



Lawrence F. Alwin, CPA
State Auditor

May 6, 2002

Members of the Legislative Audit Committee:

For fiscal year 2001, state entities subject to the Public Funds Investment Act (Act) continued to report substantial compliance with the Act's requirements. Compliance is important to protect the investment funds managed by state entities from mismanagement and loss. Investing state entities must satisfy requirements regarding (1) investment policies, (2) management controls, (3) quarterly investment reports, (4) ethics and conflict of interest disclosures, (5) training of Board members and investment officers, and (6) broker/dealer acknowledgments of investment policies.

Results of audits submitted by state agencies, universities, and community college districts disclosed the following:

- Twenty-five of 27 state agencies and universities subject to the Act were deemed to be in full or substantial compliance with the Act. As in prior years, Texas Southern University (TSU) reported new and continuing instances of noncompliance with the Act. The TSU areas of noncompliance involved investment policies, quarterly reports, ethics policies and conflicts of interest, and training requirements. Additionally, Midwestern State University did not complete a compliance audit as required by the Act. The market value of the 27 entities' investments, excluding TexPool (\$12.004 billion), was \$2.850 billion as of August 31, 2001.
- Independent audits of the 50 community college districts suggest that all districts were in overall compliance with the Act. The independent auditors of 24 districts stated without qualification that the districts they audited complied with the Act. However, independent auditors for 26 districts chose not to express an auditor's opinion regarding compliance with the Act. The State Auditor's Office maintains that the lack of an auditor's opinion provides insufficient assurance that adequate work was conducted to determine compliance with the Act. The 50 districts reported \$1.226 billion in investments at August 31, 2001.
- State entities invested most of their funds of investment classes authorized under the Act. Only \$9.266 million of state entity funds were invested in derivatives as of August 31, 2001, compared to \$12.7 million at August 31, 1999, and \$65 million at August 31, 1998.

It is uncertain whether the Texas Treasury Safekeeping Trust Company, part of the Office of the Comptroller of Public Accounts, is subject to the Act when it manages funds for clients that may themselves be subject to the Act. It is also uncertain whether three semi-independent agencies (Board of Public Accountancy, Board of Architectural Examiners, and Board of Professional Engineers) are exempt from the requirements of the Act. Legislation may be required to resolve the uncertainty.

We appreciate the cooperation of the state agencies, universities, and community college districts. Please contact Carol Smith, Audit Manager, at (512) 936-9500 with any questions.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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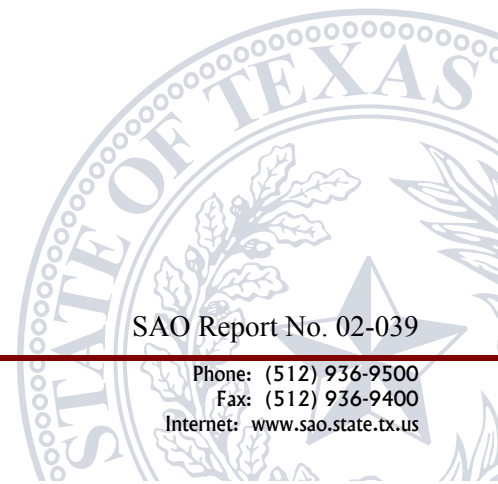
cc: All Executive Directors, Presidents, and Chancellors
of the state entities included in this report

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Section 1:

Most State Entities Complied With the Requirements of the Public Funds Investment Act

In fiscal year 2001, state entities subject to the Public Funds Investment Act (Act) continued to report substantial compliance with the Act's requirements. The provisions of the Act can be found in Section 2256 of the Texas Government Code.

Section 1-A:

Twenty-Five of 27 State Agencies and Universities Fully or Substantially Complied With the Act

Twenty-five of 27 state agencies and universities subject to the Act were deemed to be in full or substantial compliance with the Act. As in prior years, Texas Southern University (TSU) reported new and continuing instances of noncompliance with the Act. The TSU areas of noncompliance involved investment policies, quarterly reports, ethics policies and conflicts of interest, and training requirements. (See Table 1 for greater details.) Additionally, Midwestern State University (Midwestern) did not complete a compliance audit as required by the Act. Midwestern management reported extraordinary circumstances that delayed compliance. Midwestern's internal auditor was involved almost full time in work for the Board of Regents involving an investigation. Subsequent to completing the investigation, the internal auditor resigned for personal reasons. Midwestern reports that it is selecting a new internal auditor and states that conducting an audit in compliance with the Act will be the new internal auditor's "first order of business." Table 1 denotes instances of noncompliance for each entity that did not fully comply. Table 2 lists the entities that reported full compliance. As of August 31, 2001, the market value of the 27 entities' investments was \$2.850 billion (excluding TexPool's \$12.004 billion in assets).

