



Two Commodore Plaza
206 East Ninth Street, Suite 1900
Austin, Texas 78701

Phone: (512) 479-4700
Fax: (512) 479-4884

A Report on State Entities' Compliance with the Public Funds Investment Act

April 21, 1999

Members of the Legislative Audit Committee:

In fiscal year 1998, state entities subject to the Public Funds Investment Act (Act) continue to report substantial compliance with the requirements of the Act. Furthermore, the extent of state entities' investments in derivatives has decreased. Compliance with the Act and less exposure to derivatives are important to safeguard the entities' approximately \$9.2 billion in investments.

Results of the individual audits performed by state agencies, universities, and community college districts are below.

- All 30 state agencies and universities reported overall compliance with the Act and their own investment policies. The market value of total investments reported by these entities was more than \$8.3 billion as of August 31, 1998.
- Independent audits of 50 community college districts reported that 43 districts complied with the Act. We could not determine the compliance of the remaining 7 districts because the independent auditors' reports did not indicate compliance or noncompliance. The 50 districts reported approximately \$860 million in the market value of investments as of August 31, 1998.

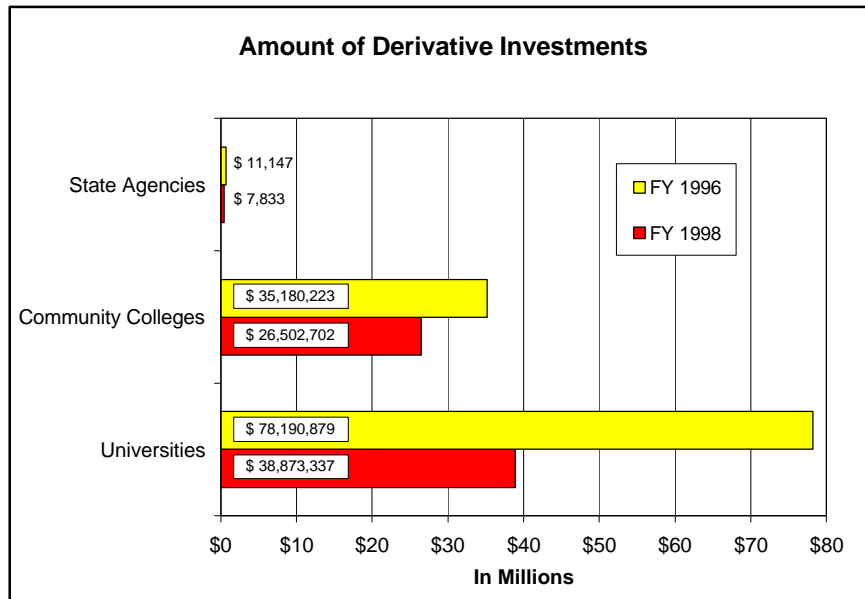
Although the number of entities reporting instances of noncompliance increased from 10 to 13, the number of entities reporting three or more instances decreased from 4 in fiscal year 1997 to 1 in fiscal year 1998. Texas Southern University was the only entity that had more than two instances of noncompliance in both fiscal years 1997 and 1998. These entities should take the corrective action recommended in their audit reports. (See the attachment for a summary of specific instances of noncompliance by each state entity.)

The number of community college districts that did not follow *The Annual Financial Reporting Requirements for Texas Public Community Colleges* with regard to compliance with the Act has decreased from 16 to 7 in fiscal year 1998. The districts should continue to ensure that their independent auditors' work covers the Act and that the audit results are adequately disclosed in the report.

The extent of state entities' investments in derivatives has declined since fiscal year 1996. As of August 31, 1998, state entities reported approximately \$9.2 billion as the book value of investments with \$65 million (0.71 percent) invested in derivatives as of August 31, 1998. This shows over a 40 percent decrease in derivative investments compared to the \$113 million

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reported in fiscal year 1996. The following figure shows the decline of derivative investments by different types of entities. For more information on derivatives, see page 6 of the attachment.



The decline in derivative investments is noteworthy, especially considering the fact that the Act does not require entities to sell the prohibited investments purchased prior to the effective date of the Act. The decline appears to be from the sale or maturity of existing derivatives as part of entities' efforts to avoid risky investments as intended by the Act.

