

DENNIS MILLIGAN
TREASURER



STATE CAPITOL
500 WOODLANE STREET, SUITE 220
LITTLE ROCK, ARKANSAS 72201

TREASURER OF STATE

Executive Summary

Dear State Board of Finance members,

I am pleased to present the Office of the Treasurer of State's Internal Audit Plan for Fiscal Year 2023. This planning document includes a summary of scope, objectives, goals, and audit methodology. It also includes an estimate of scheduled audit plan hours.

Internal Audit projects will have an adaptable time budget associated with them. If audits require more time than planned, more hours will be used to ensure accurate results. If audits require less hours than planned, direction will be sought from the Executive Team. This technique ensures audit flexibility and that the highest priority areas are well addressed.

Sincerely,

Steven Kilgore, CPA

Director of Investment Accounting
Office of the Treasurer of State

Holly Hester-Beaver

Investment Accountant,
Office of the Treasurer of State

INTERNAL AUDIT AND ACCOUNTING - ACTIVITY OUTLINE

Audit Plan Processes

A total of eighteen internal audits and two special projects are planned during the upcoming fiscal year. These audits will include review of the following audit areas:

- Broker Allocation and Trade Execution (4)
- Investment Pricing and Valuation (4)
- Investment Policy and Statutory Compliance (4)
- Investment Performance Variance Analysis (4)
- Return on Investment Distributions to Agencies (2)

Financial Reporting

- Ledger reconciliation of Investment Balances
- Return on Investment (ROI) reports
- Bond upload review
- Bond cash flow reporting to Cash Desk
- Internal risk assessment
- Development of annual audit plan
- Annual Comprehensive Financial Reporting
- External audit information provider
- Open Gov Reporting
- State Board of Finance (SBF) presentations

Special Projects

- Custodian selection
- Custodian implementation

Administration

The Internal Audit Department's responsibilities include the completion of numerous administrative tasks each year. Some of these tasks include, but are not limited to, the following:

- Agency investment reports
- Training
- General administrative

Questions

If you have any questions regarding this audit plan, please contact Grant Wallace at grant.wallace@artreasury.gov.

SCOPE

The audit will be from July 1, 2022, to June 30, 2023.

OBJECTIVES

The continuing objective of internal auditing is to assist management and the State Board of Finance at all levels in the effective discharge of their responsibilities by furnishing analysis, appraisals and recommendations concerning the investment activities of the agency. This objective is accomplished by ensuring the following:

- Compliance with applicable laws and regulations
- Reliability and integrity of financial and operational information
- Safeguarding of assets
- Effectiveness and efficiency of operations

GOAL

All work activities conducted by the internal auditors are executed to support the overall goal of Internal Audit, which is to add value and improve the operations of the agency.

AUDIT METHODOLOGY

Risk Focused Approach: Audit steps are selected with consideration of the level of inherent risk within a process; the control environment associated with the process; and the residual remaining risk.

Systematic Audit Cycle: Given the importance of the investment reporting output of distributions made to agencies, assessments of key processes are designed to take place primarily on a quarterly basis, prior to monthly distributions being made to agencies, and prior to monthly, quarterly, or annual reporting to key stakeholders.

Compliance Confirmation: Resources and regular attention will be devoted to assessing the results of compliance with applicable statutes, rules, and policies.

Operational Effectiveness Review: Internal Audit staff will seek to add value by assessing the effectiveness of investment policies to provide additional feedback for future planning.

THREE LINES OF DEFENSE

This model is based on one developed by the Institute of Internal Auditors (IIA) to describe the components of any large organization and to make clear the role Internal Audit can offer. The model is referred to as the Three Lines of Defense.

