameters for investing government funds and identifies the investment objectives, preferences or tolerance for risk, constraints on the investment portfolio, and how the investment program will be managed and monitored. The document itself serves as a communication tool for the staff, elected officials, the public, rating agencies, bondholders, and any other stakeholders on investment guidelines and priorities. An investment policy enhances the quality of decision making and demonstrates a commitment to the fiduciary care of public funds, making it the most important element in a public funds investment program.

Recommendation:

GFOA recommends that all governments establish a comprehensive written investment policy, which should be adopted by the governing body. The investment policy should be reviewed and updated annually and should include statements on the following:

- **Scope and investment objectives:** Tailor the scope and investment objectives to the type of investment to which the policy applies (e.g., excess operating funds, bond proceeds, pension fund assets).
- **Roles, responsibilities, and standards of care:** Identify the roles of all persons involved in the investment program by title and responsibility. Standards of care should include language on prudence (i.e., the prudent person rule), due diligence, ethics and conflicts of interest, delegation and authority, and knowledge and qualifications.
- **Suitable and authorized investments:** Include guidelines on selecting investment types, investment advisors, interest rate risk, maturities, and credit quality, along with any collateralization requirements.

Investment policy as checklist

- ☐ Scope
- ☐ Standards of care
- ☐ Objectives
- ☐ Delegation of authority
- ☐ Investments
- ☐ Financial partners
- ☐ Safe keeping and custody
- ☐ Investment parameters
- ☐ Internal control
- ☐ Reporting
- ☐ Performance evaluation

Investment policy

Investment Procedures
Manual

City of Best Practice, Illinois

Investment program



Cash flow forecast



Cash flow forecast

- ☐ Match sources and uses of funds
- ☐ Ensure liquidity for disbursements
- ☐ Improve investment earnings
 - ✓ Core or reserve funds and liquidity funds
- ☐ Manage investment risks
 - ✓ Market risk
 - ✓ Liquidity risk
- ☐ Identify short-term cash deficits
- ☐ Warn of impending problems

Cash flow forecast

Investing basics

- ☐ Over time, longer term investments can generate higher return

Cash flow forecast

Tips

- ☐ Use cash data and not accrual data
- ☐ Keep it simple
- ☐ Be conservative
- ☐ Focus on major items
- ☐ Consider changes
- ☐ Retain documentation

Cash flow forecast

Sources

- ☐ Historical data from general ledger
- ☐ Historical data from bank and pool statements
- ☐ Current year budget
- ☐ Capital project spending projections
- ☐ Schedule of investment maturities and coupon payments
- ☐ Payroll
- ☐ A/P schedules

Cash flow forecast

☐ Revenues

- ✓ Property tax
- ✓ Sales tax
- ✓ User tax
- ✓ Shared revenues
- ✓ Bond proceeds
- ✓ grants