Contents

Most State Entities Complied With the Requirements of the Public Funds Investment Act	1
State Entities Reported That They Invest Most of Their Funds in Authorized Types of Investments.....	6
Changes Made by the 77th Legislature Affected the Act.....	9
Uncertainty Exists Regarding the Act's Applicability to Certain State Agencies.....	9

ATTACHMENT

Table 1

Compliance Status of State Agencies and Universities			
Agency/University	Market Value of Investments^a at August 31, 2001	Areas of Noncompliance	Comments From Entity's Audit Report
Entities Deemed Not to Be in Compliance With the Act^b			
Midwestern State University	\$ 24,229,150	No Audit	Did not conduct a compliance audit as required by the Act.
Texas Southern University	\$ 27,353,028	Investment Policies	Investment policies did not include some of the required components.
		Quarterly Reports	Some investment values on the quarterly "Schedule of Changes of investment Assets" were misclassified.
		Ethics Policies and Conflicts of Interest	University officials did not file annual Conflict of Interest Statements with the President's Office. This deficiency also was noted for fiscal year 1999.
		Training Requirements	Management did not comply with all training requirements. This deficiency also was noted for fiscal year 1999.
Entities Deemed to Be in Substantial Compliance With the Act			
Department of Economic Development	\$ 98,535,339	Reporting	Investment schedules in Board reports do not include all required items.
Sam Houston State University	\$ 67,246,423	Training Requirements	Investment Officer is past due on the biennial training requirement.
School for the Blind and Visually Impaired	\$ 484,141	Record Keeping/ Documentation	Improvements in documentation and record keeping are warranted.
State Bar of Texas	\$ 24,718,368	Reporting and Approval	Reporting and board-of-directors-approval deficiencies were identified.
Stephen F. Austin State University	\$ 33,220,829	Report Reconciliation and Obtaining Receipts	Improvements are recommended concerning reconciling collateral balances and statement amounts, and obtaining safekeeping receipts.
Texas Youth Commission	\$ 789,845	Training Requirements	Investment Officer is past due on the biennial training requirement.
^a Investments exclude demand deposit balances in banks and funds held in the State Treasury. ^b Entities that reported instances of noncompliance were classified as "deemed noncompliant" based on (1) the nature of the noncompliance, (2) the number of instances of noncompliance, and (3) whether the noncompliance has been longstanding.			

Source: Entity-reported unaudited data

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Table 2

Entities That Reported Full Compliance With the Act	
Entity Name	Market Value of Investments^a as of August 31, 2001
Angelo State University	\$ 99,398,221
Board of Law Examiners	\$ 1,779,583
Department of Criminal Justice	\$ 13,574,928
Department of Housing and Community Affairs	\$ 1,124,386,708
Lamar Institute of Technology	\$ 2,934,566
Lamar State College - Orange	\$ 5,249,730
Lamar State College - Port Arthur	\$ 6,752,904
Lamar University - Beaumont	\$ 40,345,306
Local Government Investment Pool (TexPool) ^b	\$ 12,004,485,903
Parks and Wildlife Department	\$ 0 ^c
Real Estate Commission	\$ 2,086,125
Southwest Texas State University	\$ 195,563,510
Sul Ross State University	\$ 16,116,533
Texas Military Facilities Commission	\$ 5,711,485
Texas State Technical College System	\$ 8,492,343
Texas Woman's University	\$ 62,877,437
University of North Texas	\$ 149,449,327
University of North Texas Health Science Center at Fort Worth	\$ 44,652,054
Water Development Board	\$ 794,215,754

^a Investments exclude demand deposit balances in banks and funds held in the State Treasury.

^b TexPool is a public funds investment pool created to invest funds on behalf of local governments such as cities, counties, and school districts. The Comptroller of Public Accounts and the TexPool Advisory Board have oversight responsibility over the assets of TexPool.

^c The Parks and Wildlife Department has no directly controlled funds subject to the Act. However, an indirectly controlled entity, the Parks and Wildlife Foundation of Texas, Inc., has \$6.483 million of investment assets.

