Financial Related Audit of

Tom Green County Investments

Office of the State Auditor
Lawrence F. Alwin, CPA

July1995

Report No. 95-147

Key Points Of Report

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Key Facts And Findings

- Poor management controls over Tom Green County's investment function, including the lack of oversight and monitoring, allowed over 65 percent ($12.7 million) of the County's funds ($19.4 million) to be invested in long-term, high-risk collateralized mortgage obligations (CMOs), resulting in liquidity problems. County officials have indicated the need to begin liquidating these investments to meet current obligations. Actual losses that will be incurred from the liquidation cannot be estimated due to constantly changing market conditions.

- As of March 31, 1995, market values reflect a $4.5 million unrealized loss for all of the County's CMO investments. Millions of dollars were invested in these volatile derivatives over a four-year period, leaving the County with a CMO portfolio consisting of 66 percent high-risk inverse floaters and 34 percent various fixed rate classes.

- The construction bond funds carry a major portion of these investments. Almost 85 percent of bond proceeds issued for jail construction are invested in CMOs, resulting in an unrealized loss of approximately $3.7 million as of March 31, 1995. The potential investment losses could lead to increased costs for the jail facilities.

- Tom Green County's operating budget for fiscal year 1995 is $32.4 million. The County's total population is approximately 98,400 and includes the city of San Angelo, Texas.

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This financial related audit was conducted in accordance with Government Code, § 321.013(a). The financial related audit was undertaken as a result of requests from the Legislative Audit Committee and Tom Green County.

Table of Contents

Table of Contents, concluded

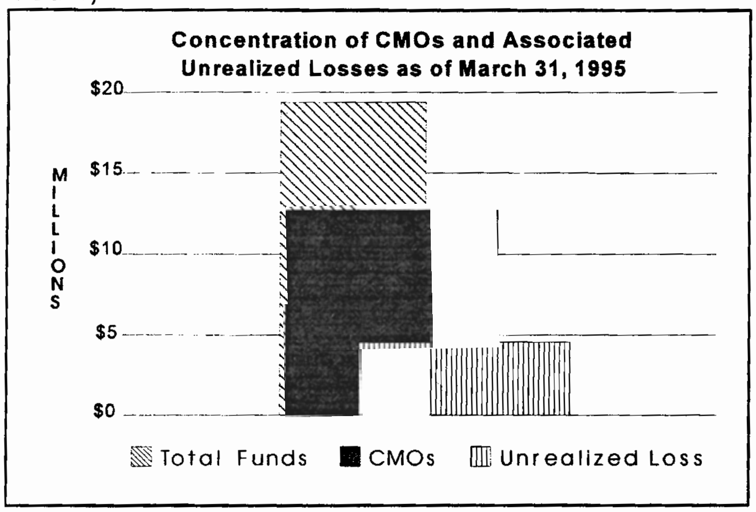
Appendices:

Executive Summary

Poor Management Controls Resulted in Liquidity Problems

Poor management controls over Tom Green County's investment function, including the lack of oversight and monitoring, allowed over 65 percent ($12.7 million) of the County's funds ($19.4 million) to be invested in long-term, high-risk collateralized mortgage obligations (CMOs), resulting in liquidity problems. (See Figure 1.) As of March 31, 1995, market values reflect a $4.5 million unrealized loss for the County.

Figure 1
Concentration of CMO Investments for Tom Green County



County officials have indicated the need to begin liquidating these investments to meet current operating costs. Actual losses that will be incurred from the liquidation cannot be estimated due to constantly changing market conditions. Twelve of the 16 funds with derivatives have more than one half of their balances invested in CMOs.

Investment management controls were weak. Although the County's investment policy addresses safety, liquidity, and yield, it does not contain clearly defined portfolio diversification limits, tolerable (acceptable) risk levels, or expected rates of return.

Other weaknesses in the management controls over the investment function include:

- inadequate control procedures to detect problems in a timely manner
- inappropriate accounting entries resulting in inaccurate information
- inadequate segregation of job responsibilities

Investments were transferred between funds at book value to ease liquidity problems. The transfer of the investments delayed the detection of liquidity problems by other County officials. County officials estimate that, as of January 1995, over $1.5 million of the investments in the current portfolio were transferred between funds at book value.

The transfer of investments when book value is higher than market value means the fund receiving the investment is giving up more cash than the investment is worth. Funds receiving the investments are, in effect, absorbing the loss for the fund that actually purchased the investment. This condition occurred during 1994 because market values declined on the County's CMOs as interest rates rose.

Collectively, County Officials Share Responsibility for Ensuring That Public Funds Are Protected

Under the County government structure, officials are elected to their positions and maintain some aspects of autonomy from other elected officials in the County. Nevertheless, certain officials share in the responsibility for ensuring that public funds are safeguarded from loss, misuse, and abuse.

This includes ensuring that funds are invested appropriately. The Commissioners' Court and the County Treasurer are elected officials, and the County Auditor is appointed by three district judges who are also elected to their positions.

In Tom Green County, the County Treasurer has responsibility for investing the County's funds, and the County Auditor and the Commissioners' Court are responsible for the oversight and monitoring of these activities. Given this shared responsibility, the County Treasurer, the County Auditor, and the Commissioners' Court all have an obligation to understand the risks associated with County investments. Before the County makes any investment, County officials should have the knowledge and expertise needed to understand the investment, provide oversight, and monitor investment transactions. If all officials do not have the requisite expertise and training needed to fulfill these responsibilities, the investment should not be purchased.

While there is shared responsibility for overseeing investments, the primary responsibility for investment decisions is delegated to the County Treasurer. Over a four-year period, the former County Treasurer invested millions of dollars in high-risk mortgage derivatives. These volatile investments are inappropriate for the types of funds used by the County, especially considering the extent of CMO investments. The potentially long-term investments purchased with short-term and intermediate-term funds is inappropriate to meet the County's cash needs.

The General Fund, which currently reflects a 32 percent investment in CMOs, should not consist of long-term investments. General Fund money should be immediately available to meet the current operating needs of the County. Investment of Tom Green County's General Fund in long-term investments jeopardizes the County's ability to meet current obligations.

CMO investments continued to be purchased after November 1993, when a broker's letter advised the former County Treasurer to diversify the portfolio. Seventeen of the 22 CMO investments currently owned by the County were purchased after the date of this letter.

The lack of oversight by the County Auditor further weakened investment management controls. Investment controls and related activity have not been reviewed by the County Auditor's Office in at least five years. The explanations offered by the County Auditor for the lack of audit activity were that the former County Treasurer refused to provide supporting documentation when requested and that had she (County Auditor) been more knowledgeable, she might have recognized the warning signals related to investment activity.

The County Auditor should have an understanding of the investments held by the County in order to properly monitor this activity. The County Auditor should be able to assess and evaluate management controls, identify weaknesses, and recommend corrective action to ensure that invested public funds are protected.

The lack of oversight and monitoring by the Commissioners' Court also contributed to the County's current financial situation. Monthly investment reports were submitted to the Commissioners' Court that reflected each investment, the balance, the coupon rate, and the stated maturity date. However, the Commissioners' Court did not question the reported investment maturities ranging from the year 2007 to 2023. Market values were not included on the report.

Commissioners interviewed indicate they placed complete reliance on the former County Treasurer. Each month, investment reports were accepted and approved by a vote of the Commissioners' Court with little or no discussion relating to investment performance.

