



**CITY OF COLORADO SPRINGS
OFFICE OF THE CITY AUDITOR**

**07-324 – MEMORIAL HEALTH SYSTEM
INVESTMENTS**

PUBLIC REPORT

SEPTEMBER 17, 2007

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City of Colorado Springs



Office of the City Auditor

Public Report

Date: September 17, 2007

To: Honorable Mayor and Members of City Council
Members of Memorial Health System's Audit Committee
Members of the Memorial Health System Board of Trustees

Re: 07-324 – Memorial Health System Investments

We performed an examination of Memorial Health System's (MHS) investments for the 12 months ended December 31, 2006. As of December 31, 2006, MHS had approximately \$196,894,000 in cash and investments.

The purpose of the audit was to evaluate the adequacy of the internal control environment as it related to investments, and to determine that investments were made in accordance with governing policies and procedures.

The attached audit report contains 11 findings and recommendations for areas where we believe internal controls could be strengthened.

As always, feel free to contact me if you have any questions.

Sincerely,

Jeff Litchfield
City Auditor

cc: Richard Eitel, Memorial Health System, Chief Executive Officer
Gary Flansburg, Memorial Health System, Chief Financial Office/Senior Vice President
Tracy Narvet, Memorial Health System, Controller/Associate Administrator
Steve Weber, Memorial Health System, Accounting Manager
John Wyckoff, Memorial Health System, Compliance Officer
Tom Kerwin, Memorial Health System, Chief Information Officer

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Introduction

AUTHORIZATION

We conducted this audit under the authority of Chapter 1, Article 2, Part 7 of the Colorado Springs City Code, and more specifically parts 703 through 706, in addition to Chapter 13, Article 1, Part 103 which state:

1.2.703: ENSURE PUBLIC ACCOUNTABILITY:

The City Auditor shall ensure that administrative officials are held publicly accountable for their use of public funds and the other resources at their disposal. The City Auditor shall investigate whether or not laws are being administered in the public interest, determine if there have been abuses of discretion, arbitrary actions or errors of judgment, and shall encourage diligence on the part of administrative officials.

1.2.704: PERFORM POST-AUDIT:

The City Auditor shall perform a current post-audit of the financial operation of the City government and its enterprises, and shall devote full time and effort to post-audit examinations and reporting. The City Auditor shall submit reports to Council of periodic audits of each enterprise, department, group, unit, division or account. The Auditor shall have access to the books and accounts of all City enterprises, groups, departments, administrative officials or employees charged with the receipt, custody or safekeeping of public funds.

1.2.705: DETERMINE EFFECTIVENESS AND EFFICIENCY OF PROGRAMS:

The City Auditor shall determine the extent to which legislative policies are being efficiently and effectively implemented by administrative officials. The City Auditor shall determine whether City programs are achieving desired objectives. The City Auditor shall review the administrative control systems established by the enterprises, department or group managers and by the City Manager, Utilities Executive Director and Memorial Hospital Executive Director and determine whether these control systems are adequate and effective in accomplishing their objectives.

1.2.706: EXAMINE BOOKS, RECORDS:

The City Auditor shall examine and inspect all books, records, files, papers, documents and information stored on computer records or in other files or records relating to all financial affairs of every office, department, group, enterprise, political subdivision and organization which receives funds from the City or under the direct or indirect control of the City Council. The Auditor may require any person to appear at any time upon proper notice and to produce any accounts, books, records, files and other papers pertaining to the receipt or expenditure of City funds, whether general or special. If that person fails to produce the papers, then the Auditor may request Council approval to search for and take any book, paper or record in the custody of that person or public official.

Introduction

13.1.103: ENTERPRISE STATUS; FUNDS; CITY ATTORNEY; CITY AUDITOR:

- C. In accord with the provisions of chapter 1 of this Code, the City Auditor shall have those duties and responsibilities imposed by City Council to ensure the public accountability of Memorial Hospital.

ORGANIZATIONAL PLACEMENT

The Colorado Springs Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council. The audited entity in this audit was Memorial Health System, which is an enterprise fund of the City of Colorado Springs under the direction of its Chief Executive Officer. The Chief Executive Officer reports to the Memorial Health System Board of Trustees, who are appointed by the City Council.