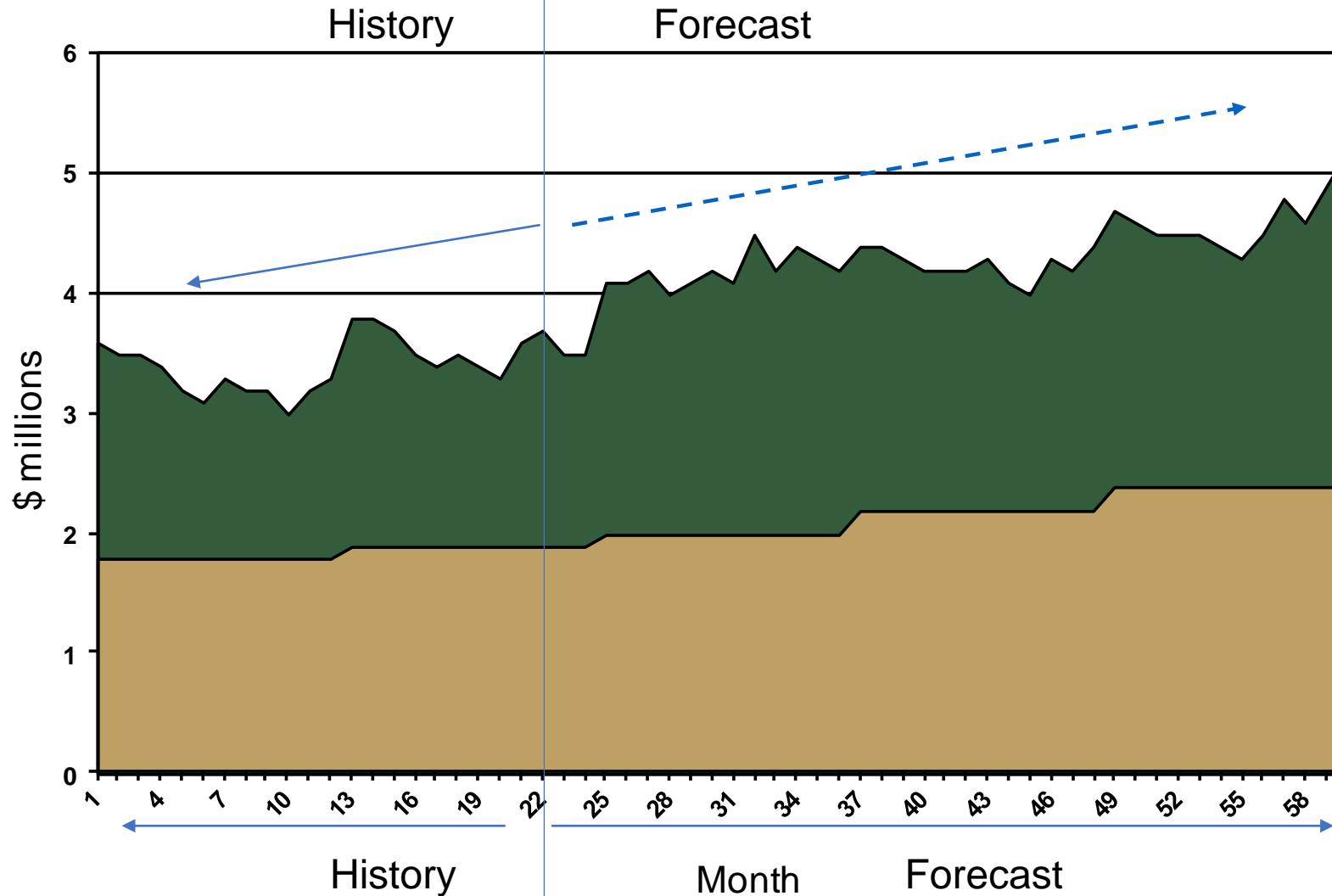
☐ Expenses

- ✓ Payroll, benefits
- ✓ Commodities
- ✓ Interest

☐ Non-recurring

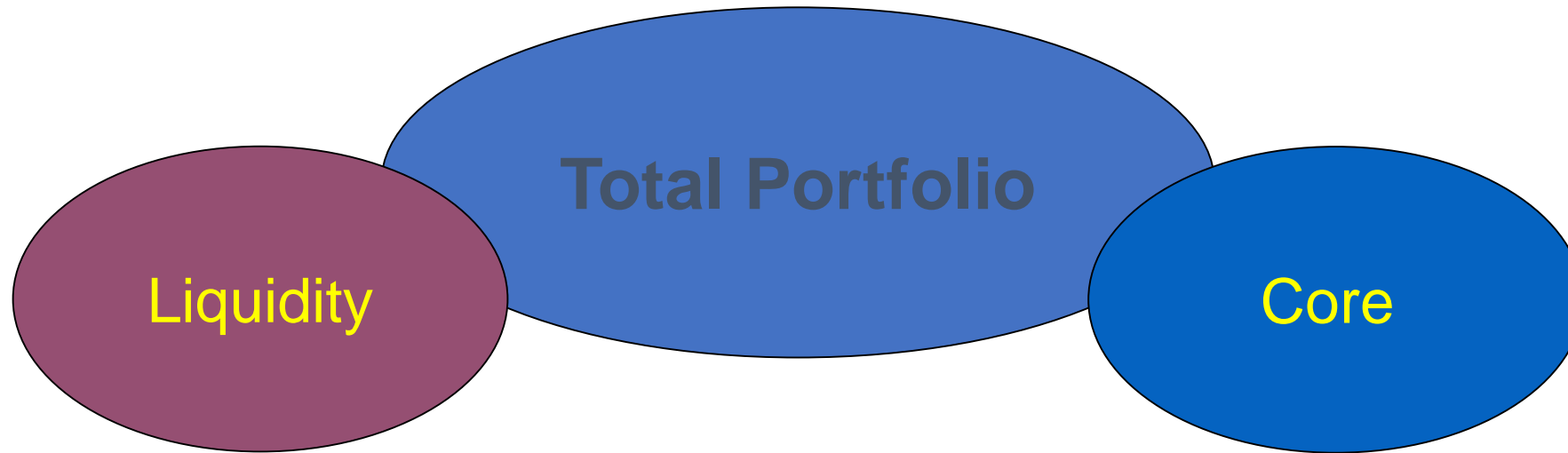
- ✓ Bond issuance
- ✓ Capital expenditures
- ✓ Lawsuits