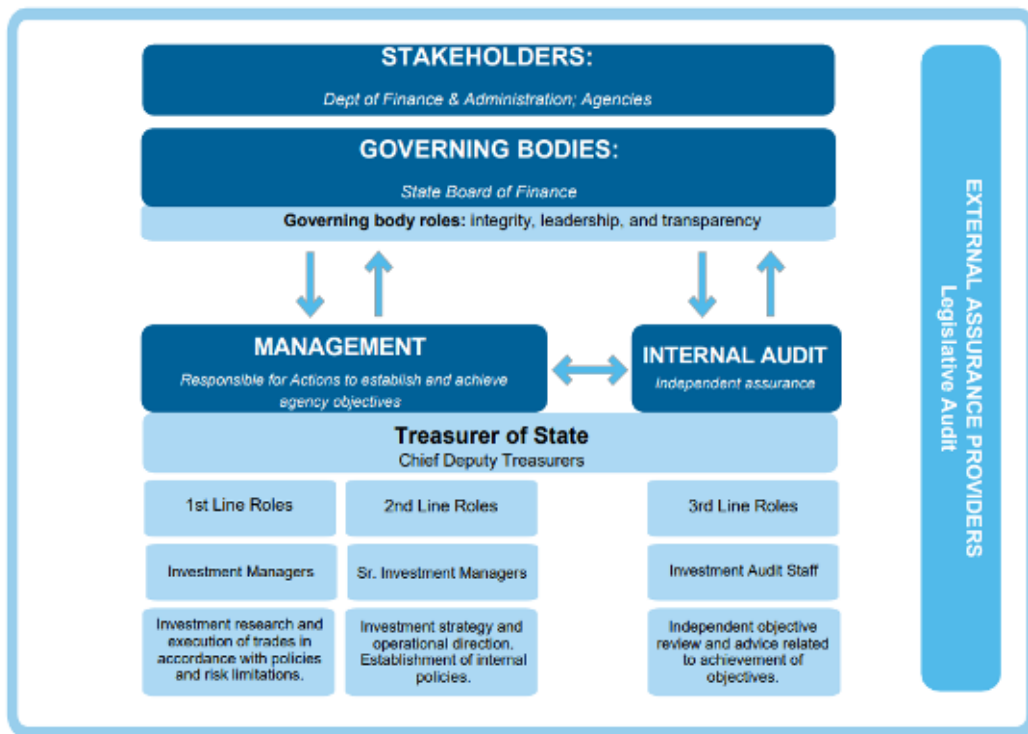
First Line Roles – Provide for delivery of products and services to clients, or to the end beneficiaries of the activity or the organization. At the Arkansas Treasury, investment managers fill these roles. They conduct research and execute trades according to the State Board of Finance Investment Policy.

Second Line Roles – Focused on the specific objectives of performance, risk management, compliance, internal control, and quality assurance. The Senior Investment Managers fill these roles. They are responsible for the establishment of internal policies, investment strategy and operational direction.

Third Line Roles – Provide for independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management, through the application of systematic and disciplined processes, expertise, and insight. The Investment Audit staff fill these roles.

This table outlines the relationships between the three lines of defense within the Office of the Treasurer of State’s investment and auditing teams. Although the elements of management are coordinated, the internal auditors formally report to the Chief Deputy Treasurer for Programs and Services, who does not have direct oversight of the investment process, and who is then able to provide direction to the Internal Audit Unit without direct conflict.

The IIA’s Three Lines Model Adapted for AR Treasury



FY 2023 AUDIT PLAN HOURS

Based on the level of review needed for each step within the investment cycle, this table represents an estimate of the internal audit hours planned for FY23.

| PLANNED AUDIT AREAS | STAFF PARTICIPATION | ESTIMATED HOURS PER STAFF MEMBER | AUDITS PER YEAR | TOTAL TIME ALLOCATION |
|--|---------------------|----------------------------------|-----------------|-----------------------|
| (1) Broker Allocation and Trade Execution | 2 | 16 | 4 | 128 |
| (2) Investment Pricing and Valuation Assessment | 2 | 32 | 4 | 256 |
| (3) Investment Policy and Statutory Compliance | 2 | 16 | 4 | 128 |
| (4) Investment Performance Variance Analysis | 2 | 16 | 4 | 128 |
| (5) Return on Investment Calculations and Methodology | 2 | 32 | 2 | 128 |
| | | Total | 18 | 768 |

| WORK CATEGORY | ESTIMATED HOURS |
|---|-----------------|
| Internal Audit Steps | 768 |
| Financial Reporting and Audit Planning | 2,452 |
| Training and Continuing Education | 80 |
| Special Projects | 160 |
| General Operational Hours | 700 |
| Total Allocated Time (2 x 40 x 52) | 4,160 |

