

# **AUDITOR'S REPORT**

## **FINANCIAL MANAGEMENT INVESTMENT PROCEDURES FOURTH QUARTER FISCAL YEAR 2018 THROUGH SECOND QUARTER FISCAL YEAR 2019**



**March 29, 2019**

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**HARRIS COUNTY AUDITOR**

March 29, 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 Fourth Quarter of Fiscal Year 2018 (December 1, 2017 through February 28, 2018), the First Quarter of Fiscal Year 2019 (March 1, 2018 through May 31, 2018) and the Second Quarter of Fiscal Year 2019 (June 1, 2018 through August 31, 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 January 31, 2017, for the Fourth Quarter of Fiscal Year 2018 and the subsequent Policy approved on December 19, 2017 for the First and Second Quarters 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 or a comparable offer was obtained in accordance with the Policy.
- 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.

Mr. William J. Jackson  
Executive Director / County Budget Officer  
Budget Management Department

- 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.
- Determined whether the investment balances in APS2 reconciled to the Comprehensive Annual Financial Report (CAFR).
- 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 Reports submitted to Commissioners Court to verify whether the reports were accurately recorded in IFAS and were 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 includes the issues identified during the engagement. We appreciate the time and attention provided by you and your staff during this engagement.

Sincerely,



Errika Perkins  
Chief Assistant 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 Investment Policy and Investment Strategy examined during the engagement period are contained in a single document (Policy) adopted by Commissioners Court on January 31, 2017 for the Fourth Quarter of FY 2018 and an updated Policy adopted by Commissioners Court on December 19, 2017 for the First and Second Quarters of FY 2019. 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, the data released as 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](http://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 Fourth Quarter of Fiscal Year 2018 through the Second Quarter of Fiscal Year 2019, we identified 2 opportunities for improvement as listed below:

### Financial Management

- None

### Auditor's Office

- Bank account reconciliations for the month ended August 2018 were not completed and approved in a timely manner by Revenue Accounting. Revenue Accounting Management should complete, review, and approve all bank reconciliations in a timely manner.
- The CAFR for the year ended February 28, 2018, contains a positive \$12.1 million reconciling item for the Cash and Investments balance titled, *Outstanding items/deposits* of which a positive \$546,807 could not be supported by Financial Accounting during audit fieldwork. Financial Accounting Management should perform research to support the positive \$12.1 million reconciling item for Cash and Investments (titled *Outstanding items/deposits*) reported in the CAFR's Notes to the Financial Statements for the year ended February 28, 2018. All supporting documentation should be retained in accordance with the Auditor's Operations Manual Procedure 2.2, *Storage, Retrieval, and Destruction of County Auditor Records*.

These opportunities for improvement are discussed in more detail within the Issues and Recommendations section of this report.

**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 Reports for the Fourth Quarter of Fiscal Year 2018 through the Second Quarter of Fiscal Year 2019 submitted to Commissioners Court were materially accurate and were in compliance with the Public Funds Investment Act. We reconciled the investment balance to IFAS as of the Fourth Quarter of Fiscal year 2018. However, we were not able to reconcile the investment balance to IFAS for the First Quarter of Fiscal Year 2019 and the Second Quarter of Fiscal Year 2019 as the investment balance is recorded at market value and the County only marks investments to market value in IFAS once a year 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 MMF balances selected for testing were accurately entered into APS2.

During the engagement period, there were 73 in-scope investment transactions with all 73 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 73 transactions. The analysis was performed for both transaction counts and dollar values for investment transaction types subject to competitive bidding (Purchases, Sales, and Partial Sales), as well as municipal bonds alternatively subject to comparable offers and are presented as Table 1 and Table 2 on the next two pages.

Additionally, a presentation of seller concentration was performed based on an analysis of a sample of 30 commercial paper transactions occurring during the 4<sup>th</sup> Quarter of Fiscal Year 2018, the 1<sup>st</sup> Quarter of Fiscal Year 2019 and the 2<sup>nd</sup> Quarter of Fiscal Year 2019. The analysis was performed for transaction dollar values and is presented as Table 3 on page 10 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. The table only includes investment transaction types that are subject to competitive bidding (Purchases, Sales, and Partial Sales), as well as comparable offers for municipal bonds. As presented in Table 1 below, Oppenheimer & Co. was awarded the highest dollar value/percentage of purchase transactions (\$231.9M, or 15.8% of purchases) (blue bar below). There were no sales transactions during the audit period.