A simpler way - Core/liquidity



- ✓ Current balance?
- ✓ Over the last few years, is it
 - Growing?
 - Shrinking?
 - Stable?
- ✓ How much does the balance fluctuate during the year?

Core/liquidity



- ❑ Liquidity layers
 - ✓ Overnight
 - ✓ Relatively short-term, or matched to expenses

- ❑ Core
 - ✓ Longer-term

Know your partners

Relationships with financial institutions – banks, depositories, broker-dealers, custodians, investment advisers – are amongst the most important for the public treasury

- ☐ Access to information and advice/expertise
- ☐ Facilitate banking, investing, custody

The selection, engagement and on-going maintenance of all financial relationships is key.

Competition

Only way to know

- ☐ RFP
- ☐ Call at least 3 brokers
- ☐ Online platforms




- ✓ Benefits, how to, cost, effect on current relationships





Safekeeping


- ❑ A firm other than the party that sells the investment provides transfer and safekeeping of the security.
- ❑ Financial firms should not serve as both broker-dealer and custodian.
- ❑ Investments should be settled in a delivery-versus-payment (DVP) basis.



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Using Safekeeping and Third-Party Custodian Services

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Type: Best Practice

Background:

The safety of public funds should be the primary objective of all governments. One of the most important protections and a control against fraud is the separation of the safekeeping and custody function from the investment function. Investment policies should include a section regarding independent third-party safekeeping or custody of securities. By arranging to have securities held by a third party, governments can effectively minimize safekeeping or custodial risk in an investment transaction.

In a third-party safekeeping agreement, the government arranges for a firm other than the party that sold the investment to provide for the transfer and safekeeping of the securities. Financial firms should not serve as both government broker-dealer and custodian. Safekeeping represents a financial institution's obligation to act on behalf of the owner under the owner's control. Custody is a more clearly defined control position by the agent responding to the owner's requirements. Custody normally does not take place in the governmental entity's depository bank.

Investments should be settled in a delivery-versus-payment (DVP) basis. In this procedure, the buyer's payment for securities is due at the time of delivery. Security delivery and payment occur simultaneously. This practice ensures that no funds are at risk in an investment transaction as funds are not released until securities are delivered, ensuring the governmental entity has either money or securities at all times during the transaction.

Recommendation:

GFOA recommends that state and local governments utilize independent third-party custodians to safeguard their investments.

Protect your deposits

- ❑ Collateral - Collateralize the government's deposits
 - ✓ follow state statute
 - ✓ pay attention to security types and maturities
 - ✓ mandate third-party safekeeping
 - ✓ require notice if value falls below “floor” or changes made

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Collateralizing Public Deposits

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Type: Best Practice

Background:

The safety of public funds should be the foremost objective in public fund management. Collateralization of public deposits through the pledging of appropriate securities or other instruments (i.e. surety bonds or letters of credit) by depositories is an important safeguard for such deposits. The amount of pledged collateral is determined by a governmental entity's deposit level and the policy or legal required collateral margin. Some states have established programs for the pooling of collateral for deposit of public funds.