Reliance Was Placed on Brokers and Dealers in Making Investment Decisions

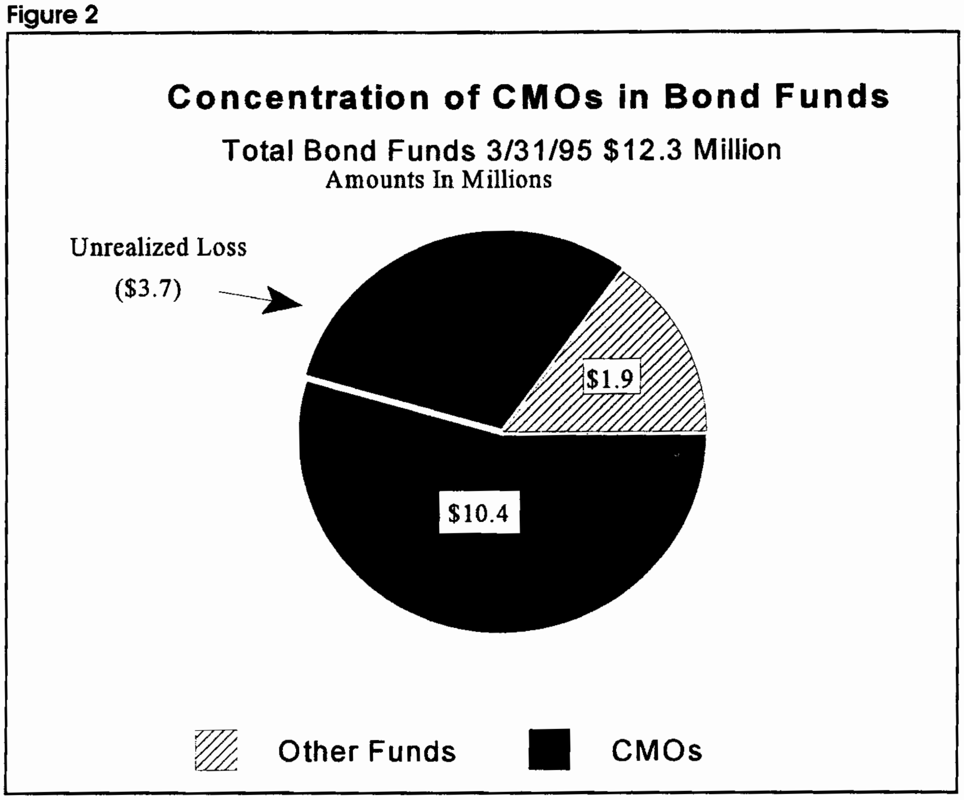
A goal of brokers and dealers is to earn money through the sale of investments. Investment personnel often rely on these professionals to help them understand risks and benefits associated with various investment instruments.

Interviews with certain County investment personnel indicate that they placed significant reliance on brokers when making investment decisions. The County Treasurer's Office does not have an independent means to fully analyze the complex CMOs. Investment decisions were apparently made based on Bloomberg data provided by the brokers and dealers.

The Construction Bond Funds Carry a Major Portion of the CMO Investments

Almost 85 percent ($10.4 million) of the combined debt proceeds issued for jail construction are invested in CMOs. The market values ($6.7 million) of these investments have declined to the extent that there is a material impact on the money available for jail construction. As of March 31, 1995, the unrealized loss on the investment of debt proceeds exceeds $3.7 million. (See Figure 2.)

Figure 2



Debt proceeds were invested inappropriately. The maturity dates of the CMO investments held by the construction bond funds extend longer than the debt's maturity. The stated maturity dates of the CMO investments in the bond funds range from 2007 to 2023, with 13 of the 22 CMOs maturing in 2023. The 1994 certificates of obligation mature in 2014, while four of the six investments held by that fund have stated maturities either in 2016 or 2023.

In order to ease liquidity problems, bond proceeds were transferred to other funds in exchange for investments. These investments were transferred at book value, rather than market value. As a result, bond funds gave up more cash than the investments were worth.

County officials estimated that $1.5 million of investments in the current portfolio have been transferred. Of that amount, over $1 million represents cash transferred from the bond funds in exchange for investments.

Interest and sinking funds, established to repay current principal and interest due on the debt, are heavily invested in CMOs, which have lost substantial value. As a result, more than $248,000 was borrowed from the General Fund to meet debt service obligations that were due on February 1, 1995, for two separate bond issues.

Delays in jail construction have increased the County's investment losses. County taxpayers have been repaying debt for almost three years for jail facilities that are not yet under construction. Delays in construction have occurred due to controversy over proposed sites for the jail and the size of the facilities.

The Investment Portfolio Was Inadequately Diversified

The CMOs held by the County represent almost 69 percent of the County's total investment portfolio. The value of these CMOs has decreased significantly, resulting in an unrealized loss of $4.5 million for the County. The decline in market value of these CMOs has a significant impact on the inadequately diversified portfolio. Had the County's investment portfolio been adequately diversified, the loss in market value and resulting liquidity problems would not have been as severe.

Inadequate diversification of investments concentrates risk within a portfolio. Investing heavily in the same type of instruments magnifies the associated risks. Investment performance of the portfolio becomes dependent on limited types of investments. Rates of return on investments fluctuate dramatically in an inadequately diversified portfolio. About 66 percent of the County's CMO investments are high-risk inverse floaters, while the remaining 34 percent represent various fixed rate classes of mortgage derivatives.

Summary of Management's Responses

Responses from the County Judge, County Treasurer, and County Auditor are included in Appendices 2 through 4 of this report. The County Judge and the current County Treasurer have indicated that the recommendations contained in this report are in the process of being implemented. The County Auditor does not agree with portions of the report.

Executive Summary

Summary of Audit Objectives and Scope

Our objectives were:

- to prepare a report disclosing the current status of the County's investment portfolio
- to evaluate management controls over the County's investment function and provide recommendations to strengthen controls
- to determine the effect of derivative investments on bond proceeds issued to construct jail facilities

The scope of this review included consideration of the investment portfolio's current status and the existence of management controls over the investment function.

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Section 1:

Poor Management Controls Resulted in Liquidity Problems

Poor management controls over Tom Green County's investment function, including the lack of oversight and monitoring, allowed over 65 percent ($12.7 million) of the County's funds ($19.4 million) to be invested in long-term, high-risk collateralized mortgage obligations (CMOs), resulting in liquidity problems. As of March 31, 1995, market values reflect a $4.5 million unrealized loss for the County. (An unrealized loss is the difference between an investment's book value and its market value, but is not recognized until the investment is sold.)

Mortgage derivatives, or collateralized mortgage obligations, are securities created using the underlying cash flows from mortgage-backed securities (mortgage loan pools) as collateral. Uncertainty exists regarding the exact timing of principal return because the mortgage payments are influenced by:

- changes in interest rates
- the current economic climate
- the geographic makeup of the underlying mortgage loans

The CMOs are subject to "extension risk" which causes the maturity of the investment to extend as interest rates rise. As a result, the market value of these volatile investments varies dramatically as market conditions change.

Investments purchased for expected maturities of one to five years could now extend as long as 20 to 25 years. Some of Tom Green County's inverse floaters reflect stated maturity dates of 2023.

The monthly cash flows received by the County decrease as the maturities extend. Tom Green County has not received any principal payments on six of the CMOs that were purchased between August 1993 and February 1994.