Source: Entity-reported unaudited data

Section 1-B:

All 50 Community College Districts Reported Compliance With the Act

Independent audits of 50 community college districts reported that all districts were in overall compliance with the Act. The 50 districts reported \$1.226 billion in investments as of August 31, 2001. Table 3 shows the market value of investments for each community college district.

All 50 districts relied upon their independent financial auditors to meet the compliance audit requirements of the Act. The independent auditors of 24 districts stated without qualification that the districts they audited complied with the Act. However, the independent auditors for the remaining 26 districts chose not to express an auditor's opinion regarding the districts' compliance status. While choosing not to express an opinion may conform with generally accepted accounting principles, the State Auditor's Office maintains that this approach does not provide sufficient assurance that adequate work was conducted to determine the districts' compliance with the Act. Districts that received limited statements are designated with an asterisk in Table 3.

The following language is typical of the limited form of assurance provided by 26 independent auditors of community colleges:

As part of obtaining reasonable assurance about whether X Community College's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, including the Public Funds Investment Act, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. **However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion.** The results of our tests disclosed no instances of noncompliance that are **required to be reported under *Government Auditing Standards***.
[emphasis added]

Providing assurance that the financial statements are free of material misstatement is different from auditing for compliance with the Act. Failure to comply with the requirements of the Act would not necessarily have an impact on the financial statements. Government auditing standards are not relevant to reporting compliance with the Act. An entity is either in compliance with the Act, or not. All occurrences of noncompliance should be reported.

Section 2256.005(n) of the Act provides that "a report under this subsection shall be prepared in a manner the state auditor prescribes." Consequently, the State Auditor's Office intends to communicate to the districts that beginning with the next biennial reporting requirement (January 1, 2004) limited statements regarding compliance with the Act will not be sufficient.

Table 3

Market Value of Investments for Community College Districts as of August 31, 2001	
Community College District	Investments^a
Alamo Community College	\$ 85,104,030
Alvin Community College ^b	2,888,057
Amarillo College ^b	76,565,332
Angelina County Junior College ^b	7,784,268
Austin Community College	49,896,776
Blinn College	21,802,842
Borger Junior College	5,516,073
Brazosport Junior College	21,615,251
Central Texas College	46,566,816
Cisco Junior College ^b	2,766,731
Clarendon College	2,931,668
Coastal Bend College	6,862,370
College of the Mainland ^b	6,970,841
Collin County Community College ^b	42,207,782
Dallas County Community College ^b	199,262,390
Del Mar College	21,324,140
El Paso County Community College	52,667,809
Galveston Community College ^b	4,482,469
Grayson County College	11,465,997
Hill College ^b	4,983,972
Houston Community College System	60,255,862
Howard County Junior College ^b	7,313,085
Kilgore Junior College ^b	10,593,507
Laredo Community College ^b	29,869,197
Lee College	35,092,883
McLennan County Junior College	14,649,270
Midland Community College ^b	8,214,763
Navarro College ^b	7,755,040
North Central Texas College	7,498,811
North Harris Montgomery Community College ^b	66,927,133
Northeast Texas Community College ^b	1,471,002
Odessa Junior College ^b	28,248,275
Panola College	4,831,095
Paris Junior College ^b	2,455,236
Ranger College	262,035
San Jacinto College	50,678,380
South Plains College	14,277,030
South Texas Community College	18,877,140
Southwest Texas Junior College ^b	3,270,020

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Market Value of Investments for Community College Districts as of August 31, 2001	
Community College District	Investments^a
Tarrant County College ^b	103,124,951
Temple College ^b	10,181,717
Texarkana College	12,316,499
Texas Southmost College ^b	6,207,042
Trinity Valley Community College	4,703,478
Tyler Junior College ^b	7,575,172
Vernon Regional Junior College	1,878,115
Victoria County Junior College ^b	10,589,247
Weatherford College of the Parker County ^b	7,514,786
Western Texas College ^b	2,483,979
Wharton County Junior College	13,333,020
Total Investments	\$ 1,226,301,060
^a Investments exclude demand deposit balances in banks.	
^b These districts received limited statements of compliance from their independent auditors.	

Source: Entity-reported unaudited data

Section 2:

State Entities Reported That They Invest Most of Their Funds in Authorized Types of Investments

State entities invested most of their available funds of investment classes authorized under the Act. The largest category of investment assets was lower-risk short-term cash management investments. These include such investments as bank deposits, money market type funds (including TexPool), repurchase agreements, and short-term government securities. The majority of the remaining assets were invested in long-term government fixed income securities, guaranteed investment contracts, mortgage-backed securities, no-load mutual funds, and equities.

