

AUDITOR'S REPORT

FINANCIAL MANAGEMENT INVESTMENT PROCEDURES THIRD QUARTER FISCAL YEAR 2019



June 28, 2019

**Michael Post, C.P.A., M.B.A.
Harris County Auditor**

Leslie Wilks Garcia, C.P.A., C.F.E.
First Assistant County Auditor



1001 Preston, Suite 800
Houston, Texas 77002-1817
(832) 927-4600

Errika Perkins, C.P.A., C.I.A.
Chief Assistant County Auditor
Audit Division

Fax (713) 755-8932
Help Line (832) 927-4558

**MICHAEL POST, C.P.A., M.B.A.
HARRIS COUNTY AUDITOR**

June 28, 2019

Mr. William J. Jackson
Executive Director / County Budget Officer
Budget Management Department
1001 Preston St, 5th floor
Houston, Texas 77002

RE: Review of the Investment Transactions as required by Texas Local Government Code §115.003(b) and Texas Government Code §2257.061 for the Third Quarter of Fiscal Year 2019 (September 1, 2018 through November 30, 2018)

In accordance with Texas Local Government Code §115.003(b) and Texas Government Code §2257.061, the Audit Services Department performed procedures related to investments managed by the Budget Management Department's Financial Management Section (Financial Management) pursuant to the Investment Policy (Policy) approved on December 19, 2017 and effective March 1, 2018, for the Third Quarter of Fiscal Year 2019.

Our procedures included the following:

- Selectively tested for compliance with the Policy.
- Selectively tested investment transactions to verify consistency of information on the investment transaction forms with external third-party information sources.
- Selectively compared County purchases and sales activity with transactions in the Trade Reporting and Compliance Engine (TRACE) that occurred on the same day and had equivalent characteristics.
- Selectively tested investment purchases and sales to verify that investments were competitively bid.
- Selectively tested investment transactions to verify that they were timely and accurately entered into the Advanced Portfolio System 2 (APS2) and that they were recorded accurately in the County's Financial System (IFAS).
- Selectively tested investment purchases regarding investment types and maturities to verify compliance with the Policy.
- Selectively tested commercial paper transactions and money market fund (MMF) balances to verify they were accurately entered into APS2.
- Verified the Investment Officer complied with Section 4.02, *Training*, and Section 4.03, *Disclosure of Relationships with Persons Selling Investments to the County*, of the Policy.

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- Selectively tested balances at the County's depositories to the pledged collateral that secures the deposit of County Funds.
- Reviewed required documentation relative to adding or deleting qualified banks, broker/dealers, custodians, money market funds, and investment pools (Financial Institutions).
- Selectively tested the accuracy of the Quarterly Investment Report submitted to Commissioners Court to verify whether the report was accurately recorded in IFAS and was in compliance with the Public Funds Investment Act.
- Selectively reviewed Financial Institution concentration for indication of any noticeable trends.
- Reviewed for postdated transactions in APS2 subsequent to our previous audit engagement.

The work performed required our staff to exercise professional judgement in completing the scope procedures. As the procedures were not a detailed examination of all transactions, there is a risk that fraud, errors, or omissions were not detected during this engagement. The official, therefore, retains the responsibility for the accuracy and completeness of their financial records and for ensuring sufficient controls are in place to detect and prevent fraud, errors, or omissions.

The enclosed Auditor's Report does not include any issues or recommendations as none were identified during our procedures. We appreciate the time and attention provided by you and your staff during this engagement.

Sincerely,



Michael Post
County Auditor

cc: District Judges
County Judge Lina Hidalgo
Commissioners:
R. Jack Cagle
Rodney Ellis
Adrian Garcia
Steve Radack
Kim Ogg
Vince Ryan

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OVERVIEW

Financial Management is comprised of the Cash Management Section, the Investment Management Section, and the Debt Management Section. The Cash Management Section is responsible for bank relations and assuring all funds on deposit with the County depositories are fully collateralized in accordance with the Policy and Chapter 2257 of the Texas Government Code. The Investment Management Section is responsible for developing and implementing portfolio investing strategies in accordance with the Policy and Chapter 2256 of the Texas Government Code. The Debt Management Section is responsible for all debt issuance of the County, including bonds, certificates of obligation, notes, and commercial paper. Financial Management acts as the Investment Agent for the Harris County 9-1-1 Emergency Network, Community Supervision & Corrections Department, Harris County Juvenile Board, Harris Health System, Harris County-Houston Sports Authority, and the Harris County Sports & Convention Corporation. Each of these entities prepares and approves its own investment policy; thus, these entities are not included in the scope of this engagement.