County officials have indicated the need to begin liquidating these investments to meet current obligations. Actual losses that will be incurred from the liquidation cannot be estimated due to constantly changing market conditions. Twelve of the 16 funds with these derivatives have more than one-half of their balances invested in CMOs. Figure 3 represents CMO investments and related unrealized losses by fund.

Figure 3
CMO Investments by Fund

Fund Name	Fund Description	Amount Invested in CMOs as of 3/31/95	Percent of Funds Invested in CMOs	CMO Market Values as of 3/31/95	Unrealized Loss on CMO Investments
Workers' Compensation Fund	Used to pay all premiums and claims	$ 49,725	99.1%	$ 42,649	($7,076)
Cafeteria Plan Trust Fund	Pays employees' deductions and claims	4,005	55.0%	3,748	(257)
Unemployment Fund	Pays premiums on unemployment insurance	18,024	59.3%	16,867	(1,157)
Library/Hughes Settlement Fund	Settlement from Hughes estate for library use only	413,275	97.4%	185,091	(228,184)
TGC Bates Fund	Fund restricted for library use only	74,792	80.5%	69,640	(5,152)
General Obligation 1994 Construction Fund	Debt issued for jail construction	1,239,044	51.6%	837,798	(401,246)
Certificates of Obligation, Series 1993 Construction	Debt issued for jail construction	945,390	93.4%	570,319	(375,071)
County Clerk Preservation Fund	Fees collected by County Clerk for expenses incurred by County Clerk's Office	71,469	69.2%	60,314	(11,155)
Uninsured Motorist Fund	Covers third-party insurance	12,158	84.8%	10,789	(1,369)
Contractual Obligation Fund[1]	Debt service fund for debt issued to purchase equipment	51,805	100.1%	44,164	(7,641)
General Obligation Refunding Bonds, Series 1987	Debt service fund, used to repay bonds issued in 1987	145,144	99.4%	125,290	(19,854)
Certificate of Obligation, Series 1992 Construction Fund	Debt issued for jail construction	8,257,323	92.9%	5,271,653	(2,985,670)
Other Funds	Various	1,432,818	29.3%	926,912	(505,905)
TOTALS		$12,714,972	65.6%	$8,165,235	($4,549,737)

[1]A negative cash balance in the Contractual Obligation Fund results in over 100 percent of the fund invested in CMOs.

Section 1-A:

Investment Management Controls Were Weak

Although the County's investment policy addressed safety of principal, liquidity, and yield, it did not contain clearly defined portfolio diversification limits, tolerable (acceptable) risk levels, or expected rates of return. In addition, there has been no investment strategy to guide investment personnel on issues concerning liquidity needs and the types of funds invested.

Inappropriate accounting entries and the lack of control procedures resulted in delaying the detection of investment losses. Appropriate accounts are not maintained to record investment activity, making certain information unavailable for decision-making purposes. Historically, the County has maintained only two accounts to record investment activity: investments and investment income. This method of accounting does not comply with generally accepted accounting principles.

- There is no account to record gains and losses on the sale of investments. Maintaining a separate account for gains and losses on investment sales can provide the Commissioner's Court and the County Auditor with information about the extent of trading and/or sales taking place in the portfolio.

- Accrued interest receivable is not recorded in a separate account. Accrued interest receivable represents interest earned, but not yet received.

- Premiums and discounts on investments are not amortized. The amortization of premiums and discounts is necessary to determine accurate book values on investments.

- The County Treasurer does not receive periodic statements from the custodian bank. These statements should be obtained and reconciled to the subsidiary ledger or general ledger to determine the accuracy of the reported investment balances. Statements from the custodian bank reflect investment balances on a monthly basis and can be used as a management tool to ensure accuracy of the accounting records.

- Inappropriate accounting entries for the CMO investments were made by the former County Treasurer. There is no evidence of the County Treasurer's signature or the County Auditor's approval before the transactions were entered into the accounting system. As a result, interest payments from investments were applied to the principal balances. This same lack of controls exists currently in the Treasurer's Office. Without authorization and approval of accounting entries, inaccurate account balances could continue to be recorded.

The lack of segregation of duties related to the investment function left all investment decisions with one person. The former County Treasurer had sole discretion over investment decisions which included the authority to initiate the acquisition, transfer, and disposal of investments. In addition, the former County Treasurer had the authority to determine the amount of money to be invested, the duration of the investments, and the type of investments purchased.

To address this issue, the Commissioners' Court is in the process of establishing an investment committee that will include a citizen with investment experience. The responsibilities of this committee will include:

- approving any investments with maturities greater than one year
- approving any sale of investments that would result in a loss
- overseeing the investment of the County's funds

Policies and procedures and the total composition of the investment committee have not yet been finalized. It has not yet been determined how often the County Treasurer will report to the committee or when the committee will report to the Commissioners' Court. In finalizing the committee's policies and procedures, the Commissioners' Court should recognize that while investment oversight can be delegated to the committee, the Commissioners' Court has ultimate responsibility for the County's funds.

There is no written ethics policy or guidelines pertaining to the relationships with brokers, banks, etc., and to personal investment activities for investment personnel or the Commissioners' Court. Ethics policies strengthen management controls and guard against the appearance of impropriety or conflicts of interest. Although no evidence of conflict of interest was noted, an ethics policy can establish clear guidelines of permissible behavior to employees and management. These policies and procedures will be critical to the success of the newly established investment committee.

During our review, we noted other issues that weaken the accountability for cash and investment transactions:

- Depository bank reconciliations are not signed and dated. Explanations for reconciling items are sometimes vague and difficult to follow.

- The same person who makes the investment decisions reviews the portfolio to determine if any investments have not received principal and interest payments for the month.

- No one is assigned the responsibility for reviewing the investment subsidiary ledger for completeness. The County Treasurer relies on monthly reconciliations of the general ledger (maintained by the County Auditor) and the subsidiary ledger (maintained by the County Treasurer) to determine accuracy and completeness. However, these reconciliations are not formalized, reviewed, or initialed and dated by the preparer or reviewer.

- There are no automated controls over the subsidiary ledger system. Unique passwords are not assigned to each user to ensure the security of subsidiary ledger data. Treasury personnel share the same password.

Recommendation:

We recommend that the County strengthen controls over investments by:

- Establishing procedures to ensure compliance with the Public Funds Investment Act, as recently amended by the 74th Legislature.

- Revising the investment policy to tighten control and monitoring of investment activity. The investment policy should establish diversification limits, acceptable (tolerable) risk levels, and expected rates of return. Certain investments should be prohibited from the County's portfolio if personnel do not possess the necessary background and expertise needed to evaluate complex financial instruments, such as collateralized mortgage obligations.

- Developing an investment strategy that aligns with the goals and objectives set forth in the investment policy. The written strategy should consider liquidity needs and the types of funds invested. High-risk investments should not be allowed in the County's portfolio.

- Preparing cash forecasts/projections periodically to ensure that the County's liquidity needs are met. The investment strategy should consider the cash projections in determining the type of investments to be acquired and the length of maturities.

- Obtaining and reconciling statements from the custodian bank on a monthly basis to ensure the accuracy of investment balances. Prepare a formal reconciliation indicating the initials of the preparer and the date. Another person should review the reconciliation and initial and date indicating approval.

- Ensuring appropriate accounting entries are made to accurately record investment activity. Establish accounts for gains/losses on investment sales, accrued interest receivable, and amortization of premium/discount on investments.

- Reviewing and approving transactions before entry into the accounting system to ensure that only appropriate and authorized transactions are entered. Explanations should be provided on journal entries to justify changes in account balances.