APPENDIX

A. RISK ASSESSMENT GRID

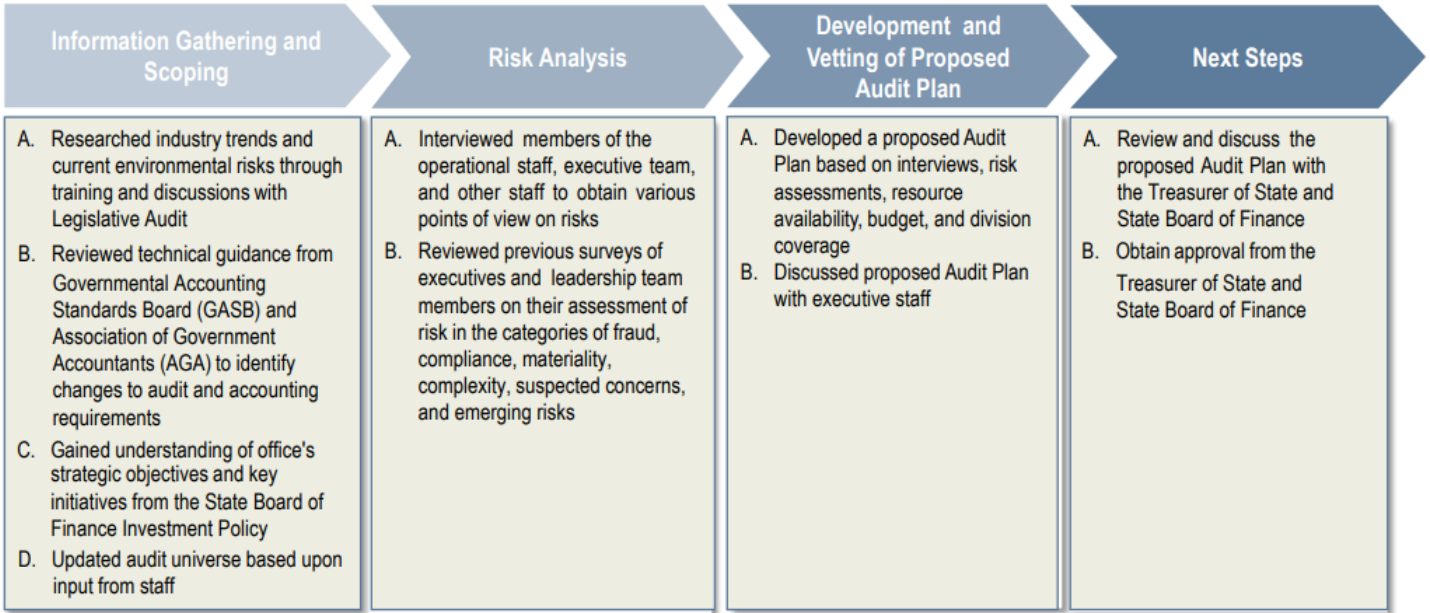
This table represents a condensed assessment of risk levels within Treasury investment processes and describes the anticipated timing for internal audit activity. A need for adjustments to the details performed for each step may arise. Step by step details of the components of each audit step are shown in Appendix E.

| INVESTMENT CYCLE STEPS | INHERENT RISKS (1 st Line) | Control Risk Mechanisms (2 nd Line) | Residual Risk | Audit Plan and Cycle (3 rd Line) |
|--|---|--|---------------|---|
| (1) Broker Allocation and Trade Execution | Moderate | Supervisory review | Moderate | Quarterly |
| (2) Investment Pricing and Valuation Assessment | Moderate | External pricing service | Moderate | Quarterly |
| (3) Investment Policy and Statutory Compliance | Moderate | Supervisory review | Moderate | Quarterly |
| (4) Investment Performance Variance Analysis | Moderate | Supervisory review | Moderate | Quarterly |
| (5) Return on Investment Calculations and Methodology | Moderate | IT Department review | Moderate | Semi-Annually |

B. INVESTMENT UNIT RISK ASSESSMENT

In coordination with Legislative Audit, and after inquiries and interviews with the Investment Team, detailed process outlines for the purchasing and sale of securities were prepared to supplement the process summaries prepared by the Investment Team.