**TABLE 1**

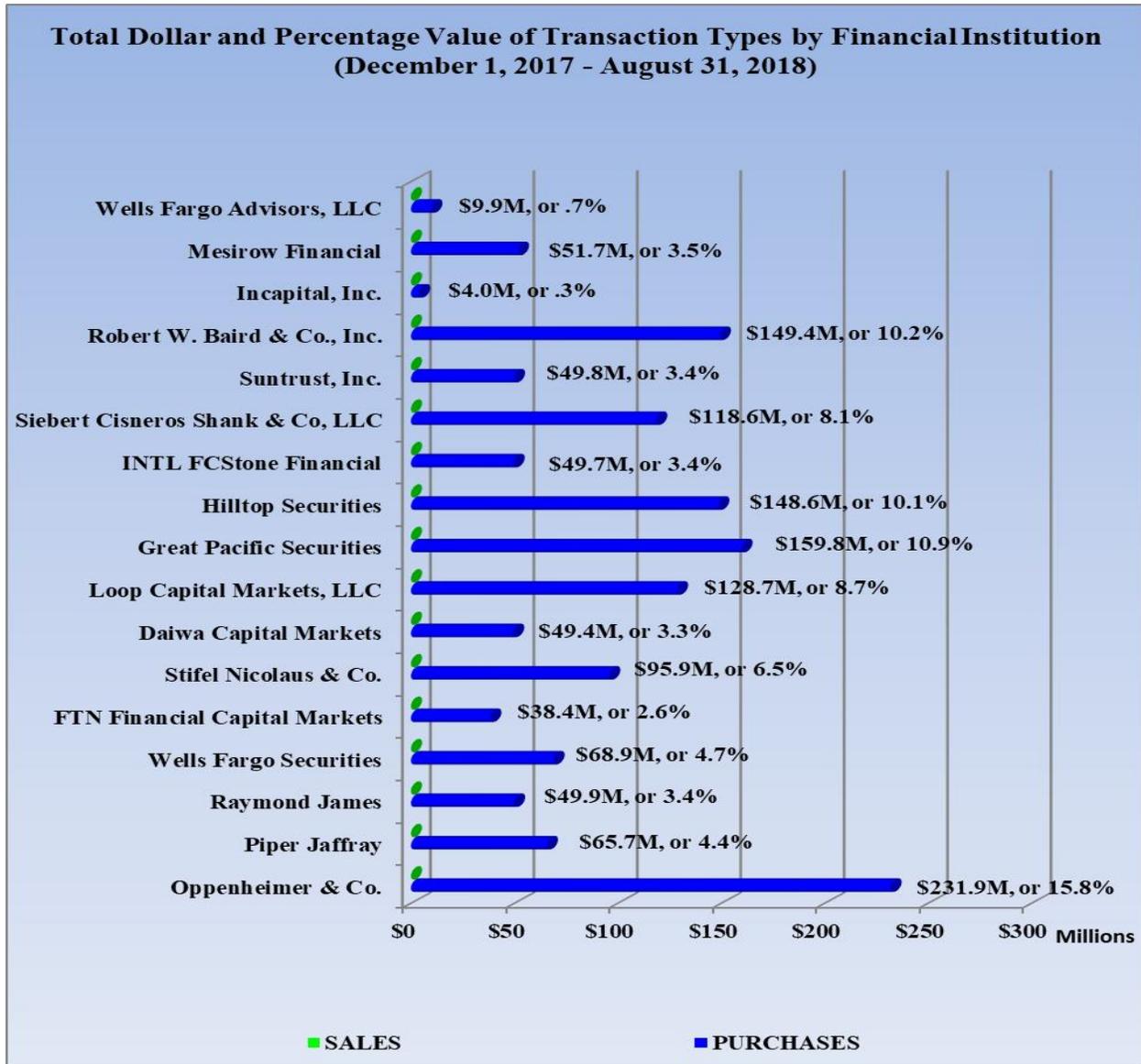


Table 1 – Due to minor rounding, some of the totals for each pricing group (Purchases, Sales, and Partial Sales) may not equal 100%

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. The table only includes investment transaction types that are subject to competitive bidding (Purchases, Sales, and Partial Sales), as well as comparable offers for municipal bonds. As presented in Table 2 below, Siebert Cisneros Shank & Co, LLC was awarded the highest number/percentage of purchase transactions (18, or 24.7% of purchases). There were no sales transaction during the audit period.