- Developing an ethics policy for investment personnel which provides guidelines pertaining to relationships with brokers, banks, and external advisors and which includes procedures to guard against possible conflicts of interest.

Other procedures needed to improve management's controls over cash and investing transactions include:

- Developing a formalized process for depository bank reconciliations and reconciliations between the general and subsidiary ledgers. Reconciling items should be fully explained. These reconciliations should be signed and dated by both the preparer and reviewer.

- Establishing unique passwords for data entry into the investment subsidiary ledger system to ensure the accountability and integrity of the investment balances.

- Obtaining training for investment personnel on various types of investments and their associated risks. Investments should not be purchased, unless the risks and benefits of the instruments are fully understood.

Section 1-B:

Investment Transfers Delayed the Detection of Liquidity Problems

Investments were transferred between funds at book value to ease liquidity problems. The transfer of the investments delayed the detection of liquidity problems by other County officials. County officials estimate that, as of January 1995, over $1.5 million of the investments in the current portfolio were transferred between funds at book value.

The transfer of investments at book value from January 1994 to the present means the fund receiving the investment is giving up more cash than the investment is worth. Funds receiving the investments are, in effect, absorbing the loss for the fund that actually purchased the investment. Transfers of investments should be clearly documented so those approving the transactions may recognize the true effect.

Investments should be transferred at market value when restricted funds are involved. Some of the County's funds are restricted for specific purposes. For example, the County received about $400,000 in the fall of 1994 from a settlement that restricted the money's use for the County Library. Subsequently, CMOs were transferred from other funds to the Library/Hughes Settlement Fund where the unrealized losses were absorbed using the $400,000. The funds transferring the investments became liquid and were used to meet current obligations. As a result, the $400,000 settlement consists entirely of CMO investments worth about $185,000 as of March 31, 1995.

The effect of transfers of investments no longer held by the County have not been determined by County officials. Figure 4 illustrates the funds involved in the transfers of investments currently held by the County.

Figure 4
Estimated Investment Transfers Between Funds

Fund	Estimated Net Cash Owed To Other Funds (Funds That Received Cash)	Estimated Net Cash Due From Other Funds (Funds That Gave Up Cash)
General Fund	$ 998,629	
Community Supervision and Corrections	144,713	
County Clerk Preservation	102,164	
Court Residential Treatment	95,936	
Workers' Compensation Fund	94,228	
Farm To Market Fund	62,696	
Contractual Obligation, 1992	34,015	
General Obligation Bond, 1994 Construction Fund		$ 635,451
Library/Hughes Settlement		401,216
Certificates of Obligation Series, 1992 Construction Fund		389,196
General Obligation Refunding Bonds		49,910
Employee Self-Funded Insurance Fund		34,548
Uninsured Motorist Coverage		12,099
TGC Bates Fund		9,961
Totals	$1,532,381	$1,532,381

Recommendation:

We recommend the County reconstruct the amount of investments transferred between funds since January 1994 to determine potential liability of the County's various funds. A formal decision should be made, in consultation with legal counsel, regarding any required reimbursement of funds for losses incurred from investment transfers.

The County should also consider prohibiting the transfer of investments between funds at book value. Investment transfers between funds should be made only after approval by the Commissioners' Court.

Section 2:

Collectively, County Officials Share Responsibility for Ensuring That Public Funds Are Protected

Under the County government structure, officials are elected to their positions and maintain some aspects of autonomy from other elected officials within the County. Nevertheless, certain officials share in the responsibility for ensuring that public funds are safeguarded from loss, misuse, and abuse. This includes ensuring that funds are invested appropriately. The Commissioners' Court and the County Treasurer are elected officials, and the County Auditor is appointed by three district judges who are also elected to their positions.

In Tom Green County, the County Treasurer has responsibility for investing the County's funds, and the County Auditor and the Commissioners' Court are responsible for the oversight and monitoring of these activities. Given this shared responsibility, the County Treasurer, the County Auditor, and the Commissioners' Court all have an obligation to understand the risks associated with County investments. Before the County makes any investment, County officials should have the knowledge and expertise needed to understand the investment, provide oversight, and monitor investment transactions. If all officials do not have the requisite expertise and training needed to fulfill these responsibilities, the investment should not be purchased.

The primary responsibility for the inappropriate investment decisions rests with the former County Treasurer. However, the County Auditor and the Commissioners' Court did not adequately perform their responsibilities for oversight and monitoring of the investment activities.

Section 2-A:

The Former County Treasurer Made Inappropriate Investment Decisions

The former County Treasurer purchased the first mortgage backed security for Tom Green County in December 1990. In May 1991, the first collateralized mortgage obligation (CMO) was purchased. From that date, significant purchases in various classes of CMOs were made with County funds.

The former County Treasurer invested millions of dollars over a four-year period in high-risk mortgage derivatives. Even after interest rates rose by .25 percent on February 4, 1994, an inverse floater was purchased that same month. Additional CMOs were acquired as late as May 1994, after interest rates had risen .75 percent during the calendar year, further decreasing the market values. One investment that was bought and sold within a four-month period during 1994 reflected a negative yield of about six percent because the security was sold at a loss.

The CMO investments are inappropriate for the types of funds used by the County, especially considering the extent of CMO investments. The potentially long-term investments purchased with short-term and intermediate-term funds are inappropriate to meet the County's cash needs. The majority of the County's funds are short-term which means that money should be available for spending within a 12-month time frame. The County's construction funds are intermediate in nature and should be available to meet costs based on the estimated construction schedules for the jail facility.

The General Fund, which currently reflects a 32 percent investment in CMOs, should not consist of long-term investments. General Fund money should be immediately available to meet the current operating needs of the County. Investment of Tom Green County's General Fund in long-term investments jeopardizes the County's ability to meet current obligations.

Bank authorizations initiated by the former County Treasurer reflect stated maturity dates of the purchased CMOs ranging from 2007 through 2023. These bank authorizations were prepared by the former County Treasurer to authorize the bank to release cash for the purchase of these investments. The purchase of these risky investments with County funds is inappropriate.

In a letter dated November 18, 1993, one brokerage firm advised the former County Treasurer to diversify the County's portfolio. The letter stated that "unanticipated developments can seriously reduce the return on any one security below the anticipated return." It further states, "Because of the aggressive pre-payment assumptions (on CMOs), we believe you should consider a more active diversification program with the securities in your portfolio today."

This letter was written before the first interest rate increase on February 4, 1994. However, the former County Treasurer continued purchasing CMOs. Nineteen of the 25 CMOs in the County's current portfolio were purchased subsequent to the November 1993 letter. One CMO, purchased in May 1994, was sold to the County by the brokerage firm that wrote the letter.

The Public Funds Investment Act (Chapter 2256, Government Code) requires that

> Investments shall be made with judgment and care, under prevailing circumstances, that a person of prudence, discretion, and intelligence would exercise in the management of the person's own affairs, not for speculation, but for investment, considering the probable safety of capital and the probable income to be derived.

Documentation provided to the former County Treasurer before investments were purchased indicate that some of the instruments failed standardized high-risk tests. The Federal Financial Institutions Examination Council established criteria to determine high-risk investments for financial institutions. Bloomberg data provided to the former County Treasurer before the purchase date of certain investments indicates a "thumbs down" sign with "high risk" printed on the screen, indicating that these instruments failed the high-risk tests. Yet, these investments were purchased with County funds. The former County Treasurer stated that she did not understand the significance of these symbols or statements.