The Executive Director of the Budget Management Department serves as the County Investment Officer (CIO) reporting to Commissioners Court. The Director of Financial Management, the Investment Manager, and three other designees from within Financial Management represent the five approved County designees who can initiate and approve investment transactions. The CIO, as well as the County designees, are responsible for the investment activities and compliance with state statutes and the Policy. Investment advisory services are provided by First Southwest, a division of Hilltop Securities.

The County's investment and collateralization requirements are established by Texas Government Code Chapters 2256 and 2257, which are referred to as the Public Funds Investment Act and the Public Funds Collateral Act, respectively. The Public Funds Investment Act requires both a written Investment Policy and an Investment Strategy. The County Policy, adopted on December 19, 2017, acts as both the investment policy and the investment strategy for the County, in one single document. The Policy covers areas such as the County's investment objectives, authorized investment instruments, the system of internal controls, bid solicitation requirements, allowable maturity maximums by fund type, portfolio weighted average maturity maximums, and diversification and risk tolerance guidelines. Additionally, it includes specific investment strategies for fund groups that address each groups' investment options, and it describes the priorities for suitable investments as well as collateralization requirements in accordance with the Public Funds Collateral Act. The appendices to the Policy include a list of County Designees authorized to approve County investment transactions and a list of approved Financial Institutions.

As required by Section 5.05, *Internal Controls*, of the Policy, the County has a written documented system of management level and internal accounting controls. These controls are established in Financial Management's procedure, *Internal Controls and Compliance Program - Investments*, and are intended to prevent losses of public funds arising from fraud, employee error, misrepresentation by third parties, unanticipated changes in financial markets, or imprudent actions by employees and officials of the County. The controls deemed most important by the Policy include "controls to avoid or detect collusion, segregation of duties,

segregation of transaction authority from accounting and recordkeeping, custodial safekeeping, avoidance of bearer-form securities, clear delegation of authority, specific limitations regarding security losses and remedial actions, approved written confirmation of telephone transactions, minimization of authorized investment personnel, documentation of transactions and strategies, and adherence to ethics standards.” The design and operating effectiveness of these controls is not in the scope of this engagement.

The financial industry, through the Financial Industry Regulatory Authority (FINRA), has developed TRACE, which is an electronic system used for the mandatory reporting of over-the-counter secondary market transactions in eligible fixed income securities. All Financial Institutions that are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under the Securities and Exchange Commission (SEC) approved set of rules. Transaction-level information on publicly traded TRACE eligible securities is available in real-time as the transactions are reported to TRACE; however, it may be several weeks before a Financial Institution enters the information on a trade. Currently, for each transaction, TRACE market data includes, among other fields:

- FINRA symbol;
- Committee on Uniform Securities Identification Procedures (CUSIP) number;
- Date and execution time for current day's transactions;
- Price, yield, and quantity, subject to certain volume limits;
- Contra-party type (customer or Financial Institution) and buy or sell side indicator; and
- Various modifiers, indicators (e.g., the trade was executed at a special price; the settlement does not follow market convention), and administrative messages.

FINRA makes the real-time TRACE market data available to professional users for a fee while non-professionals have access to transaction-level data at no charge at www.finra.org/marketdata and other publicly accessible web sites. As part of our procedures, we performed an analysis of the pricing groups (highest, lowest, other, or same) received (for sales) or paid (for purchases) by the County based on the TRACE market data for similar trades made on the same day.

RESULTS

Based on the procedures performed covering investment transactions occurring during the Third Quarter of Fiscal Year 2019, Financial Management materially complied with the following Policy and/or statutory requirements:

- Maturity maximums by fund type and the overall portfolio;
- Competitive bidding;
- Authorized investment types;
- Collateral;
- Annual investment officer training;
- Annual conflicts of interest disclosures;
- Documentation and authorization of new Financial Institutions;
- Finance Committee meeting requirements; and
- Quarterly Investment Report requirements.