Federal law imposes certain limitations on collateral agreements between financial institutions and public entities in order to secure governmental entity deposits. Under certain circumstances, as are discussed in recommendations below, the Federal Deposit Insurance Corporation (FDIC) may void an otherwise perfected security interest and leave the governmental depositor with only the right to share with other creditors in the pro rata distribution of the assets of a failed institution for the amount of deposits that exceed the FDIC coverage. Separate governmental 'corporations' such as economic development corporations or water supply corporations, etc., do not fulfill the FDIC's definition of 'public unit'¹ and therefore even accurately completed collateral definition may not be honored by the FDIC on a bankruptcy.

Recommendation:

GFOA recommends the use of a written agreement with pledging requirements as protection for state or local government's deposits. GFOA encourages governmental entities to establish adequate and efficient administrative systems to monitor such pledged collateral, including state or locally administered collateral pledging or collateral pools. To accomplish these goals, GFOA recommends the following:

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Collateral

Must have agreement that:

- ☐ is in writing;
- ☐ was approved by the board of directors of the depository or its loan committee
- ☐ has been, continuously, from the time of its execution, an official record of the depository institution

FHLB LOCs as security

- ☐ Created by Congress in 1932
- ☐ Cooperative of eleven banks
- ☐ A bank can only become a member of an FHLB in its district
- ☐ Regulated by Federal Housing Finance Agency (FHFA), like Fannie Mae and Freddie Mac
- ☐ FHLB debt interest is state and local income tax exempt
- ☐ Ten percent of annual earnings of FHLBanks annually go to affordable housing and community development programs.
- ☐ Debt issuance to fund the various FHLBanks takes place on a consolidated basis and is subject to U.S. Treasury approval; consequently, FHLBanks are jointly and severally liable for their combined obligations.
- ☐ Each FHLBank and the FHLB system, as a whole, share the Aaa/AA+ credit rating
- ☐ FHLBanks have a fiscal agency agreement with the Fed

FHLB LOCs as security

- ❑ No loss on advances in their more than eight-decade history due to collateralization of advances, and conservative underwriting
- ❑ FHLBanks are self-capitalizing. To become a member of an FHLBank, a financial institution must purchase stock in that FHLBank. When a member bank needs to access advances, it must not only pledge high-quality collateral, but also purchase additional activity-based stock in proportion to its borrowing. So during times of high advance/ lending activity, capital automatically increases.

FHLB LOCs as security

Credit Ratings

On August 29, 2017, S&P affirmed the FHLB System's long-term senior debt rating of A-1+. On November 14, 2017, Moody's affirmed the long-term rating of Aaa, and short-term deposit rating of P-1. The outlook on the FHLBank System is stable, reflecting the stable outlook on the U.S. Government.

Diversification

- ❑ Generally, greater risk increases opportunity for higher returns, along with increased volatility of returns
- ❑ Useful strategy for managing risk in portfolio is through diversification.
- ❑ Diversification of investments in a portfolio is based on the different types of risk – primarily interest rate or market risk, liquidity risk and credit risk. Diversification is achieved by investing in variety of securities with dissimilar risk characteristics that respond differently to changes in the market.