SCOPE AND METHODOLOGY

We performed an examination of Memorial Health System (MHS) investments for the 12 months ended December 31, 2006. As of December 31, 2006, MHS had approximately \$196,894,000 in cash and investments. The purpose of this audit was to evaluate the adequacy of the internal control environment as it related to investments and to determine that investment policy objectives were being met.

The audit was conducted in accordance with the *Standards for the Professional Practice of Internal Auditing*, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. The audit included interviews with appropriate personnel and included such tests of records and other supporting documentation as deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests were performed. Sufficient competent evidential matter was gathered to support our conclusions.

BACKGROUND

Section 1.2.704 of the City Code states: "The City Auditor shall perform a current post-audit of the financial operation of the City government and its enterprises" and section 1.2.705 states "the City Auditor shall examine and inspect all books, records, files, papers, documents and information stored on computer records or in other files or records relating to all financial affairs of every office, department, group, enterprise, political subdivision and organization which receives funds from the City or under the direct or indirect control of the City Council." Considering the magnitude of this requirement, the City Auditor has established a practice of methodically auditing all major systems at least once every five years. The purpose of these system audits is to evaluate the internal controls that are used to ensure the reliability of financial information. Investments system is one of the major systems that will be audited on a rotating basis.

Introduction

On March 27, 2007 an amendment to the Code of the City of Colorado Springs pertaining to investment allocations of MHS's Capital Improvement Fund was approved by City Council. The amendment allows MHS to invest up to fifty percent of its investments in equities or corporate bonds. Prior to this amendment, the City Code limited MHS to thirty percent investment in equities and corporate bonds. While the purpose of this amendment was to increase investment yield, it will also introduce additional volatility to MHS's investments.

OVERALL CONCLUSION

We conclude the internal control environment at MHS as it relates to investment policies, practices and objectives, except for the items noted in this report, were adequate. Also, except for the items noted in this report, the investment objectives were being met. We identified 11 areas where internal controls could be strengthened.

***We have made no determination as to which findings are more important than others.
Therefore, the findings are not necessarily listed in order of importance***

Findings, Recommendations and Responses

1. Documented policies and procedures did not adequately address all of the internal control activities in place.

Internal controls identified by MHS staff during the risk assessment process were compared to policies and procedures for adequate documentation. Investment and cash policies existed, but did not detail all control activities used to protect assets and to authorize transactions. Documentation of controls is necessary to limit variances in routine tasks and to provide consistency between current and future staffs.

Auditor's Recommendation:

We recommend that investment and cash policy and procedures be updated to accurately document all controls in place to safeguard assets and ensure proper authorizations.

MHS's Response:

We agree with the auditors' recommendation. The investment and cash policy will be reviewed and updated to incorporate more detail.

Findings, Recommendations and Responses

2. MHS had erroneously granted an unauthorized individual the ability to transact business on its behalf.

Confirmations were sent from the Office of the City Auditor to banks/institutions used by MHS for investment, safekeeping, and excess benefit trust fund administration. The confirmation requested that each bank/institution provide details regarding those individuals authorized to transact on behalf of MHS. The details provided by each bank/institution were then compared to MHS's list of authorized individuals for exceptions.

One confirmation contained an unauthorized individual, MHS's investment consultant.

Auditor's Recommendation:

We recommend that MHS request that the unauthorized individual be removed from the bank's records. In addition, we recommend that MHS investigate how the investment consultant was initially added to the bank's records of authorized individuals.

MHS's Response:

We agree with the auditors' recommendation. The bank error has already been corrected.

Findings, Recommendations and Responses

3. MHS failed to update its list of Authorized Individuals and Institutions for 2006.

During 2005, MHS terminated its relationship with an authorized institution. The list of Authorized Individuals and Institutions for 2006 was not updated to reflect the termination of this relationship.

Auditor's Recommendation:

We recommend that MHS maintain an accurate up-to-date list of Authorized Individuals and Institutions.

MHS's Response:

We agree with the auditors' recommendation. The list of Authorized Individuals and Institutions is updated at the beginning of each year. The list had already been corrected and updated for 2007.

Findings, Recommendations and Responses

4. General ledger account reconciliations were not reviewed and approved.

MHS's Capital Improvement Fund and Debt Service Reserve Funds general ledger account reconciliations were prepared by the Accounting Manager on a monthly basis. The December 2006 reconciliations that we examined did not contain evidence of timely preparation or evidence of review. One of the reconciliations we reviewed contained an error. While this error did not change the account balance, there may be other errors contained in reconciliations that could go undetected without a secondary review and approval process.

