

File



COMMISSIONERS OF THE LAND OFFICE

COMMISSIONERS

ADMINISTRATION

Clifton H. Scott, Secretary
John C. Rahhal, Assistant Secretary

Brad Henry, Governor
Mary Fallin, Lt. Governor
Jeff A. McMahan, State Auditor
Sandy Garrett, State Superintendent
Terry Peach, Agriculture Board President

September 30, 2004

The Honorable Brad Henry
Governor of Oklahoma
212 State Capitol Building
Oklahoma City, OK 73105

RE: Internal Audit Report
Review of the Investment Division

Dear Governor Henry:

A compliance audit of the investment division has been completed. The investment activities are in compliance with the State Statutes, CLO's Investment policy and plan, and the instructions from the Commissioners. There are a few items in the report that need to be addressed; most of the items are in accounting and reporting.

The audit covered the year to date period ending June 30, 2004. The new Investment Director, Phyllis Bolt, was hired in May 2004. She seems to be very capable and has settled quickly and nicely into the Investment Director's position.

The audit report is enclosed. Should you have questions or comments about the audit, please call me at 604-8118.

Sincerely,

Roy Cooper

Roy Cooper, CPA
Chief Internal Auditor

Enclosure: Review of the Investment Division
c: Clifton H. Scott

Commissioners of the Land Office

INTERNAL AUDIT REPORT Review of the Investment Division

PURPOSE

The purpose of this audit was to conduct a compliance audit of the investment activities of the Investment Division of the Commissioners of the Land Office (CLO). The review was to determine if CLO's investment activities are in compliance with the Constitution of the State of Oklahoma, Oklahoma Statutes, and the Commissioner's Investment Plan and Policy.

SCOPE

The scope of this audit was to review the internal and environmental controls of the investment process. The review encompassed the activities and performance of the Investment Committee, Investment Division, Investment Consulting Firm, Money (Investment) Managers, the custodial trustee's duties of the Master Custodian Bank, and the accounting and reporting of investment transactions and assets. Audit tests were performed by reviewing documents and amounts for the year ending June 30, 2004. In keeping with general auditing practices, every portion of the investment activities was not examined. The areas examined were those the auditor felt represented the highest risk of noncompliance, misappropriation or misuse.

OBJECTIVES

- Verify that the Investment Committee and the Investment Division are following the Commissioners' directions.
- Determine if the cash management practices of the CLO Investment Division are adequate and performed in a timely manner allowing for maximum earnings while providing cash flow.
- Verify that fees charged by the Investment Consulting Firm, the Master Custodial Bank and Money Managers are in accord with their contractual agreements.
- Verify that the Investment Consulting Firm is performing its duties as dictated by their contractual agreement with the CLO.
- Determine if investment practices of the Money Managers are in compliance with the CLO's Investment Plan and Investment Policy, their contractual agreements with the CLO, Oklahoma Statutes, and any regulatory requirements.

- Determine if the contractual agreements between CLO and the Money Managers and Master Custodian Bank are adequate and within the mandates of the CLO Investment Plan and Investment Policies, and State Statutes.
- Confirm compliance with the CLO policies and procedures, Oklahoma Statutes, and regulatory requirements regarding the Master Custodian Bank in its capacity as custodial trustee.
- Ascertain that the CLO's Investment Plan and Investment Policy is sufficient to provide assurance that investments are safeguarded and risk is properly monitored and evaluated.
- Determine that investments are properly recorded, and the accounting and financial statement presentation is correct.

BACKGROUND INFORMATION

Herbert Johnson, prior Investment Division Director, retired June 2003. Investment Division Director, Phyllis Bolt, was hired in May 2004. Stephen Coit performed the duties of the Investment Division Director during the interim.

Concerning Permanent Fund Principle:

A change in the Oklahoma Statutes allowed the CLO to invest in equities (stocks) in 1995. The total investment portfolio book value was \$755,573,709 with a market value of \$758,121,861 on June 30, 1995. The portfolio's book value on June 30, 2004, was \$1,105,541,350 with a market value of \$ 1,163,306,464. An increase of \$349,967,641 in book value and \$405,184,603 in market value.