The former County Treasurer also indicated that she did not understand the extension risk associated with CMO investments, nor did she understand the risk presented by an inadequately diversified portfolio. Whether or not the risks were fully appreciated, these CMOs were not appropriate investments for County funds.

The former County Treasurer obtained training through the Texas Association of Counties (TAC) to achieve the status of Certified Investment Officer. CMOs were included in this training program, which occurred during the time the investments were purchased.

Recommendation:

We recommend that only appropriate investments be purchased with County funds. As mentioned throughout this report, strong management controls are necessary to ensure funds are invested in compliance with the Public Funds Investment Act, which emphasizes safety of principal, liquidity, and yield, in that order.

Section 2-B:

The Lack of Oversight by the County Auditor Further Weakened Investment Management Controls

Investment activity and related controls have not been reviewed by the County Auditor's Office in at least five years. The explanations offered by the County Auditor for the lack of audit activity were that the former County Treasurer refused to provide supporting documentation when requested and that had she (County Auditor) been more knowledgeable, she might have recognized the warning signals related to investment activity.

The lack of oversight for the investment function contributed to a failure to detect and report control weaknesses in a timely manner. The following review functions were not performed:

- Controls over the investment function were not tested and evaluated to determine if transactions were recorded appropriately and whether judgmental errors were made in the investment decision-making process.
- The investment portfolio was not monitored to ensure compliance with the County's investment policy or applicable state laws.
- An evaluation of the investment portfolio was not made to determine if investments met the County's liquidity needs.

- The portfolio was not analyzed to determine if investments were adequately diversified or to evaluate the County's exposure to the risks associated with the investments.

The County Auditor should have an understanding of the investments held by the County in order to properly monitor this activity. The County Auditor needs to be able to assess and evaluate the management controls, identify weaknesses, and recommend corrective action to ensure that invested public funds are protected. In addition, the County Auditor should be able to analyze any investments and related activity (i.e. associated risks and investment returns) authorized and used by the County.

Management controls over the investment function are necessary to help reduce or prevent errors in recording investments and in making investment decisions. The oversight function is an integral part of a management control system which can provide assurances that investments are managed effectively and efficiently. Oversight also helps ensure that investments are protected from loss, misuse, fraud, and decision-making errors.

Under Article 115.002 V.T.C.S., the County Auditor is required to check the books and "examine in detail the reports" of the county treasurer at least quarterly. The County Auditor has general oversight of the books and records of a county, according to state statutes. The County Auditor is required by state statute (Article 115.003 V.T.C.S.) to "fully examine the condition of" the cash held by the County Treasurer at least quarterly. In addition the County Auditor has a responsibility to ensure "that none of the funds are invested in any manner except as authorized by law."

Accounting entries and transactions related to investments are not thoroughly reviewed by the County Auditor before entry in the general ledger system. Recording transactions accurately and appropriately is an important element in the management control system. Reviewing these transactions provides a mechanism for monitoring investment activity as it occurs.

- Although some accounting entries do not reflect justification or reason for the transaction, the County Auditor stated that she does not question them.

- The County Auditor indicated that she does not know why some of the reconciling items appeared on the bank reconciliation because explanations are sometimes vague. There is no evidence to indicate that bank reconciliations are reviewed by the County Auditor or that reconciling items are traced to ensure they are cleared or corrected from one month to the next.

- There is no signature and date by the County Auditor to indicate that depository bank reconciliations have been reviewed.

- There is no indication that reconciling items are traced to subsequent bank statements or reconciliations to ensure they are cleared or corrected.

Because the above weaknesses exist, certain conditions were not detected in a timely manner, including the existence of liquidity problems. Investments were transferred between funds at book value to ease liquidity problems. Certain funds absorbed losses actually incurred by the funds where the investments were initially purchased. The investment portfolio was inadequately diversified due to the high concentration of CMO purchases over the last four years.

In addition, inappropriate accounting entries were made which misstated the investment balances. Monthly interest payments received on the CMOs were applied to the investments' principal balances. Appropriate accounts were not maintained for investment activity that would provide adequate information for oversight bodies. The failure to detect these conditions in a timely manner did not prevent errors or disclose the inappropriate decisions made by the former County Treasurer.

Recommendation:

We recommend the County Auditor obtain the necessary training and expertise needed to evaluate the County's investments and related management controls. Investment activity should be reviewed in conjunction with the quarterly review of the County Treasurer's office, as required by law.

An evaluation of the management controls over the investing function should be performed at least annually. As part of this evaluation, the County Auditor should determine if investments and related controls adhere to the County's investment policy and strategy. Compliance with the Public Funds Investment Act (Chapter 2256, Government Code) should also be evaluated. The results of this work should be reported to the Commissioners' Court. Investment activity, such as risks and returns, should also be analyzed and reported to the Commissioners' Court periodically.

Reconciliations should be reviewed. Reconciling items should be traced to subsequent bank statements or journal entries to ensure they are cleared/corrected. Accounting transactions should be rejected and returned to the Treasurer's Office if explanations for the accounting entries are not provided. The accounting entries initiated by the Treasurer's Office should include the initials of the preparer and the date.

Section 2-C:

The Lack of Oversight and Monitoring by the Commissioners' Court Also Contributed to the County's Current Financial Situation

The Commissioners' Court did not adequately fulfill its responsibility for the oversight and monitoring of investment activity. Commissioners interviewed indicate they placed complete reliance on the former County Treasurer and did not question investment activity. They do not appear to have the training, background, or expertise needed to monitor complex investments.

> The Commissioners' Court is required to examine all accounts and reports that relate to county finances and compare the accounts and reports with accompanying vouchers at each regular term, according to state statutes (Article 115.022, V.T.C.S.).

Monthly investments reports were submitted to the Commissioners' Court which reflected each investment, the balance, the coupon rate, and the maturity date. However, the Commissioners' Court did not question the length of maturity on the investments even though some extend as long as 2023. The monthly reports did not give any indication of market values for the investments.

Minutes from the Commissioners' Court meetings gave no indication that investments were discussed routinely. Each month, these investment reports were approved by a vote of the Commissioners' Court, with little or no discussion related to investment activity or performance.

The current Commissioners' Court took action after the substantial decline in the investments' market values was communicated to them in January 1995. These actions included:

- obtaining an independent analysis of market value on the CMO investments
- revising the County's investment policy
- establishing an investment committee
- contacting other County authorities who initiated requests for this audit

Monitoring investment activity is necessary to ensure that goals and objectives are met and that the appropriate investment mix is maintained to protect the invested funds. Monitoring investments also ensures that funds are invested in accordance with the established investment policy.

Recommendation:

We recommend the Commissioners' Court consider obtaining training related to monitoring investment activity. Certain investments should be prohibited by the County's investment policy if County officials do not have the necessary training and expertise to make appropriate decisions, provide oversight, or monitor activity. Investments should be actively and routinely monitored to ensure that goals and objectives are met. An investment strategy should be developed in conjunction with the Treasurer's Office to ensure that funds are invested in accordance with the County's established goals and objectives and the Public Funds Investment Act. The market value of each investment should be included in monthly reports submitted to the Commissioners' Court.

Section 3:

Reliance Was Placed on Brokers and Dealers in Making Investment Decisions

A goal of brokers and dealers is to earn money through the sale of investments. Investment personnel often rely on these professionals to help them understand risks and benefits associated with various investment instruments.