The extent of state entities' investments in potentially high-risk mortgage-backed derivative securities was small as of August 31, 2001. Total derivative securities investments totaled \$9.266 million. This is a decrease from fiscal year 1999 when state entities reported \$12.7 million of derivative investments and from an approximate \$65 million invested in derivatives as of August 31, 1998. The Act prohibits most derivative investments but allows entities to hold prohibited investments purchased prior to September 1, 1995. Figures 1 through 3 show the allocation of state agency, university, and community college investment assets by investment category as of August 31, 2001.

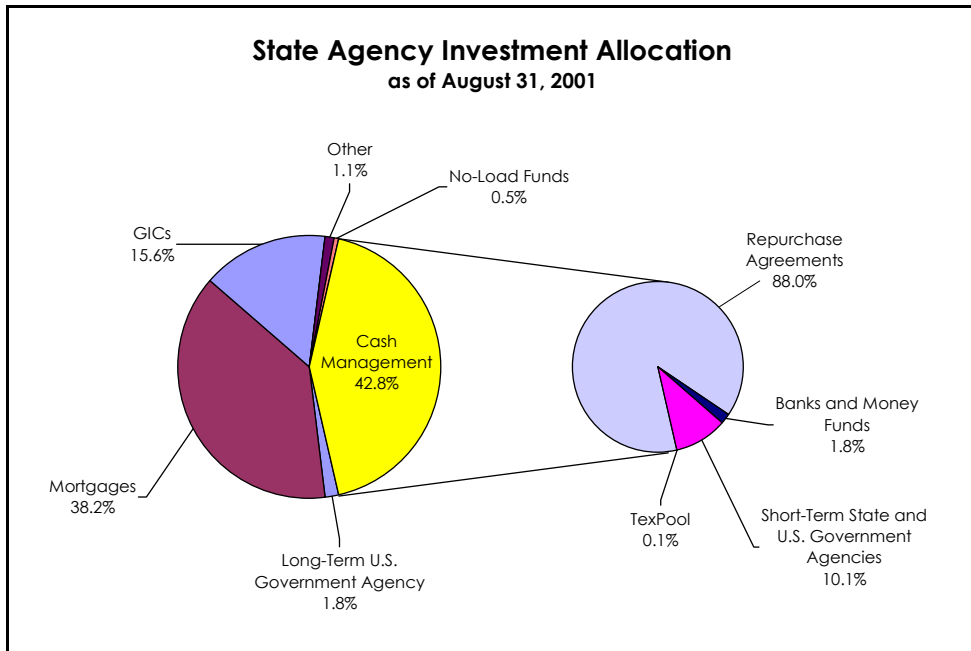
Four community college districts and four universities reported owning potentially high-risk mortgage-backed derivative securities as indicated in Table 4.

Table 4

Cost and Market Value of Mortgage-Backed Derivatives Held By Community College Districts and Universities as of August 31, 2001			
	Cost	Market Value	Unrealized Gain/(Loss)
Community College District			
Amarillo College	\$ 122,892	\$ 294,312	\$ 171,420
Coastal Bend College	\$ 12,911	\$ 12,901	\$ (10)
Odessa Junior College	\$ 1,895,250	\$ 1,540,187	\$ (355,063)
McLennan County Junior College	\$ 303,809	\$ 285,228	\$ (18,581)
University			
Angelo State University	\$ 492,895	\$ 475,875	\$ (17,020)
University of North Texas Health Science Center at Fort Worth	\$ 1,977,898	\$ 1,779,885	\$ (198,013)
Southwest Texas State University	\$ 4,365,233	\$ 4,327,135	\$ (38,098)
Sul Ross State University	\$ 564,460	\$ 550,674	\$ (13,786)