Best practices for internal controls over financial reporting require that general ledger account reconciliations be reviewed and approved by a knowledgeable person, independent of the preparer, in a timely manner.

Prior to the completion of this review, MHS implemented a policy requiring the Controller's review and approval of the Capital Improvement Fund and Debt Service Fund general ledger accounts on a monthly basis.

Auditor's Recommendation:

We recommend that all general ledger account reconciliations continue to be reviewed and approved in a timely manner by someone other than the preparer.

MHS's Response:

We agree with the auditors' recommendation. This was corrected after it was reported the first time by the City Auditors, as part of the Cash Disbursements audit.

Findings, Recommendations and Responses

5. Excess Debt Service Reserve Funds exceeded the maximum allowable.

Per the bond indenture agreement, funds on deposit in the Debt Service Reserve Funds may not exceed certain limits as defined in the agreement.

MHS had accumulated approximately \$2.0 million in excess of amount allowable for Debt Service Reserve Funds. This excess resulted in a misclassification on MHS December 31, 2006 Balance Sheet as "Restricted Funds." These funds should be classified as "Cash and Equivalents." MHS will also not be able to utilize the excess funds earned on the Debt Service Reserve Funds until such funds are moved to the operating fund.

Prior to the completion of this review MHS contacted its financial advisor regarding the excess Debt Service Reserve Funds. The financial advisor indicated that MHS is able to withdraw the amount on deposit in the Debt Service Reserve Fund in excess of the agreement limits.

Auditor's Recommendation:

We recommend that excess funds accumulated in the Debt Service Reserve Funds be transferred to the operating cash account on an annual basis. An analysis of funds on deposit in the Debt Service Funds should be completed prior to year end so that audited financial statements are accurately presented.

MHS's Response:

We agree with the auditors' comment. We agree that an analysis of the reserve should be done as of the end of each year and we are currently over the allowed amount. MHS did review the requirements during this audit and has lowered the amount in the Excess Debt Reserve Fund. MHS is currently working with our investment advisor to allow us to carry more in the Debt Service Reserve. We prefer to have additional funds in the Reserve as the requirement is based on a variable interest rate and can fluctuate daily. Having additional funds would allow us to make sure that the requirement is fulfilled.

Findings, Recommendations and Responses

6. The excess benefit plan trust funds were not evaluated within 120 days of year end as specified in plan documents.

Per the Memorial Hospital Excess Benefit Plan, the adequacy of the excess benefit plan trust assets are to be evaluated within 120 days after each plan year. The 2005 evaluation was not completed until February 6, 2007. The 2006 evaluation was not completed until June 7, 2007.

Auditor's Recommendation:

We recommend that evaluation of the adequacy of excess benefit plan trust funds be completed within 120 days after each plan year as specified in the Memorial Hospital Excess Benefit Plan.

MHS's Response:

We agree with the auditors' recommendation. Although the fund has been adequately funded all years and no adjustments have been made, we agree that the evaluation should be completed within 120 days of year end.

Findings, Recommendations and Responses

7. The Financial Advisory Agreement did not adequately address the performance criteria regarding the annual arbitrage calculation.

On an annual basis, RBC Dain Rauscher (RBC) provided an arbitrage calculation to MHS. The Financial Advisory Agreement (Agreement) with RBC did not specify terms related to the annual calculation such as completion dates, reports to be provided to MHS to support the conclusion or items that will be provided by MHS to facilitate the calculation, etc.

Auditor's Recommendation:

We recommend that details regarding the arbitrage calculation performed by RBC be added to the Agreement.

MHS's Response:

We agree with the auditors' recommendation. Future contracts and agreements with the Financial Advisor will be more specific.

Findings, Recommendations and Responses

8. Computer data was not adequately protected against unauthorized data entry or modification.

We reviewed all employees with access to add, change and delete journal entries. Our purpose was to ensure data accessibility was limited according to job function. The Accounting Manager indicated that seven employees currently require journal entry access in the performance of their job. However, 31 employees had add, change and delete access to process journal entries. The Controller and Accounting Manager had access to add, change and delete journal entries.

Prior to the completion of our audit MHS removed access to add, change and delete journal entries from 20 employees including the Controller. Eleven information system employees still had access to add, change and delete journal entries.