Although not related to the Policy and/or statutory compliance items listed above, we observed the following as they relate to the scope procedures:

- The information listed on the County's investment forms agreed to the underlying supporting documentation for each of the transactions selected for testing, and they were accurately and timely entered into APS2 and interfaced into IFAS at book value after approval from Financial Accounting.
- The Investment Report for the Third Quarter of Fiscal Year 2019 submitted to Commissioners Court was materially accurate and was in compliance with the Public Funds Investment Act. We were only able to reconcile the investment balance to IFAS once a year as of the fiscal year end as the County does not mark investments to market value in IFAS until after the end of the fiscal year.
- There were no pricing anomalies with the investment purchase transactions selected for testing when comparing the price the County paid to the TRACE market data for similar transactions occurring on the same day. Based on our knowledge of the industry, it is not reasonable to assume Financial Management will obtain the lowest price every time they purchase an investment or obtain the highest price every time they sell an investment because the market is always changing and multiple prices can be offered during the course of one day.
- There were no postdated investment transactions entered into APS2 subsequent to our previous audit engagement.
- Commercial paper and money market fund (MMF) balances selected for testing were accurately entered into APS2.

During the engagement period, there were 45 in-scope investment transactions with all 45 relating to purchases after excluding commercial paper, calls, maturities, demand deposit accounts, time deposits, loans, and MMF activity, since they are not normally subject to competitive bidding. A presentation of Financial Institution concentration was performed based on an analysis of these 45 transactions. The analysis was performed for both transaction counts

and dollar values for investment transaction types subject to competitive bidding (Purchases and Sales), as well as municipal bonds alternatively subject to comparable offers and are presented as Table 1 below and Table 2 on the next page.

In addition, a presentation of seller concentration was performed based on an analysis of all 42 commercial paper transactions occurring during the 3rd Quarter of Fiscal Year 2019. The analysis was performed for transaction dollar values and is presented as Table 3 on page 9 of this report.

Table 1 below presents the total dollar and percentage value of all transaction types (Purchases only) that occurred during the audit period for each Financial Institution. As presented in Table 1 below, Robert W. Baird was awarded the highest dollar value/percentage of purchase transactions (\$65.6M, or 18.4% of purchases) (blue bar below). There were no sales transactions during the audit period.