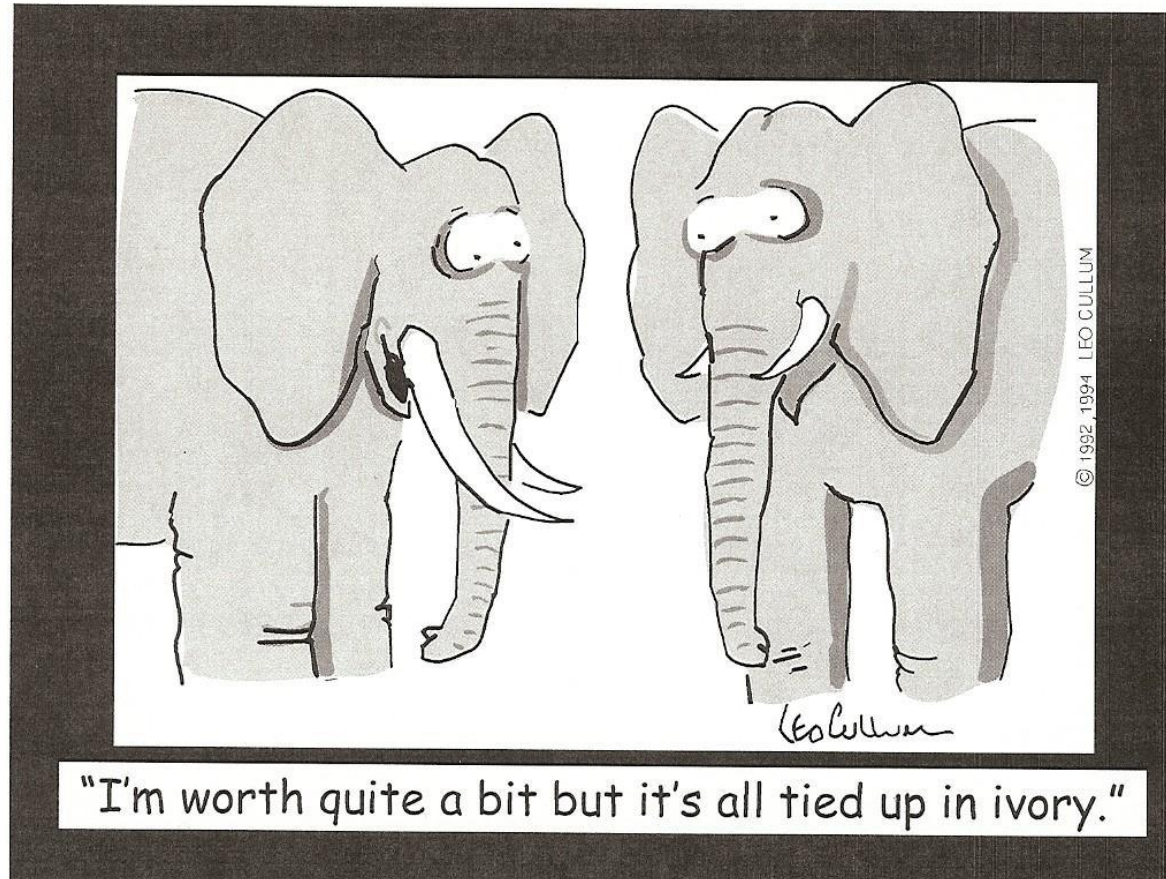
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Diversifying the Investment Portfolio

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Type: Best Practice

Background:

Government investors have a fiduciary responsibility to protect public funds and to prudently manage their investments in order to achieve the investment objectives of safety, liquidity, and return. Generally, greater risk in a portfolio increases the opportunity for higher returns. However, greater risk also increases the volatility of the returns, which is another definition of risk. The effective management of risk in a portfolio is critical for achieving an entity's investment objectives.

A useful strategy for managing risk in a portfolio is through diversification. To this end, a government should establish a target risk profile. In establishing a risk profile, an entity considers its investment objectives and constraints, risk tolerances, liquidity requirements and the current risk/reward characteristics of the market. The profile should be adjusted as needed to changes in any of those considerations. Such a profile provides a framework and discipline for making individual investment decisions that manage the risk and create the structure of a portfolio.

The government entity's risk profile, in turn, helps it determine appropriate levels of diversification. Diversification of investments in a portfolio is based on the different types of risk - primarily interest rate or market risk, liquidity risk and credit risk. Diversification is achieved by investing in a variety of securities with dissimilar risk characteristics that respond differently to changes in the market. Areas where diversification can be achieved include the maturity distribution in a portfolio (market and liquidity risk), sector allocation (credit risk), issuer allocation (credit risk), and the structures (noncallable vs. callable) of securities (market and liquidity risk).