**TABLE 2**

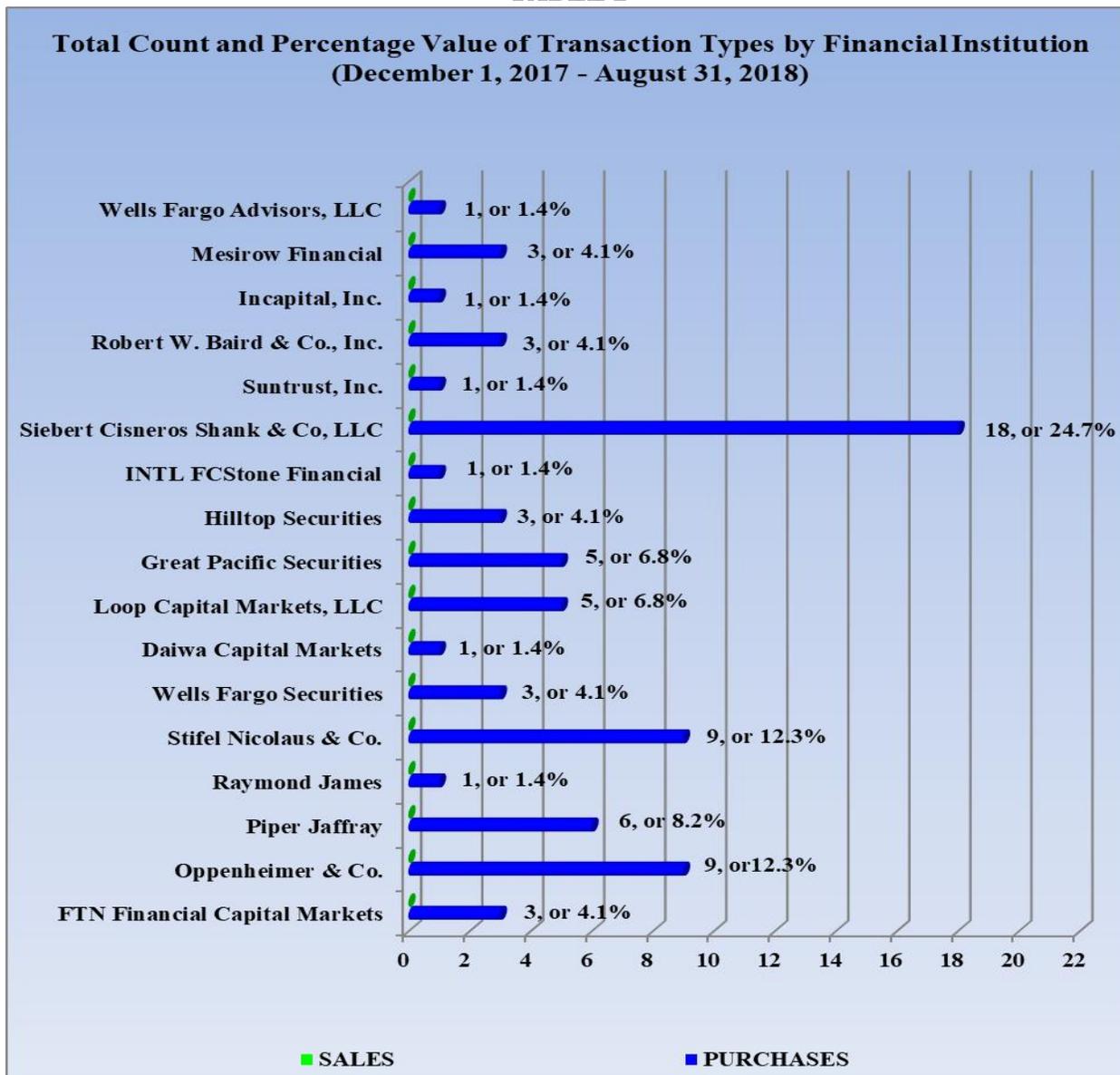


Table 2 – Due to minor rounding, some of the totals for each pricing group (Purchases, Sales, and Partial Sales) may not equal 100%.