The above increases came from gains in sales of securities (stocks & bonds) of \$115,658,295 and \$234,309,346 from oil & gas bonuses and royalty, and real estate sales. The difference between the cost and market value is an unrealized gain (on paper) of \$55,216,962 as of June 30, 2004.

The book and market value of the CLO investment portfolio for equity investments (stocks) on June 30, 1996 was \$205,014,712 and \$218,080,332, respectively. The book value of equity investments increased to \$409,226,649 (37 % of the total portfolio) with a market value of \$462,478,492 (40 % of the total portfolio) by June 30, 2004. Oklahoma Statutes allow equity investments to be 60% of portfolio at book value.

See attached exhibit for Review of Investment portfolio history.

Concerning Revenue Funds Income:

Bond interest has supplied 69% of the \$608.8 million income in the last ten years. Stock dividends furnished 6%, not including the hedge fund that furnished 4% of the funds in just three years. Short term investments earned 4% during this ten year period and rental income and farm loans supplied 17%. Farm loans, for the most part, have been paid off

and will not be producing any meaningful income in the future. Investment income has grown at an average rate of approximately 1.9% a year in the past ten years.

SUMMARY

The review found the CLO's investment activities to be in compliance with the Constitution of the State of Oklahoma, Oklahoma Statutes, Investment Plan and Investment Policy of the Commissioners of the Land Office, and the instructions from the Commissioners' of the CLO, except for the following exceptions and accounting problems.

1. Failure To Timely Record Directed Broker Fees In General Ledger. Annual Report is Understated.

Directed brokers are stock brokers that CLO has made an agreement with to receive a cash rebate of approximate one-half of their normal commission. This cash rebate is deposited by the brokers directly to the CLO's account at Bank of Oklahoma (BOK). The money managers, at their discretion, may use the directed brokers if they feel they are getting good execution of stock transactions. The CLO allocate the rebate money to the account of the money manager that used the brokers. This allows the money manager the benefit of not only getting the rebate money to invest in stocks, but also increases his account on which his management fee is based. Accounting for the rebate and allocating it to the money managers by the CLO is performed in the month following end of each quarter.

Finding:

On June 30, 2004, there was \$166,000 direct broker rebate fees in CLO's bank account that was not recorded on CLO's books. Each month the CLO's assets are understated. The financial statements and general ledger for fiscal year ending June 30, 2003 was understated by \$139,070.32.

Directed broker rebate fees balance is not recorded monthly to CLO's books (general ledger). It is allowed to accumulate until the end of each quarter when it is reconciled with the directed brokers' records. It is recorded to the general ledger when the funds are transferred to the money managers in the month following end of each quarter. On July 6, 2004, \$96,175.67 of the \$139,070.32 broker rebate fees were reconciled and transferred to the money managers.

Comments:

The Accounting Division Director said if he recorded the balance each month he would have to make extra reverse accounting entries when the quarterly entry is made.

The Investment Director stated "we know that it is there and we are reconciling it quarterly and moving the reconciled amount out to the proper money managers. Because

we get the money monthly and only receive the directed brokerage statements quarterly, there will always be money in the account waiting to be allocated. She indicated they will be diligent about reconciling the directed brokerage fees as soon as she gets the statements from the directed brokers. She also said they are in the process of trying to expand the number of directed brokers to make it even more profitable for us.”

Corrective Action:

The year end financial statements will be adjusted to include directed broker rebate fees balance.

2. Bank Of Oklahoma Is Charging A Quarterly Fee For CLO's Hedge Fund Investment And For Funds That Are Being Accumulated By CLO At BOK.

The CLO's contract with BOK provides BOK with an annual asset based fee of .9 basis points (.00009) on the total market value of assets held by the bank to be paid quarterly.

Finding:

a. CLO is being charged a fee of approximately \$5,901.51 annually on \$65 million that was invested in the hedge fund Structured Servicing Holdings, L.P. This is allowed under CLO's contract. The investment in Structured Services Holdings was made in 2002. Unlike other money managers BOK does not have custody of the Structure Servicing investment instruments or account for individual transactions for this account.