Source: The investment portfolio composition data reported by individual entities

We appreciate the assistance and cooperation of the management and employees of the state agencies, universities, and community college districts during our compilation of this information. If you have any questions about this report, please contact Carol Smith, CPA, Audit Manager, at 479-4700.

Sincerely,

Lawrence F. Alwin, CPA
 State Auditor

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Attachment

cc: All Executive Directors, Presidents, Chancellors, and Internal Audit Directors of the Agencies and Universities included in this report

Objective, Scope, and Methodology

The objective of this review was to determine whether state entities complied with the requirements of the Public Funds Investment Act (Government Code, Chapter 2256). The Act requires investing state entities to satisfy requirements regarding (1) investment policies, (2) management controls, (3) quarterly investment reports, (4) ethics and conflict of interest disclosure, (5) training of board members and investment officers, and (6) broker/dealer acknowledgment of investment policies. State entities consist of state agencies, universities, and community college districts.

The statute requires state agencies subject to the Act to submit an annual audit report on compliance to the State Auditor. In accordance with this statute, we collected and analyzed (1) internal audit reports, (2) external audit reports, and (3) investment portfolio compositions. This information is self-reported by entities, and we did not audit the reports or investment data.

Compliance Status of State Agencies and Universities

Table 1

Investing Entity	Market Value of Investments at August 31, 1998	Overall Compliance	Instances of Non-compliance	Comments
Angelo State University	\$79,044,350	Yes		
Board of Law Examiners	\$1,919,910	Yes	Investment Policies Quarterly Reports	The Board of Directors did not perform the annual review of the investment policy. Quarterly investment reports do not include beginning market values or additions and changes to market value; the reports do not state the compliance of the portfolio with the investment policy; management does not require or maintain evidence to ensure that quarterly investment reports have been received by the Board of Directors.
Department of Economic Development	\$99,444,551	Yes	Investment Policies	Provisions of the investment policy were not reviewed during the year to determine if modifications were necessary.
Lamar University Institute of Technology	\$0 (Investments are managed by Lamar University-Beaumont)	Yes	Quarterly Reports	Management did not sign all investment reports and reconciliations; the Investment Officer did not prepare quarterly cash flow projections to submit to the President.
Lamar University - Beaumont	\$26,050,397	Yes		
Lamar University - Orange	\$3,091,911	Yes		
Lamar University - Port Arthur	\$1,889,209	Yes		
Local Government Investment Pool (TexPool)	\$6,647,597,000	Yes		
Midwestern State University	\$18,092,975	Yes		
Office of the Attorney General	\$0	Yes		
Sam Houston State University	\$51,062,763	Yes		

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Table 1 (continued)

Investing Entity	Market Value of Investments at August 31, 1998	Overall Compliance	Instances of Non-compliance	Comments
Southwest Texas State University	\$117,686,193	Yes	Investment Policies Management Controls	The investment policy contains an incorrect reference. Common stock certificates are not maintained in one central location.
State Bar of Texas	\$24,588,546	Yes	Investment Policies Training Requirements	Investment policy does not address (1) methods to monitor the market price of investments and (2) a requirement for settlement of all transactions on a delivery versus payment basis; the current investment policy was not reviewed during fiscal year 1998. Not all members of the Audit and Finance Committee have attended the training required by the Act.
Stephen F. Austin State University	\$15,567,039	Yes	Investment Policies	Two minor elements of the policy were inadvertently deleted although actual procedures fulfilled the requirements of the deleted portions of the policy.
Sul Ross State University	\$10,964,788	Yes	Investment Policies	Investment policies were not followed consistently in the area of competitive bids on the sale of securities.
Department of Housing and Community Affairs	\$959,825,310	Yes		
Texas Department of Banking	\$2,492,665	Yes		
Department of Criminal Justice	\$12,905,805	Yes		
Texas Military Facilities Commission	\$6,699,705	Yes	Investment Policies	The investment policy is not updated to reflect the September 1, 1997, amendments to the Act.