Interviews with various County investment personnel indicate that they placed significant reliance on brokers when making investment decisions. The County Treasurer's Office does not have an independent means to fully analyze the complex CMOs, such as access to Bloomberg data.

Investment personnel apparently relied on Bloomberg data provided by brokers in making investment decisions. Reliance was apparently placed on the assumptions made by brokers concerning estimated maturities, yields, and market pricing for some of the purchased CMOs.

Evidence indicates that price quotations from more than one broker were not obtained before CMOs were purchased. Seeking bids from more than one broker provides an independent check to ensure that investments are obtained at a competitive price.

The County Treasurer's Office used the same six brokerage firms to purchase CMOs and mortgage-backed securities. From 1990 (when the first mortgage backed security was purchased) through May 1994, all CMOs were purchased from the same firms. Based on our review of the investment portfolio through April 1995, no CMOs have been purchased since May 1994.

The former County Treasurer indicates that she received most of her investment training through the Texas Association of Counties (TAC). Many of these training courses were taught by the same brokers who sold the CMO investments to Tom Green County.

The current $12.7 million CMO portfolio was purchased from five of the six brokers used by the County over the last four years. Approximately 84 percent of the current CMO portfolio was purchased from only two of the brokers. Additionally, over 54 percent of the inverse floaters, which have seen the most significant decline in value, were purchased from a single broker.

The County Treasurer's Office also relied on these same brokers and dealers to provide market values on the CMO investments. In some cases, the same brokers and dealers that sold the investment to the County also provided the market value. The lack of independent pricing sources is a concern because:

- Obtaining only one offer price during the purchasing process could result in paying more than market value for a particular instrument.

- During the monitoring process, objective pricing information may not be provided, which could result in inappropriate investment decisions.

Members of the National Association of Securities Dealers are subject to the "Rules of Fair Practice." These brokers and dealers are required to make reasonable efforts to obtain the customer's financial status and investment objectives before executing transactions. They are also required to determine the suitability of an investment before selling to the potential investor. Many reputable brokerage firms insist on reviewing an entity's portfolio before selling them investments.

The professional standards that guide brokers and dealers do not alleviate the responsibility of the County Treasurer's Office to ensure that appropriate investments are made with public funds. The County Treasurer's Office should have adequate technical knowledge and expertise to properly analyze the risks associated with investments. If the expertise to analyze complex investments is not available, then other types of investments should be considered. If the extent and level of risk associated with mortgage derivatives is not fully understood, then these investments should not be purchased.

Recommendation:

The County should not invest in complex securities for which it does not have qualified personnel or advisors to independently analyze the investments on an ongoing basis. When possible, more than one price quote should be obtained before purchasing securities. The County should also obtain market values from a source independent of the brokers who sold the securities to ensure the most reliable information is used to make investment decisions.

Section 4:

The Construction Bond Funds Carry a Major Portion of the CMO Investments

Almost 85 percent ($10.4 million) of the combined debt proceeds issued for jail construction are invested in CMOs. The market values ($6.7 million) of these investments have declined to the extent that there is a material impact on the money available for jail construction. As of March 31, 1995, the unrealized loss on investments of debt proceeds exceeds $3.7 million.

Debt for construction is generally issued with the intention to use the proceeds over a three-year period as governed by the Internal Revenue Code for tax exempt issues. The maturity dates of the CMO investments in these funds range from 2007 to 2023, with 13 of the 22 CMOs maturing in 2023. The table on the following page (Figure 5) illustrates the extent to which the debt proceeds are invested in CMOs.

Figure 5
Investment of Jail Construction Funds

	1992 Certificates of Obligation	1993 Certificates of Obligation	1994 Certificates of Obligation	TOTAL
Original Amount Issued	$9,000,000	$1,500,000	$2,600,000	$13,100,000
Unspent Proceeds (Fund Balance) as of 3/31/95	$8,886,318	$1,012,003	$2,399,960	$12,298,281
Amount invested in CMOs as of 3/31/95 (book value)	$8,257,323	$ 945,390	$1,239,044	$10,441,757
Percentage of Unspent Proceeds Invested in CMOs as of 3/31/95	92.9%	93.4%	51.6%	84.9%
Market Value of CMOs as of 3/31/95	$5,271,652	$ 570,319	$ 837,798	$ 6,679,769
Percentage Decline in Market Value (compared to book value)	36.2%	39.7%	32.4%	36.0%

Section 4-A:

Debt Proceeds Were Invested Inappropriately

In order to ease liquidity problems, bond proceeds were transferred to other funds in exchange for investments. These investments were transferred at book value, rather than market value. As a result, bond funds gave up more cash than the investments were worth on transfers that occurred during 1994. The transfer of investments between funds at book value has resulted in the use of bond proceeds for purposes other than jail construction. This could ultimately involve a violation of bond covenants if bond proceeds are not used for jail construction.

The extent of bond proceeds used to support other funds through investment transfers is not readily determinable. County officials estimated that $1.5 million of investments in the current portfolio have been transferred. (See Figure 4 on page 13.) Of that amount over $1 million represents cash given up by the various bond funds for those investments.

Poor management controls, inaccurate accounting entries, and the numerous transfers from 1993 through 1994 hinder the determination of the actual amount of proceeds used to support other funds. However, with the rise in interest rates during calendar year 1994, CMOs transferred during this time were probably done at a loss to the fund assuming the investment. Market values continued to decline throughout 1994 as interest rates rose.

The transfer of investments to the 1994 Construction Fund, months after the proceeds were deposited, indicates that bond proceeds were used to ease the liquidity problems experienced by other County funds. Of the six CMOs currently owned by the 1994 Construction Fund, four were transferred from other funds. Three of these investments were transferred from the General Fund, the remaining investment came from the County Clerk's Fund.

The interest and sinking funds, which have been established to repay the current principal and interest due on the debt, have been heavily invested in long-term, high-risk CMOs. The value of these investments has declined significantly. As a result, more than $248,000 was borrowed from the General Fund to meet the debt service obligations that were due on February 1, 1995, for two separate bond issues.

The maturity dates of the CMOs in the interest and sinking funds violate Article 836, V.T.C.S. This statute states that interest and sinking funds cannot be invested longer than the maturity date of the debt. The 1994 certificates of obligation mature in 2014, while four of the six CMOs held by that fund could mature in either 2016 or 2023.

Recommendation:

The Commissioners' Court, the County Treasurer, and the County Auditor should review bond covenants and state statutes related to investments, in consultation with legal counsel, to ensure debt proceeds and all County funds are invested appropriately, and to ensure that required restitution is made in any case where it is determined investments were inappropriately transferred.

Section 4-B:

Delays in Jail Construction Have Increased the County's Investment Losses

County taxpayers have been repaying debt for almost three years for jail facilities that are not yet under construction. Since the issuance of the first certificates of obligation in 1992, delays have occurred in selecting a site for the jail facilities. In addition, issues related to the size of the jail facilities have led to further delays by the Commissioners' Court. Additional debt of $2.6 million was issued in the spring of 1994 to cover increased construction costs due to the need for larger jail facilities, as recommended by the Jail Standards Commission. However, controversy continued over jail site selection. As a result of these delays, unused debt proceeds became vulnerable to investment losses, and construction costs continued to increase.

Recommendation:

We recommend the Commissioners' Court monitor investment values to ensure losses are minimized to the extent possible. In the future, debt issuances should be timed to meet estimated construction schedules as closely as possible to minimize the costs to the taxpayers.