We tested all of the investment transactions (73 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 a sample of 30 commercial paper purchases and all commercial paper sales that occurred during the audit period for each seller. As presented in Table 3 below, GE Capital Treasury Services was awarded the highest dollar value/percentage of purchase transactions (\$123.2M, or 20.7% of commercial paper purchases) (blue bar below) and Toyota Motor Credit Corp. was awarded the highest dollar value/percentages of sales transactions (\$8.0M, or 66.9%) (green bar below).

**TABLE 3**

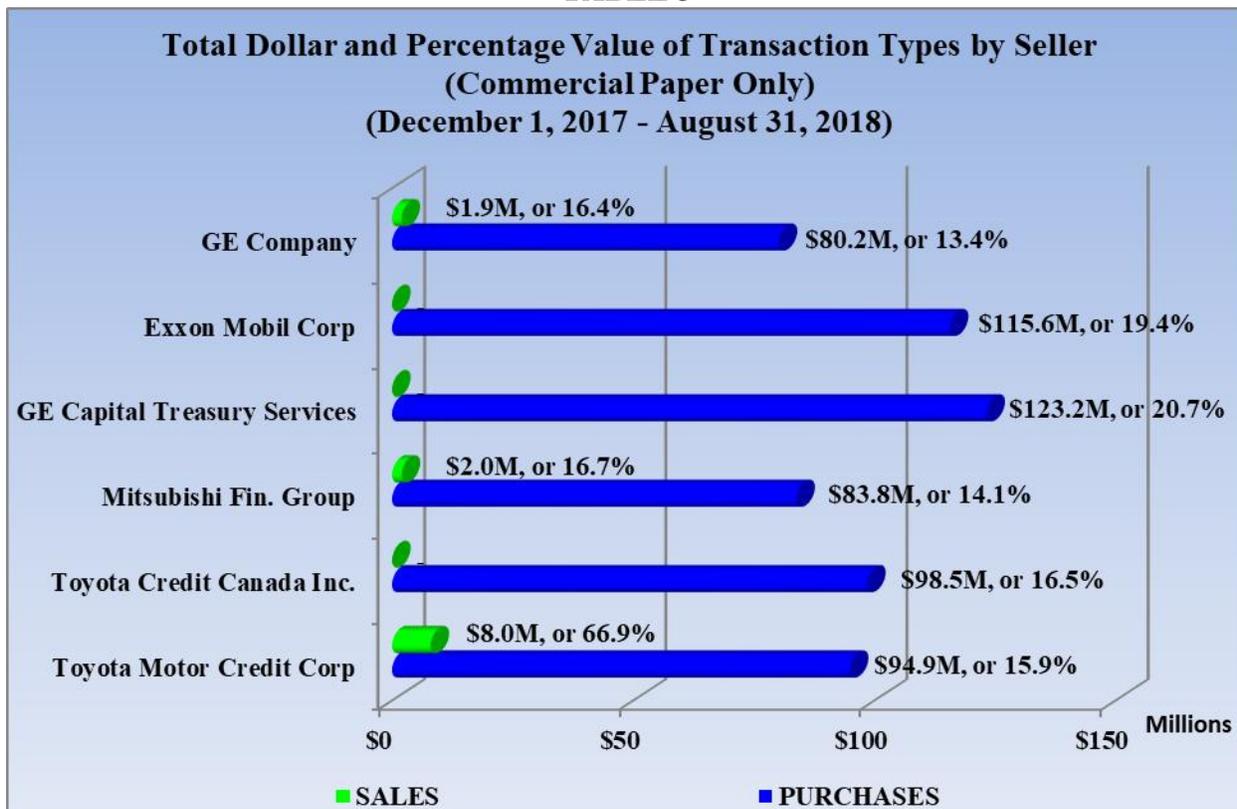


Table 3 – Due to minor rounding, some of the totals for each pricing group (Purchases and Sales) may not equal 100%.

We examined a sample of commercial paper purchase transactions (30 total) and all commercial paper sales transactions (4 total) noted in Table 3 above. We noted that these transactions were recorded accurately in APS2.