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Table 1 (continued)

Investing Entity	Market Value of Investments at August 31, 1998	Overall Compliance	Instances of Non-compliance	Comments
Parks and Wildlife Department	\$11,416	Yes	Investment Policies	Investment policies were violated as follows: funds are not invested in the State Treasury, amounts in excess of \$100,000 are not collateralized, and investments were not made by an authorized Investment Officer.
Texas Real Estate Commission	\$2,262,202	Yes		
School for the Blind and Visually Impaired	\$700,000	Yes	Training Requirements	Some new Board members did not receive the required training in a timely manner.
Texas School for the Deaf	\$14,894	Yes	Management Controls Training Requirements	The Board has inappropriately designated the superintendent as the Investment Officer. The agency lacked documentation to support that the Investment Officer and the Board members received the required training.
Texas Southern University	\$21,946,697	Yes, except for the noted items under "Comments"	Management Controls Quarterly Reports Ethics Policies and Conflict of Interest Training Requirements Broker/Dealer Acknowledgement	Investment transactions were not reconciled and recorded on a monthly basis; supporting documentation for investment transactions was not always available. Quarterly reports of investment activity were not presented to the Board of Regents for the second and fourth quarters. University officials did not file an annual Disclosure of Conflict of Interest Statement. The Act's training requirement was not satisfied by the University's Investment Officer. External investment managers have not signed a statement acknowledging receipt of the University's investment policies.
Texas State Technical College System	\$8,999,107	Yes		

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Table 1 (concluded)

Investing Entity	Market Value of Investments at August 31, 1998	Overall Compliance	Instances of Non-compliance	Comments
Water Development Board	\$77,360,966	Yes	Quarterly Reports Broker/ Dealer Acknowledgement	Reports of investment transactions did not contain all elements required by the Act such as (1) beginning book value and market values for all investments, (2) ending book and market values for certain securities, and (3) statement of compliance with regard to the investment portfolio. The required signed acknowledgement was dated after the start of business for one authorized dealer.
Texas Woman's University	\$51,095,884	Yes		
Youth Commission	\$605,456	Yes		
University of North Texas	\$95,099,228	Yes		
University of North Texas Health Science Center at Fort Worth	\$15,637,970	Yes		
Total Investments of Agencies and Universities			\$ 8,352,656,937	

Compliance Status of Community College Districts

Table 2

Overall Compliance with the Act (Market Value of Investments as of August 31, 1998)			
Alamo	\$ 79,086,650	McLennan	\$ 4,644,045
Alvin	0	Midland	12,724,686
Amarillo	18,475,565	Navarro	5,915,000
Angelina County	9,581,993	North Harris Montgomery	30,387,958
Austin	33,739,333	Northeast Texas	1,176,178
Blinn	430,000	Odessa	26,469,072
Borger - formerly Frank Phillips	3,121,790	Panola	3,697,214
Brazosport	11,602,361	Ranger	233,135
Central Texas	31,135,133	San Jacinto	32,486,045
Cisco	3,116,217	South Plains	8,777,750
Coastal Bend - formerly Bee County	5,637,045	South Texas	20,759,703
Collin County	29,739,352	Southwest Texas	3,826,029
Dallas County	138,617,644	Tarrant County	34,520,031
Del Mar	30,869,947	Temple	10,962,780
El Paso	44,967,418	Trinity Valley	6,084,648
Grayson County	\$5,421,951	Tyler	8,506,198
Hill	5,240,428	Vernon Regional	1,360,116
Houston	104,500,597	Victoria	3,293,593
Howard	4,671,382	Weatherford	3,624,994
Kilgore	13,281,182	Western Texas	3,419,590
Laredo	3,386,001	Wharton County	12,840,731
Lee	9,300,704		
Subtotal of Investments \$ 821,632,189			
Compliance Could Not Be Determined ^a			
Clarendon	\$ 4,302,621 ^b	Paris	\$ 744,853 ^b
Galveston	5,326,056	Texarkana	17,587,486
Mainland	0	Texas Southmost	4,852,199 ^b
North Central Texas	5,165,030 ^b		
Subtotal of Investments \$ 37,978,245			
TOTAL INVESTMENTS \$ 859,610,434			
^a The independent audit reports did not follow the requirements of <i>The Annual Financial Reporting Requirements for Texas Public Community Colleges</i> . This means that they did not include a statement of compliance in the report or submit a letter to the State Auditor. Therefore, we were unable to determine compliance.			
^b Although the independent audit report did not mention compliance with the Act, a statement of compliance with investment policies was included in the Notes to Financial Statements.			