Auditor's Recommendation:

We recommend:

- General ledger journal entry user access be limited based on employee job requirements.
- Access should be limited to the minimum necessary to adequately perform job duties.
- Access should be restricted for those employees who approve journal entries so that they do not have access to also enter journal entries.

MHS's Response:

We agree with the auditors' recommendation.

Findings, Recommendations and Responses

9. A computer user was not provided a unique username and password as required by MHS's Compliance Policy.

MHS's Compliance Policy states that "in accordance with HIPPA Security Standards, all users that require access to confidential business information must be given their own login ID and passwords."

The Accounting Manager gained access to the financial system using a unique username and password. He then allowed another accountant to enter journal entries. The accountant had not been given his/her own login ID and password as required by MHS's Compliance Policy. Sharing of IDs and passwords falsifies the audit trail of who entered data. This falsification could impact accountability as well as the protection of assets and financial data.

Prior to the completion of our audit the accountant was given his/her own login ID and password as required by MHS's Compliance Policy.

Auditor's Recommendation:

We recommend that employees needing access to computer systems complete the appropriate Security Access Request form and go through the approval process to obtain authorized access. No employee should be permitted to work under another employee's user ID and password.

MHS's Response:

We agree with the auditors' recommendation. This was an error by MHS and was corrected immediately.

Findings, Recommendations and Responses

The following findings are presented in the context of City Code 1.2.709, which instructs the City Auditor to make periodic reports to Council which includes “recommendations for lessening expenditures, for promoting frugality and economy in City affairs and for an improved level of fiscal management.”

10. MHS may want to consider developing more detailed cash management plans, which would allow the entity to maximize its earning potential on excess cash.

MHS maintained a large amount of excess cash in its operating cash account which earned approximately 5% in 2006. The total cash balance did not appear to be necessary for daily operations. Based on MHS Daily Cash Balance report for three month’s during 2006, the average daily cash balance was \$32.2 million. For our purposes, we will assume that is representative of the year. If MHS had invested \$25 million of this balance at the 2006 annual net rate of return per MHS Investment Performance Evaluation Report of 7.7%, the incremental investment earnings would have been approximately \$675,000. The December 2006 Audited Financial Statements, Footnote Five, Long-term Debt states ‘The Health System maintains two line of credit agreements with a bank totaling \$5,000,000, which expire on July 15, 2007 and bear interest at the bank’s prime rate less .75%. No amounts were outstanding under these lines of credit at December 31, 2006 and 2005.’ This line of credit would help mitigate the risk of maintaining a lower cash account balance.

As mentioned in the Background section of this report, the City Code was amended during March 2007 to allow MHS to invest up to fifty percent of its investments in equities and corporate bonds. This amendment creates an opportunity for MHS to evaluate its investment strategy and manage excess cash to potentially earn a greater rate of return. The MHS Investment Performance Evaluation Report stated the 2006 annual net rate of return on U.S. Equity Investments at 16.4%.

Auditor’s Recommendation:

MHS should consider managing its operating cash account to maintain the minimal necessary balance for operations. The remainder could be transferred to an investment account in order to earn a higher rate of return.

MHS’s Response:

We partially agree with the auditors’ recommendation. MHS does manage the funds based on the current system needs. During 2006, MHS had several large building projects in process as well as a large electronic medical record system implementation. MHS felt it necessary to have the cash readily available for construction payments and any potential operational problems arising from the system implementation.

Findings, Recommendations and Responses

11. MHS may want to consider changing their Rate of Return Investment Objective.

The Investment Policy contained the following Investment Objective:

“The Capital Improvement Fund is expected to achieve an absolute return of 5% over rolling 5-year periods”

Selecting an absolute rate of return in a Market environment that can experience large fluctuations in short time periods is not a good indicator of fiscal management. For example, in a period of low returns, a return of 5% might not be possible, while in a period of high returns, a return of 5% might be unacceptable.

Auditor’s Recommendation:

MHS should consider using an Investment Policy Investment Objective broad enough to allow for market changes and narrow enough to comply with Uniform Prudent Investor Act per City Code.

MHS’s Response

We agree with the auditor’s comment. As mentioned in the background section of this report as well as comment number 10, MHS received approval from the City Council in March, 2007 to amend the City Code, as well as the MHS investment policy by allowing up to fifty percent of its investments in equities. MHS is currently in the process of revising the investment policy.