# ISSUES AND RECOMMENDATIONS

## Auditor's Office

### Bank Reconciliations

#### Background

Pursuant to the Auditor's Operations Manual Procedure 11.4.2, *Month End Procedures, Bank Reconciliations*, the County Auditor's Office Revenue Accounting Department (Revenue Accounting) prepares the following reports and schedules at month end:

- Current Master Listing of all Bank Accounts
- Bank Reconciliation Tracking Schedule
- Custodial Reconciliation Tracking Schedule
- Custodial vs. General Ledger Comparison Schedule
- Bank Reconciliation Status Schedule
- Total Count of Open Bank Accounts
- Bank Reconciliation Exception Report
- Custodial Account Outstanding Items Schedule
- Bank Accounts Opened During Fiscal Year
- Bank Accounts Closed During Fiscal Year

The Bank Reconciliation Team utilizes a master listing of bank accounts to ensure that each bank account is reconciled on a monthly basis.

#### Issue

Bank account reconciliations for the month ended August 2018 were not completed and approved in a timely manner by Revenue Accounting. In addition, one of our selected bank reconciliations for the month of August 2018 that had a balance of \$105,178,864.69 (9.86%) of the County's combined demand deposit accounts and money market funds was not available for review during fieldwork.

Not completing bank reconciliations in a timely manner impairs the department's ability to detect fraud, errors and/or omissions which could result in a misstatement in the County's financial statements and/or financial loss to the County.

#### Recommendation

Revenue Accounting Management should complete, review, and approve all bank reconciliations in a timely manner in accordance with the Auditor's Operations Manual Procedure 11.4.2, *Month End Procedures, Bank Reconciliations*.

## ISSUES AND RECOMMENDATIONS

### **Bank Reconciliations (Continued)**

#### **Management Response**

Management agrees with the issue. Revenue Accounting has taken several steps to improve the bank reconciliation process including:

1. Creation of the Financial Controls group, including a new Assistant Director position, to oversee the bank reconciliation process.
2. Collaboration with Universal Services to improve the existing Access database used in the bank reconciliation process and to explore options for purchasing or creation of a new bank reconciliation software using updated technology.
3. Contracted with a consultant to evaluate the bank reconciliation process and make recommendations for efficiencies.

As of the date of this report, the general concentration bank reconciliation is completed through December 2018 and the January 2019 reconciliation is nearing completion.

# ISSUES AND RECOMMENDATIONS

## Auditor's Office

### Cash and Investments Reconciliation

#### Background

Pursuant to Texas Local Government Code Section 114.025, *County Auditor's Monthly and Annual Reports to Commissioners Court and District Judges*, "the county auditor shall make monthly and annual reports to the Commissioners Court and to the district judges of the County. Each report must show:

- Aggregate amounts received and disbursed from each county fund;
- condition of each account on the books;
- Amount of county, district, and school funds on deposit in the county depository;
- Amount of county bonded indebtedness and other indebtedness; and
- Any other fact of interest, information, or suggestion that the auditor considers proper or that the court or district judges require."

A CAFR is a set of financial statements comprising the financial report of a state, municipal, or other governmental entity that complies with the accounting requirements promulgated by the Governmental Accounting Standards Board (GASB).

#### Issue

The CAFR for the year ended February 28, 2018, contains a positive \$12.1 million reconciling item for the Cash and Investments balance titled, *Outstanding items/deposits* of which a positive \$546,807 could not be supported by Financial Accounting during audit fieldwork.

As a result, we are unable to reconcile the investment balance recorded in APS2 to the cash and investment balance recorded in the CAFR for the 12 month period ended February 28, 2018.

#### Recommendation

Financial Accounting Management should perform research to support the positive \$12.1 million reconciling item for Cash and Investments (titled *Outstanding items/deposits*) reported in the CAFR's Notes to the Financial Statements for the year ended February 28, 2018. All supporting documentation should be retained in accordance with the Auditor's Operations Manual Procedure 2.2, *Storage, Retrieval, and Destruction of County Auditor Records*.

## ISSUES AND RECOMMENDATIONS

### **Cash and Investments Reconciliation (Continued)**

#### **Management Response**

Management agrees with the finding. The majority of this issue was caused by the change of the County's depository and the lack of adequate reports from the depository. Research indicated the District Clerk Registry and County Clerk Registry funds also contributed to the variance. In the next CAFR we will make sure to appropriately classify the District Clerk Registry and the County Clerk Registry's reconciling items in the appropriate Money Market Fund category. We will work to research the remaining unsupported reconciling amount.