Comments:

The Investment Director said the overall fee is reasonable and somewhat low compared to other custody banks. She said the fee for Structured Servicing Holdings and accumulated revenue offsets the other money manager accounts that have lots of custodian services and transactions.

General Counsel said the fee for Structure Servicing Holdings, L.P. investment will be addressed when CLO renews its contract with BOK in 2006.

Finding:

b. Funds that are provided by our oil and gas revenues are accumulated in CLO's account at BOK. BOK charges their contract fee on these amounts. Sometimes the funds grows to \$25 and \$30 million before they are distributed to and invested by the money managers.

Comments:

The Investment Director said the Investment Committee is presenting the Commissioners with a six-month plan for investing accumulated revenue as it is received. This will prevent large balances from accumulating, and put them to work earning money.

3. Annual Reports Have Not Been Published Timely.

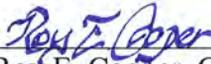
Oklahoma Statute Title 64, Paragraph. 51, B, 8 requires “Before October 1 of each year, the Commissioners shall publish an annual report of all Trust operations, presented in a simple and easily understood manner to the extent possible. The report shall be submitted to the Governor, the Speaker of the House of Representatives, the President Pro Tempore of the Senate, the State Department of Education and each higher education beneficiary. The annual report shall cover the operation of the Trusts during the past fiscal year, including income, disbursements and the financial condition of the Trusts at the end of each fiscal year on a cash basis. The annual report shall also contain a summary of each Trust's assets and current market value as of the report date.”

Finding:

The previous report was published and issued January 29, 2004 for the fiscal year ending June 30, 2003. June 30, 2002 report and June 30, 2001 report were published on January 27, 2003 and June 30, 2000 numbers were published May 7, 2001.

Corrective Action:

The Annual Report for June 30, 2004, was issued on September 9, 2004.



Roy E. Cooper, C.P.A.
Chief Internal Auditor

September 22, 2004

DISTRIBUTION

Brad Henry, Governor
Mary Fallin, Lt. Governor
Jeff McMahan, State Auditor
Sandy Garrett, State Superintendent of Public Instruction
Terry Peach, President of State Board of Agriculture
Clifton H. Scott, Secretary
John C. Rahhal, Assistant Secretary
Phyllis Bolt, Investments Division Director
Stephen Coit, Assistant Investments Division Director
Perry Kaufman, General Counsel
Tom McCreary, Accounting Division Director
Bill Andrew, Investment Committee Member
Norman Cooper, Investment Committee Member, OEA
Steve Tinsley, Investment Committee Member, Oklahoma State Auditor's Office

Review of Investment Portfolio

EXHIBIT

	<u>Equities Investments</u>		<u>Fixed Investments</u>		<u>Alternative Investment</u>		<u>Total Investments</u>	
	<u>Cost</u>	<u>Market</u>	<u>Cost</u>	<u>Market</u>	<u>Cost</u>	<u>Market</u>	<u>Cost</u>	<u>Market</u>
30-Jun-96	205,014,712	218,080,332	575,019,480	569,366,090			780,034,192	787,446,422
30-Jun-97	191,143,752	248,291,355	629,292,272	635,613,997			820,436,024	883,905,352
30-Jun-98	218,911,748	301,852,305	663,368,194	685,507,767			882,279,942	987,360,072
30-Jun-99	289,571,780	421,955,973	640,297,646	633,200,782			929,869,426	1,055,156,755
30-Jun-00	428,693,918	631,348,720	558,579,079	544,414,369			987,272,997	1,175,763,089
30-Jun-01	405,376,241	489,664,555	587,644,570	584,736,135			993,020,811	1,074,400,690
30-Jun-02	379,895,050	374,476,451	589,539,931	589,287,414	25,000,000	25,500,000	994,434,981	989,263,865
30-Jun-03	332,728,127	377,721,275	577,252,988	613,798,129	65,027,580	68,665,398	975,008,695	1,060,184,802
30-Jun-04	409,226,649	462,478,492	631,313,064	636,501,308	65,001,637	64,326,664	1,105,541,350	1,163,306,464

Amounts includes cash and cash equivalents.