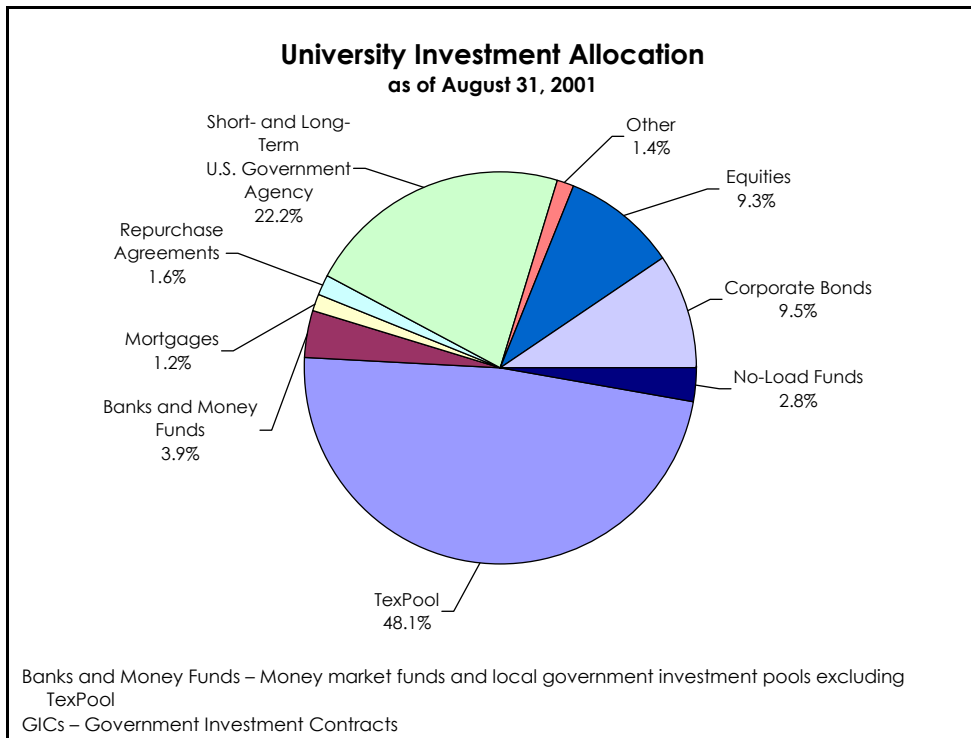
Source: Entity-reported unaudited data

Figure 1



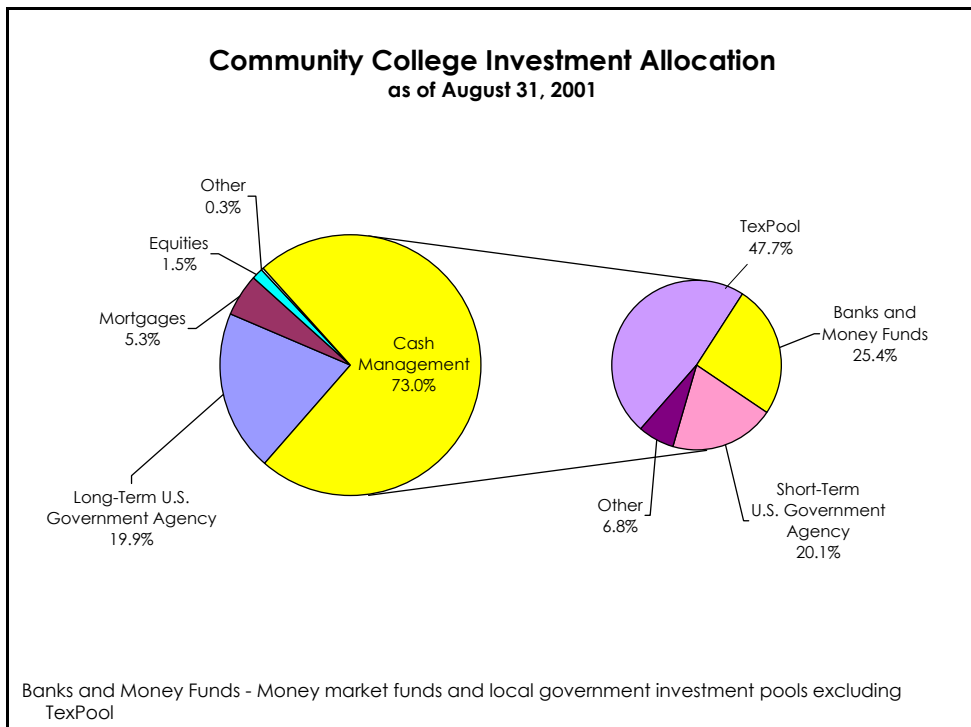
Source: Entity-reported unaudited data

Figure 2



Source: Entity-reported unaudited data

Figure 3



Source: Entity-reported unaudited data

Section 3:

Changes Made by the 77th Legislature Affected the Act

House Bills 675 and 2957, passed by the 77th Legislature in 2001, affect compliance with the Act:

- House Bill 675 reduced the Act's training requirements for water districts. Both the number of people required to take the training and the number of training hours have been reduced.
- House Bill 2957 authorized entities covered by the Act to accept United States Government instrumentality-issued letters of credit as collateral for bank deposits. The Federal Home Loan Bank of Dallas, a U.S. Government instrumentality, is developing a program to issue letters of credit pursuant to House Bill 2957. Public entities holding bank deposits are required by the Public Funds Collateral Act, found in Section 2257 of the Texas Government Code, to have collateral for deposits over the federal deposit insurance limits.