Section 5:

The Investment Portfolio Was Inadequately Diversified

The CMOs held by Tom Green County make up about 69 percent of the County's total investment portfolio. The value of these CMOs has decreased significantly, resulting in an unrealized loss of $4.5 million for the County. The decline in market value of these volatile CMOs has a significant impact on the inadequately diversified portfolio. Had the County's investment portfolio been adequately diversified, the loss in market value and resulting liquidity problems would not have been as severe.

Inadequate diversification of investments concentrates risk within a portfolio. Investing heavily in the same type of instruments magnifies the associated risks. Investment performance of the portfolio becomes dependent on limited types of investments. Rates of return on investment activity fluctuate dramatically in an inadequately diversified portfolio.

About 66 percent of the County's CMO investments are high-risk inverse floaters, while the remaining 34 percent represent various fixed rate classes of mortgage derivatives. As shown in Figure 6, the County's inverse floater class of CMOs, representing the majority of the portfolio, are the most volatile and have seen the greatest declines in value as compared to the fixed rate classes.

Figure 6
Composition of CMO Portfolio as of March 31, 1995

Class	Percent	Dollar Amount
Inverse Floater:		
Total Estimated Decline In Value	(45.6)%	$(3,840,914)
Greatest Decline For A Single Security	(74.8)%	$(771,875)
Least Decline For A Single Security	(13.1)%	$(191,062)
Fixed Rate:		
Total Estimated Decline In Value	(16.6)%	$(708,846)
Greatest Decline For A Single Security	(25.3)%	$(207,841)
Least Decline For A Single Security	(3.3)%	$(10,708)

The County's CMO investments have threatened the safety of public funds due to the substantial declines in market value on an inadequately diversified portfolio. Safety of capital refers to conducting investment transactions so that public funds are not lost. The safety of capital involves the reduction of various types of risk, such as interest-rate risk, credit risk, and market risk. Diversification is a strategy often used to reduce these types of risks. A reduction in overall risk is achieved by placing funds in various instruments, each having a different risk level.

Recommendation:

We recommend the Commissioners' Court include adequate portfolio diversification as a part of the County's investment policy. The County should consider including percentage limits on types of investments in order to clearly indicate the portfolio diversification requirements.

Appendix 1:

Objective, Scope, and Methodology

Objectives

The objectives of this financial related audit were:

1. to prepare a briefing report for Tom Green County and the Legislature disclosing the current status of the County's investment portfolio

2. to evaluate management controls over the County's investment function and provide recommendations to strengthen controls

3. to determine the effect of derivative investments on bond proceeds issued to construct jail facilities

Audit Scope

The initial scope of this financial related audit included consideration of:

- the existence of management controls over the investment function
- whether the derivative investments' level of risk was properly disclosed to the County Commissioners
- the status of the current investment portfolio
- whether violations of bond covenants have occurred as a result of investments in derivatives and if there is any potential liability regarding arbitrage requirements on the bonds

Methodology

Information collected to accomplish our objectives included the following:

- State statutes relevant to the investment of public funds
- Bond official statements
- Annual financial reports for fiscal years 1990-1994
- Investment subsidiary ledger and the general ledger maintained by the County
- Market values obtained by the County custodian bank from an independent source as of March 31, 1995
- Investment schedules prepared by various County personnel

Procedures conducted to accomplish our objectives included reviewing:

- Commission meeting minutes for fiscal years 1990-1995
- Investment transactions for fiscal year 1994
- Correspondence between the County and its investment brokers

In addition, we conducted interviews with the County's personnel, attorneys, and auditors, as well as other interested parties. We also analyzed the current investment portfolio.

Other Information

Fieldwork was conducted in March and April 1995. The financial related audit was conducted in accordance with applicable professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

The audit work was performed by the following members of the State Auditor's staff:

- Dianne Oldroyd, CPA (Project Manager)
- Ann Huebner
- William A. Wood, CPA
- Catherine Smock, CPA (Audit Manager)
- Deborah L. Kerr, Ph.D. (Audit Director)

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Appendix 2:

County Judge's Response

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TOM GREEN COUNTY

MICHAEL D. BROWN
COUNTY JUDGE

June 15, 1995

Diane Oldroyd, Project Manager
Office of the State Auditor
P. O. Box 12067
Austin, Texas 78711-2067

Dear Ms. Oldroyd:

I would like to thank you and your staff and commend you for the thorough report on the investments of Tom Green County. I am pleased to report that we are in the process of instituting the changes to our investment policy and procedures which were outlined in the report. Being newly elected and not being part of the previous administration, which must ultimately shoulder its portion of responsibility for these problems, I feel that I must offer my opinions on your department's report.

I would like to comment on the fact that while the types of securities purchased by the former Treasurer were deemed inappropriate for our county in 1994, approximately $8 million of the same types of securities were contained in the County's portfolio in 1993 and were not reported on or questioned by the County's hired outside financial auditor in the course of their FY 1993 audit. Supporting information accompanying these instruments indicated the failed high risk security tests and had maturity dates which were in conflict with the requirements of investments for a governmental subdivision such as ours. I find it difficult to place any substantial blame for any losses on the previous Commissioner's Court when the professionals hired to examine and report on the County's finances obviously did not question or even mention that these securities may have been inappropriate.

The Treasurer is an elected position operating under the laws of the State of Texas and is under no control of any other elected official other than the budgetary authority of the Commissioner's Court. The Commission's Court of Tom Green County delegated the investment authority for the County's money to the Treasurer as specified by statute and with the understanding that such authority would be exercised with the utmost competence and under the provisions of the investment policy of the County and all applicable law.

The Commissioner's Court as a management body has to have adequate and correct information in order to make decisions based on that information. I believe that the information provided the Commissioner's Court, from the sources relied on for that information, was neither adequate nor correct in most cases and that the information that was provided was couched in cryptic terminology which was very difficult to decipher and apply.

112 West Beauregard ▪ San Angelo, Texas 76903 ▪ (915) 659-6557 ▪ (915) 659-3258 Fax
Affirmative Action/Equal Opportunity Employer

Again, thanks for all of the hard work and if I may be of any further assistance, please do not hesitate to call.

Yours very truly,

Michael D. Brown

112 West Beauregard ▪ San Angelo, Texas 76903 ▪ (915) 659-6557 ▪ (915) 659-3258 Fax
Affirmative Action/Equal Opportunity Employer

Appendix 3:

Current County Treasurer's Response

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TOM
GREEN
COUNTY

TOM GREEN COUNTY

113 W. Beauregard San Angelo, Texas 76903-5887

June 27, 1995

Donna Long
County Treasurer
Tom Green County
113 West Beauregard
San Angelo, Texas 76903

Dianna Oldroyd, CPA
Supervising Auditor
State of Texas
State Auditor's Office
P.O. Box 12067
Austin, Texas 78711-2067

When I came into office I found that the Treasurer's Office had not been audited by the County Auditor. The Auditor's office had not been auditing the Investments, Cobra Insurance, County Insurance ETC. What the Auditor did do was verify data entry on payroll, receipts, and our manual ledgers and PC ledgers to the bank balances. This practice is still being done except for the manual ledgers which are no longer kept, they are now done on computers.

I requested that the Auditor immediately do a complete and thorough audit of the Treasurer's office, which should have been done before I came into office being as there was a "changing of the guard" per say. The progress has been slow as for as the audit of the securities have been. The Auditor's Office now agree with the corrected posting of Principal and Interest that my office came up with. There are still a few lose ends as to getting the general ledgers in agreement with our Security reports.