TABLE 1

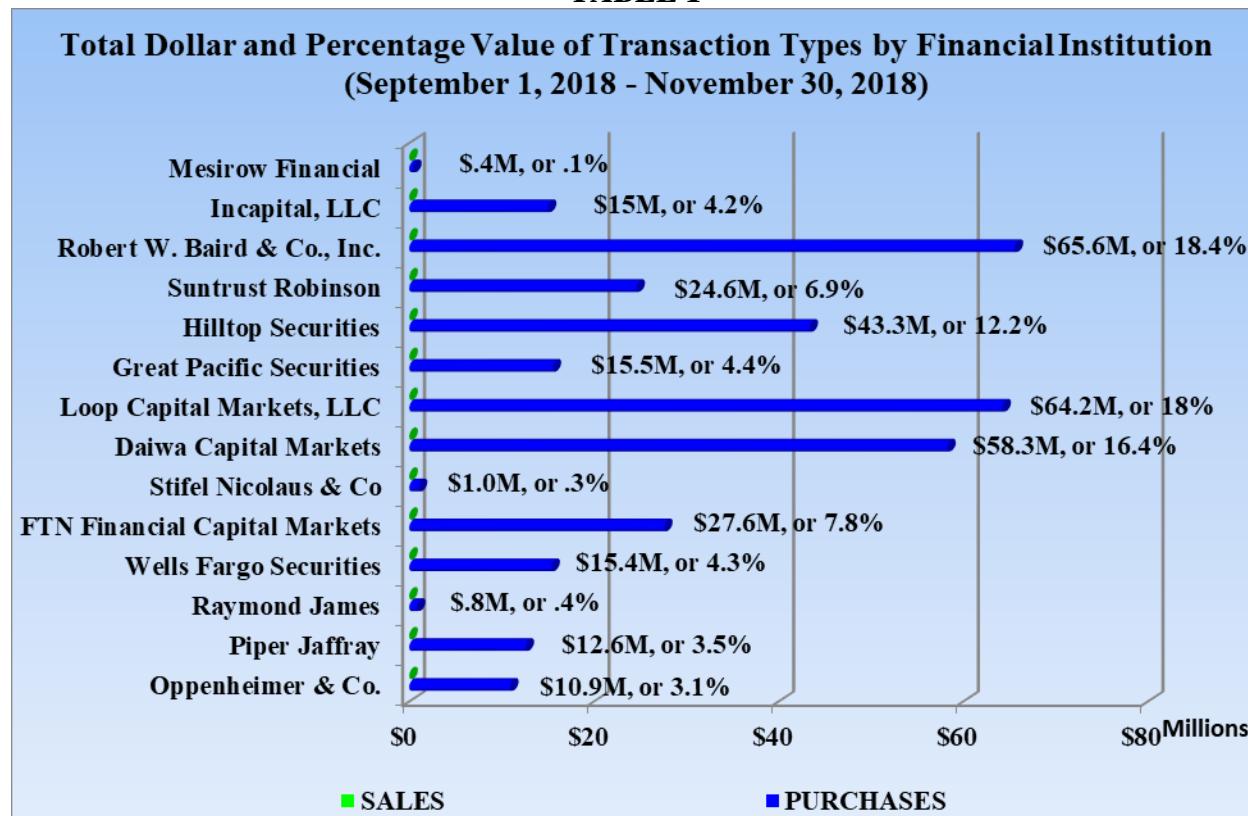


Table 1 – Due to minor rounding, some of the totals for each pricing group (Purchases and Sales) may not equal 100%.

Table 2 below presents the count and percentage value of all transaction types (Purchases only) that occurred during the audit period for each Financial Institution. As presented in Table 2 below, Robert W. Baird was awarded the highest number/percentage of purchase transactions (6, or 13.3% of purchases) (blue bar below). There were no sales transactions during the audit period.

TABLE 2

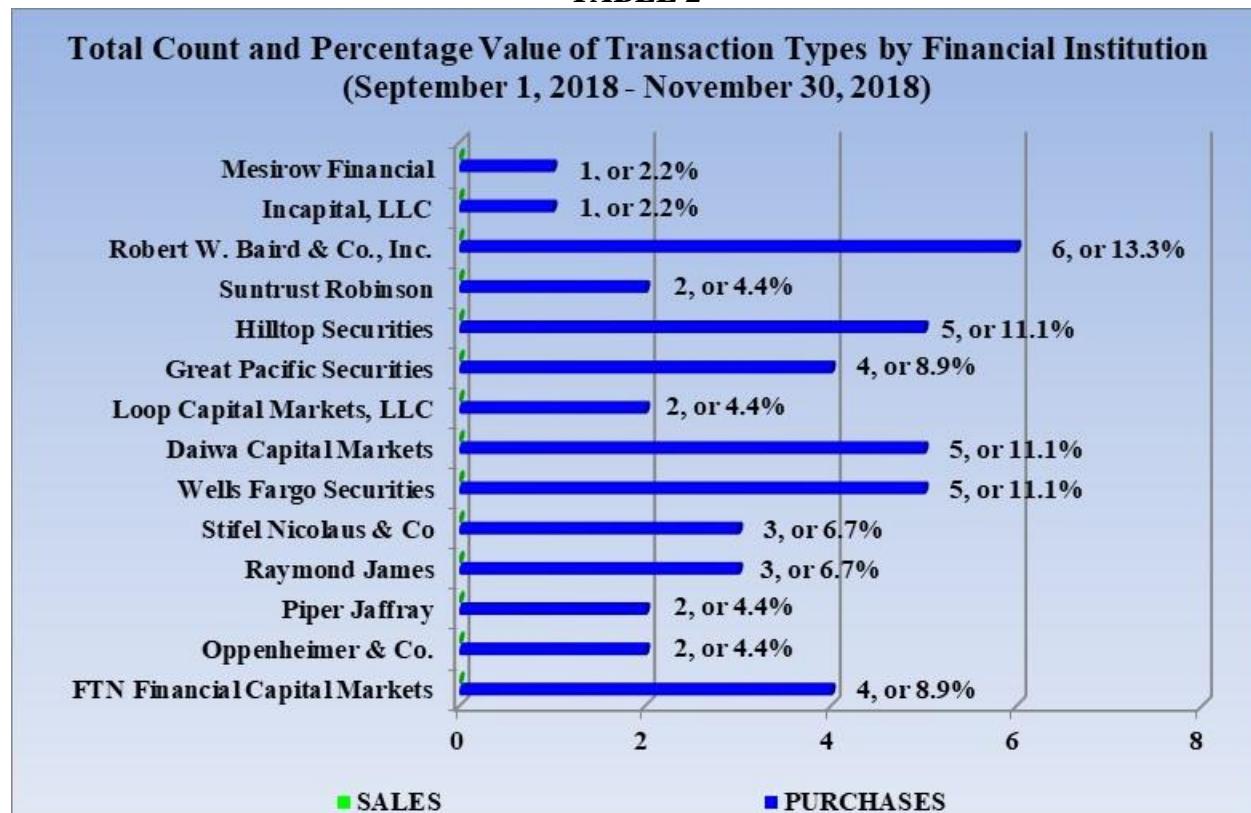


Table 2 – Due to minor rounding, some of the totals for each pricing group (Purchases and Sales) may not equal 100%.