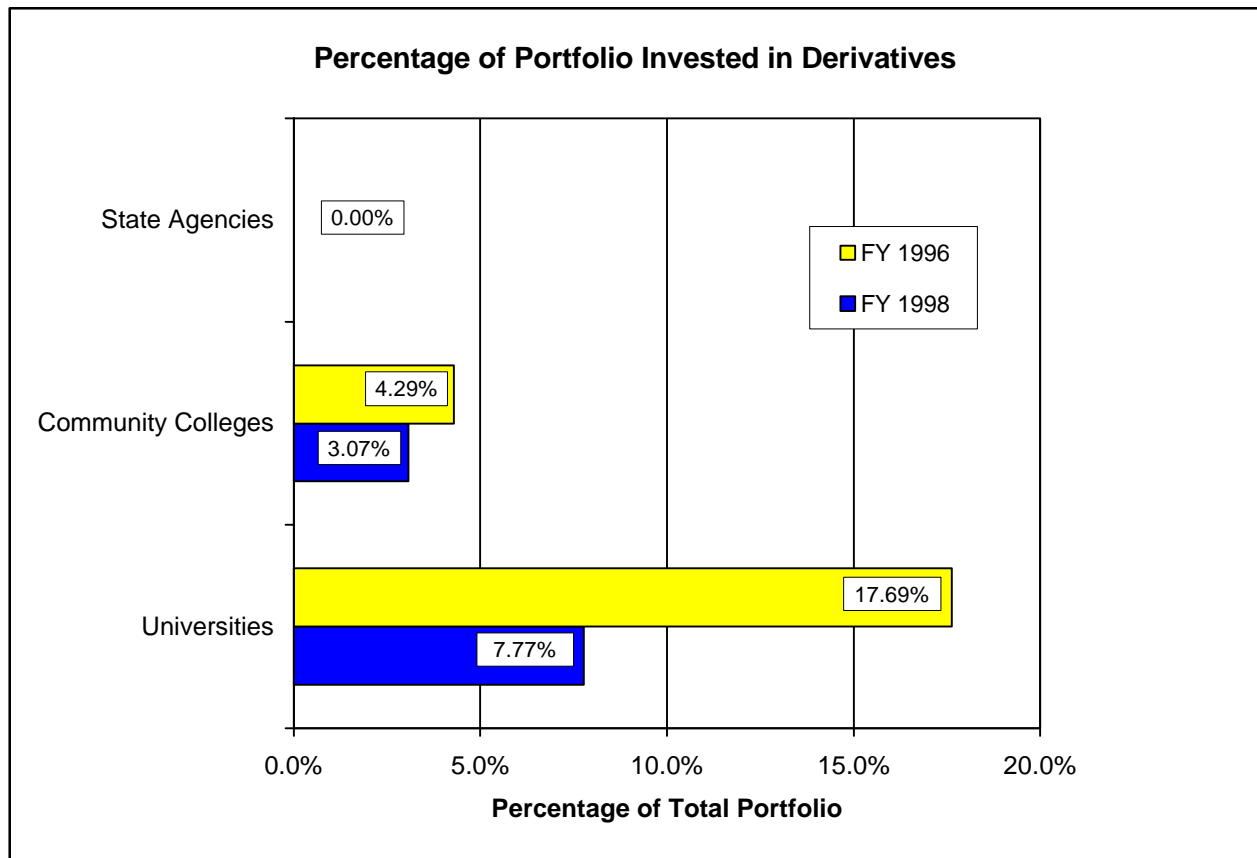
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Derivative Investments

Derivatives are financial instruments (security or contract) whose value is linked or “derived” from changes in interest rates, currency rates, and stock and commodity rates. 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
- Current economic climate
- Geographic makeup of the underlying mortgage loans

The figure below shows what percentage of the state entities’ total portfolio is invested in derivatives.



Source: The investment portfolio composition data reported by individual entities