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Non-GAAP/Cash Basis Statements

Definitions

Cash basis

Income and expenditures are recorded when payment is received or made

GAAP basis

Revenues and expenditures are recorded when they are incurred

Comparison

Attribute	Cash Basis	GAAP Basis
Definition	Accounting method in which revenue is recorded when payment is received and expenses are recorded when payment is made	Accounting method in which revenue is recorded when it is earned and expenses are recorded when they are incurred, regardless of when payment is received
Income recognized	When payment is received	When product is delivered or services is performed
Expenditures recognized	When paid	When incurred
Accounts payable/receivable	Balance sheet does not report	Balance sheet does report

Benefits

- Generally, an easier method for smaller entities and for entities that conduct business primarily in cash
- For external reporting, just one basis of accounting. GAAP basis has both modified accrual and full accrual
- Easier to understand, particularly for elected officials unfamiliar with finance or accounting
- Monthly board reporting matches external annual audit/financial statements
- Less expensive and less time consuming to prepare for external financial reporting/audit

Limitations

- Provides less information regarding revenue and expenses of an entity; accounting for outstanding commitments and prepaid cash receipts, method allows for less accurate measurement of net income or loss
- Easier to “manipulate” by delaying or accelerating when bills are paid (to match budget, etc.)
- Property tax or state revenues that are delayed could result in significant fluctuations
- Less consistency between years
- Not a complete picture of the financial health of the organization

Internal Controls

Why are internal controls important?

Accountability

- Citizens
- Grantors
- Board
- Management

Accurate Reporting

- Internal – budgeting and cash flow
- External – bondholders, grantors and financial statement users

Internal controls defined

Internal Control is a process, affected by management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with laws and regulations

Challenges for small governments

- Limited resources (personnel and fiscal)
- Errors or theft have the possibility of having a greater impact on your overall financial health
- Too much trust

Benefits for small governments

- Size of the organization allows you to have a strong understanding of the financial activity
- Board can take an active role in control structure

Internal control components

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

Control environment

- Set of standards, processes, and structures that provide the basis for carrying out internal control across the government
- Sets the tone for the government/tone at the top
- Foundation for all other control components

Control environment – practical application

- Establish current policies with regard to ethical behavior, conflicts of interest, etc.
- Enforce appropriate discipline for failure to comply with these policies
- Provide a “whistle blower” policy that allows employees to report fraud by the management team

Risk assessment

- What could go wrong?
- Risks from both external and internal sources
- Link identifies policy objectives to specific risk factors

Risk assessment - examples

- Policy of receiving the highest rate of return on investments must be linked to interest rate risk
- Policy of allowing payment from vendor statements rather than original invoices must be linked to the risk of duplicate payments
- Policy of decentralized cash receipts must be linked to the risk of untimely deposits and recording the GL

What can go wrong? Cash disbursements

- Payments could be made to fictitious vendors
- Disbursement could be made for the wrong amount
- Duplicate payments could be made on an invoice
- Disbursements could be recorded in the wrong period

What can go wrong? Cash receipts

- Funds received could be credited to the wrong customer account
- Cash could be stolen by an employee
- Amounts receivable may never be collected due to failure to follow up on past due amounts

Control activities

- The actions established through policies and procedures to help ensure that management's directives mitigate risks to the achievement of objectives are carried out
- Includes approvals, authorizations, verifications, reconciliation, security of assets and segregation of duties
- Utilize compensating controls where “textbook approach” is not practical
- Evaluate the benefit of existing monitoring controls

Control activities – practical application

- Involve elected officials – manual check signing
- Avoid unintentionally circumventing controls - signature stamps
- Have bank statements mailed directly to someone outside of accounting
- Involve a 2nd person in bank statement reconciliation – review and approve
- Use a centralized receipting location, when possible
- Be aware of wire and ACH controls – two employee sign offs
- Educate staff on what their approval/sign off means
- IT controls

Information and communication

- Requires pertinent information to be identified, captured and communicated in a form and timeframe for employees to carry out their responsibilities
- Reports must contain relevant operational, financial, and compliance information

Information and communication - example

Cash Disbursements

Communication with Departments

- Budget to actual report by budgeted line
- Request to explain certain variances

Communication with Board/Council

- Budget to actual comparison by Department
- Explanation for variance over a certain threshold

Monitoring

- Monitoring ensures that internal control continues to operate effectively
- Can be both on-going and/or annual in nature

Monitoring - examples

- Performing a review of bank reconciliation on a monthly basis and signing off as having reviewed them
- Monthly comparison of actual receipts to budgeted receipts and investigate significant discrepancies
- Monthly comparison of cash disbursements to budgeted expenditures and investigate significant discrepancies

Your questions