Interviews of executive staff, other staff, and Legislative Audit feedback from prior years were used to identify areas of risk and potential internal audit projects. This information was combined into an overall audit plan designed to address critical risks to achieving Office of the Treasurer of State objectives while being sensitive to operational requirements. The Audit Plan also includes hours for ad hoc projects and special requests. The following approach was taken in creating the Audit Plan:



C. THREE LINES MODEL

The Institute of Internal Auditors developed a “Three Lines Model” to show how the risk and control environment of an organization should best work in conjunction with the internal audit staff to reduce the level of residual risk prior to review by external auditors and to enhance operational outcomes. The result should be greater efficiencies in the work of the external auditors and greater operational effectiveness. The Three Lines Model may be explained as representing (1) the checks and balances within the execution of a process (for example, user authentication mechanisms at the trading level), (2) management structures and supervisory feedback, and (3) internal audit activities.

Within the Three Lines Model, some degree of overlap between the functions provided at the First and Second lines is expected: First line staff may often provide the initial input received on activities and complete checklists or spreadsheets to confirm compliance. In addition, some important roles are performed by independent external vendors such as the trading system, the accounting platform, and the bank custodian, which each impact the process flow and control environment.

The Internal Audit Unit assesses risk levels after review of the processes for each unit as described by process leaders, the Executive Team, and process descriptions made available by the independent accounting platform. Inherent Risk is defined in terms of the potential magnitude, and frequency, of a failure to operate as intended. Control Risk measures the potential that the controls built into a process, or hard-wired into a system, might not always be designed properly or operate effectively to mitigate the relevant risk. Within this level of risk, management oversight may be included.

The level of remaining risk, the “residual risk,” then determines the depth and frequency of review performed by internal auditors. The level of review performed by internal auditors, if well conducted and documented, may then influence the depth and types of further review required by Legislative Audit.

Risk levels were assessed based on discussion of the processes for each unit as described by the Investment Team and the Executive Team. These controls and mechanisms have also been reviewed by Legislative Audit staff. Additional reference material on investment accounting audit plans is to be received and considered this fiscal year. Therefore, the number and types of audits may be expanded.

D. AUDIT METHODOLOGY

The goal of the Treasury Accounting and Audit Unit is to take a risk-focused approach to its activities, and to concentrate its efforts on those areas most likely to benefit from additional review. Office of the Treasurer of State activities are primarily divided between those which have an abbreviated time-period between receipt and distribution to agencies, and those which have a longer life cycle or holding period before expenditure, i.e., the saving and investment roles of the Treasurer, which are the focus of this summary.

The review cycle for the audit steps is organized to allow for identification of issues for remediation prior to the issuance of financial performance and inventory reporting to external parties, and prior to distribution of investment income to depositing agencies. Assessment of longer-term processes and compliance-related issues were placed on a quarterly review cycle. The output of daily, weekly, or monthly assessments and adjustments will generally be in the form of memos to internal staff or to the accounting platform vendor. Audit findings on compliance and longer-term trends will be sent to the Executive Team with follow-up addressed as needed.

Risk assessment is defined as a “systematic process for assessing and integrating professional judgements about probable adverse conditions and/or events.” The risk assessment process provides a means of organizing and integrating professional judgements for development of the annual work schedule. For the current fiscal year, the Office of the Treasurer of State risk assessment was conducted (1) at the agency level to identify functions mostly likely to benefit from internal audit review and (2) within the divisions or functions selected for audit by the Internal Audit Team. Moderate to high-risk activities were identified for planning appropriate internal audit procedures. An assessment of the key functional areas of the agency identified the savings and investment life cycle to be the more specialized division and most likely to benefit from internal audit activity. The following summary outlines the assessment of risk and recommended levels of internal audit activity based on discussion with key staff members and the executive leadership team.