We tested all of the investment transactions (45 total) noted in Table 1 and Table 2 above. We noted that these transactions were either competitively bid or a comparable offer (for municipal bonds) was obtained in accordance with the Policy.

Table 3 below presents the total dollar and percentage value of all commercial paper transaction types (Purchases only) that occurred during the audit period for each seller. As presented in Table 3 below, Toyota Motor Credit Corporation was awarded the highest dollar value/percentage of purchase transactions (\$282.7M, or 63.5% of commercial paper purchases) (blue bar below). There were no commercial paper sales transactions during the audit period.

TABLE 3

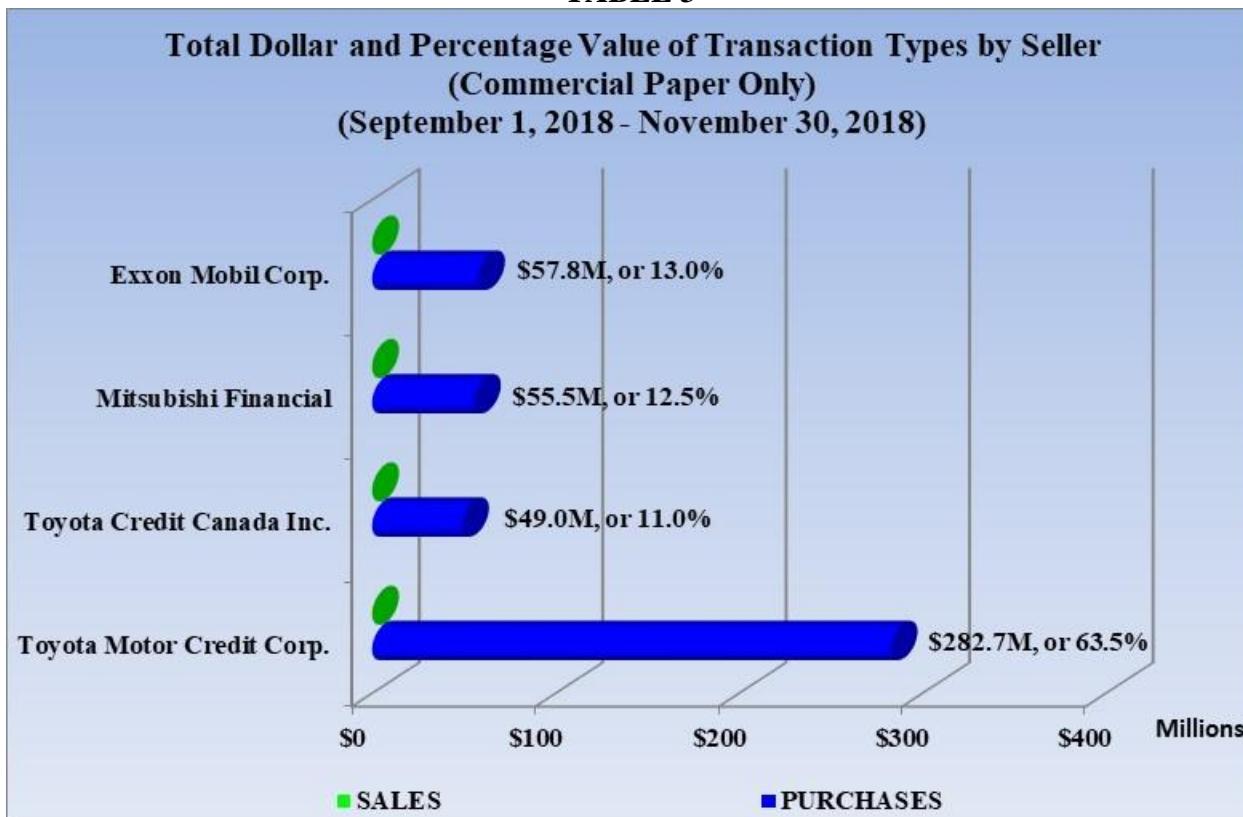


Table 3 – Due to minor rounding, some of the totals for each pricing group (Purchases and Sales) may not equal 100%.

We examined all of the commercial paper transactions (42 total) noted in Table 3 above. We noted that these transactions were recorded accurately in APS2.

As no issues or recommendations were identified during testing, the Issues and Recommendations Section that normally follows the Results Section is not necessary.