Section 4:

Uncertainty Exists Regarding the Act's Applicability to Certain State Agencies

Legislation may be required to resolve uncertainty regarding the Act's applicability to certain state agencies. Senate Bill 736 (77th Legislature) designated the Board of Public Accountancy, the Board of Architectural Examiners, and the Board of Professional Engineers as semi-independent agencies as part of a pilot project. One aspect of this semi-independent status is the ability to maintain funds outside of the State Treasury. Senate Bill 736 directs each agency to deposit its funds "in interest-bearing deposit accounts" at the Comptroller of Public Accounts' Texas Treasury Safekeeping Trust Company (Trust Company). The Comptroller is required to contract with each agency for the maintenance of the deposit accounts "under terms comparable to a contract between a commercial banking institution and its customers." While Senate Bill 736 makes clear that each agency must deposit its funds with the Trust Company, it does not specifically exempt agencies from the compliance and allowable investment requirements of the Act.

The Trust Company itself is exempt from the Act and operates pursuant to

Texas Treasury Safekeeping Trust Company

The State Treasury, part of the Office of the Comptroller of Public Accounts, conducts operations through the Texas Treasury Safekeeping Trust Company (Trust Company). The Comptroller of Public Accounts is the sole officer, director, and shareholder of the Trust Company.

The Trust Company provides the Treasury with direct access to the Federal Reserve System. With this access, the Treasury can initiate and receive wire transfers, pay state warrants, and settle and maintain custody of government securities without using a separate bank. On September 1, 2001, the mission of the Trust Company was expanded to include providing investment management services for Treasury and client (other public entities) funds in a manner similar to that of The University of Texas Investment Management Company.

the same compliance and allowable investment requirements that govern the State Treasury (Chapter 404 of the Texas Government Code). However, Senate Bill 736 does not clarify whether the Trust Company is subject to the compliance and allowable investment requirements of the Act when it manages funds for clients who are themselves subject to the Act.

In addition, Senate Bill 736 directs the Trust Company to act as a deposit-taking institution, similar to a commercial bank, for the three semi-independent agencies. Acting as a deposit-taking entity similar to a bank contradicts provisions of the Trust Company's authorizing statute, raises questions as to whether the Trust Company is liable for investment losses, and potentially moves the Trust Company closer to being subject to various federal banking laws.

Recommendations:

The Legislature may wish to consider the following:

- Create a safe harbor whereby any state entity may avoid compliance with the Act if it employs the Trust Company to act as all three of the following: (1) a fiduciary, (2) an investment advisor, and (3) a safekeeping custodian of a state entity's funds. Such a safe harbor would encourage entities, many of which have little or no investment experience, to place responsibility for the investment of public funds into presumably expert hands while relieving state entities of the potentially burdensome responsibility of complying with the Act. Adoption of this recommendation presupposes that the Trust Company would be governed by an appropriate body of fiduciary law, such as the Uniform Prudent Investor Act.
- Clarify that the Trust Company is not subject to the Act when it manages funds for clients that may themselves be subject to the Act.
- Clarify that the Trust Company is not a deposit-taking institution similar to a bank whereby the Trust Company guarantees the return of the deposit. Instead, the Trust Company should act as a fiduciary, and investment advisor, and a safekeeping custodian for its clients.

Objective, Scope, and Methodology

This review reports on state entities' compliance with the Public Funds Investment Act (Texas Government Code, Chapter 2256). Investing state entities must satisfy requirements regarding (1) investment policies, (2) management controls, (3) quarterly investment reports, (4) ethics and conflict of interest disclosures, (5) training of Board members and investment officers, and (6) broker/dealer acknowledgments of investment policies. State entities consist of state agencies, state universities, and community college districts.

State entities subject to the Act must submit a compliance audit report to the State Auditor biannually. We collected and analyzed (1) internal audit reports, (2) external audit reports, and (3) investment portfolio compositions. The entities provided the information contained in this report; we did not audit the reports or investment data provided.