E. PRIMARY AUDIT STEPS

| | |
|---|--|
| <p>(1) Broker Allocation and Trade Execution</p> | <ul style="list-style-type: none"> • Confirm transaction reports contain accurate brokerage firm names for each trade. • Identify any data quality issues. • Review Bloomberg trade tickets to supplement missing data from custodian uploads. • Compilation of totals of trades by broker, segmented by type of security and type of trade (buys versus sells). • Comparison of brokerage usage to the State Board of Finance approved broker list. Review of concentrations by firm, counting affiliated firms together. • Reporting concentrations and broker usage data to Executive Team. |
| <p>(2) Investment Pricing and Valuation Assessment</p> | <ul style="list-style-type: none"> • Selection of a sample of dates for review of end-of-business day pricing including all securities in inventory on the selected dates for comparison between the primary pricing service from the accounting platform and the alternative pricing service from the bank custodian. • Select a subset of each sector to confirm how often the pricing is updated by the pricing service. • Review average variances between pricing services by type of bond. • Assess the potential impact of pricing methodology on return-on-investment calculations and distributions to agencies. • Advise on whether changes in the primary pricing service should be considered or whether additional inquiries are needed as to the methodology for valuation. |
| <p>(3) Investment Policy and Statutory Compliance</p> | <ul style="list-style-type: none"> • Review the financial reporting output to assess the overall portfolio mix for compliance with the applicable statutes and State Board of Finance policy. • Review in detail any holdings, which as of the end of a month, appear to be above or close to the applicable limits. Calculate whether there would have been compliance with these limits on the last business days before the trades. • For securities which do not appear to have been in compliance on the trade date, inquire of the Investment Team. • Report to the Executive Team on any apparent non-compliance areas discovered. |
| <p>(4) Investment Performance Variance Analysis</p> | <ul style="list-style-type: none"> • Review the return-on-investment report by sector for results not clearly related to known investment market trends. • Review details by security to identify negative rates of return or unusually high rates of return. • Review selected securities showing significant variances in total return or book return for the performance assessment period dating back to the purchase dates. • Review trade summaries prepared by the Investment Team for securities showing significantly adverse results as measured from the purchase date. |

| | |
|---|---|
| | <ul style="list-style-type: none"> • Report to the Executive Team on reasons identified for major performance outliers. |
| <p>(5) Return on Investment Calculations and Methodology</p> | <ul style="list-style-type: none"> • Review the return-on-investment results for reasonableness and recalculate monthly returns from aggregate daily returns. Confirm book return annualizes properly. • Review outliers among daily returns and returns by security type. • Review the components of returns for proper accounting results. • Assess the impact of the methodology used to compare calculated return-on-investment to the amounts distributed. • Report to the Executive Team on any proposed change in the distribution process or the return-on-investment calculation methodology. |

ANNUAL CONFLICT OF INTEREST STATEMENT

International Standards for the Professional Practice of Internal Auditing (Standards) require internal auditors to have an impartial, unbiased attitude and avoid any conflict of interest in fact and appearance. The Standards state:

- Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.
- If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.
- Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.
- Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.
- Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.
- If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting engagement.

Disclosure of impairments to independence: (Please list or indicate "None".)

None

I certify that I have disclosed any information of which I am aware that might be viewed as impairment to my objectivity in conducting FY2023 Internal Audit activities. Any future impairment to my independence or objectivity that arises during the fiscal year will be immediately reported to the Treasurer of State and the State Board of Finance.

Steven Kilgore
Internal Auditor

8-10-2022
Date

ANNUAL CONFLICT OF INTEREST STATEMENT

International Standards for the Professional Practice of Internal Auditing (Standards) require internal auditors to have an impartial, unbiased attitude and avoid any conflict of interest in fact and appearance. The Standards state:

- Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.
- If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.
- Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.
- Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.
- Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.
- If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting engagement.

Disclosure of impairments to independence: (Please list or indicate "None".)

NONE

I certify that I have disclosed any information of which I am aware that might be viewed as impairment to my objectivity in conducting FY2023 Internal Audit activities. Any future impairment to my independence or objectivity that arises during the fiscal year will be immediately reported to the Treasurer of State and the State Board of Finance.

Holly Bellwe
Internal Auditor

8-10-2022
Date