As of June 7th ,1995 all principal and interest had been corrected and all securities involving transfers had been reversed back to the originally ownership. This had been decided early on that the fairest and correct way would be to reverse these securities. As a result, the Library/Hughes settlement as been made whole again. The Library Board has been notified.

After coming into the office an investment committee was formed informally by the County Judge to assist in investment decisions. This committee was later made official through the County Commissioners' Court. Recommendations on investments are discussed between myself, my Chief Deputy Dianna Spieker, and then with Gail Cheek, an internal auditor.

One of my questions have been why did the court borrow the money to build the jail when they did not have good figures or a place to build.

When I came into the office, my Chief Deputy made me aware that even though we placed our reports in the Commissioners' mail boxes on thursday afternoon some of the court complained that they did not received them until right before court. I then decided that we needed to try and give the court at least a week to review the reports. This has been implemented.

Beginning with the March report we began showing market values, percentages owned by each fund, the principal and interest balances previous month, current payments for Principal & Interest, and the new balances current month.

Treasurer's personnel was never told they had to sign and date the bank reconciliations Etc. They are now. They are also giving a more detailed explanation on their work of any discrepancies with the bank or auditor.

In the course of organizing the office there is now a chart projection of the cash flow. A comparison for the last three years of actual and an average of revenue and expenditures.
We are obtaining information monthly from our custodial bank on market values and a Federal Reserve statement of securities balances to ensure accuracy of investment balances.

Training will be again available to Dianna Spieker to keep her certification. I will attend the beginning classes to learn about investments.

If we can be of further service, please call upon us again.

Sincerely,

Donna Long

Donna Long
County Treasurer

cc: TGC District Attorney's
Keith Davis, Attorney At Law

Appendix 4:
County Auditor's Response

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Tom Green County

San Angelo. Texas

June 29, 1995

Dianne Oldroyd, CPA
State Auditor's Office
P.O. Box 12067
Austin, TX 76711-2067

Ms. Oldroyd,

This is in response to your comments of Tom Green County's investment management.

I explained to you during our visits that until September, 1993, investments were carried by hand in a subsidiary investment ledger. There were cards typed by the Treasurer with cusip numbers and the amounts paid by the fund, but there were never original security documents. In the summer of 1993, the Treasurer's general lêdger was in such terrible shape that I asked Hope to review it and see if it balances with her general ledger, and to reconcile it to her cash flow statement. In October, 1993, we implemented a new software system which enabled us to post investment transactions to the general ledger. Not having seen the original documents, I did not write in my audit letters that investments have been audited. I can see now, that the Treasurers' actions should have been a warning and that I could have acted on it by asking the District Judges for a court order.

You are wrong in your assessment, Yes, I do question unusual transactions.

I do not accept this statement, what question did you ask, I can't recall at this moment, but Hope has been doing this job for the last 12 years.

So a signature was missing and some were not dated. You forget that we send an audit letter and emphasize the dates.

I disagree completely, this is one persons idea about another persons work. This is an office that audits millions of dollars during a year.

Sincerely,

Rebecca Papazian

Rebecca Papazian
County Auditor

Appendix 5:

Glossary of Selected Key Terms

Average Life - The average number of years the principal in a mortgage pool is expected to remain outstanding.

Collateral - The underlying mortgage backed securities backing a CMO deal.

Collateralized Mortgage Obligations (CMO) - A security created using the underlying cash flows from mortgage backed securities as collateral. A CMO shifts the uncertainty regarding the exact timing of principal return in a mortgage backed security. This uncertainty exists because the timing of mortgage principal payments is influenced by changes in interest rates, the current economic climate, and the geographic makeup of loans.

Coupon - The interest rate paid on a security.

Credit Risk - The likelihood that a part involved in an investment transaction will not fulfill its obligations. This type of risk is often associated with the issuer of the investment security and is affected by the concentration of deposits or investments in a single instrument or with a single institution.

Derivatives - Financial arrangements whose returns are linked to, or derived from, some underlying stock, bond index, commodity, or other asset. They come in two basic types: options and "forward-type" derivatives, which include forwards, futures, and swaps. They may be listed on exchanges or negotiated privately between institutions.

Derivative Securities - Trade like normal bonds, but their returns are determined by, or derived from, factors other than plain interest rates. For instance, returns on "structured notes" may vary in line with changes in stock prices, commodity prices, foreign exchange rates, or two different interest rates. Returns on mortgage derivatives involve bets on the rate at which homeowners will repay mortgages and often act like leveraged interest rate options.

Extension Risk - Possible illiquidity of an investment due to a change in interest rate that slows down prepayments. The investor may have to hold the investment longer than originally intended to recover the amount invested.

Floater - A CMO class created from fixed rate mortgage backed collateral whose coupon adjusts on a monthly basis versus a market index.

High-risk - A type of security deemed unsuitable for specified investors by certain regulatory agencies.

Index - A benchmark measure of interest rates used in calculating coupons on adjustable securities.

Inverse Floater - A CMO class whose coupon adjusts opposite to the changes in a market index.

Legal Risk - The possible financial loss resulting from an action by a court or by a regulatory or legislative body that could invalidate a financial contract.

Market Risk - The risk that the market value of an investment, collateral protecting deposits, or securities underlying a repurchase agreement will decline. This type of risk is affected by the length to maturity of a security, the need to liquidate a security before maturity, the extent that collateral exceeds the amount invested, and the frequency at which the amount of collateral is adjusted for changing market values.

Mortgage-backed Securities - The securities are structured by pooling together standardized residential mortgage loans of similar characteristics. The investor purchases a pro-rata share of the interest and principal that the borrowers pay on the mortgage loans in the pool.

Prepayment - An additional principal payment made on a mortgage loan.

Prepayment Risk - The risk associated with the extension or contraction of principal repayments in a pooled mortgage security. Prepayments of any loan in the mortgage pool by a borrower will shorten the average life of the security and also affect the yield. As interest rates decline, the borrowers are more likely to refinance their mortgage into a lower rate loan.

Tolerable Risk - The level of risk an entity is willing to accept without regard to the potential returns. Only investment activity below this threshold will be undertaken. Tolerable risk should be established when the entity outlines its investment objectives.

Tranche - A security class of a CMO deal.

Unrealized Loss - The difference between the book value of the investment and its market value, but it is not realized until the investment is sold.

Volatility - The relative impact of changing interest rates in general market conditions on an investment.

Weighted Average Life - The average amount of time the principal balance of a mortgage pool is outstanding.

Yield - The annual return on an investment (from dividends or interest) expressed as a percentage of either cost or current price.

Yield to Maturity - Refers to the yield of a bond also taking into account the premium or discount of the bond.

Copies of this report have been distributed to the following:

Legislative Audit Committee

Honorable James E. "Pete" Laney, Speaker of the House, Chair
Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
Representative Robert Junell, Chair, House Appropriations Committee
Representative Tom Craddick, Chair, House Ways and Means Committee

Governor of Texas

Honorable George W. Bush

Legislative Budget Board

Sunset Advisory Commission

Tom Green County

The Honorable Michael D. Brown, County Judge
Mr. Gary Acevedo, Commissioner Pct.1
Mr. Karl Bookter, Commissioner Pct. 2
Mr. Delbert Caffey, Commissioner Pct. 3
Mr. Tim Weatherby, Commissioner Pct. 4
Ms. Donna Long, County Treasurer
Ms. Rebecca Papazian, County Auditor
Mr. Stephen Smith, District Attorney