

COMMISSION MEMBERS

The Honorable Pete C. Alfaro
Chairman, Baytown

Nicholas T. Serafy, Jr.
Vice-Chairman, Brownsville

Steve Fryar
Brownwood

Patsy Reed Guest
Duncanville

Don Bethel
Lamesa

Bill Mahomes
Dallas

Gogi Dickson, PH.D.
San Antonio



INTERNAL AUDIT DEPARTMENT

Audit Report
on

EXECUTIVE MANAGEMENT

Dwight Harris
Executive Director

Linda S. Reyes, PH.D.
Deputy Executive Director

**Public Funds Investment Act
Compliance**

INTERNAL AUDIT DIRECTOR

Karin L. Hill, CIA, CGAP

Internal Audit Department
P.O. Box 4260
Austin, TX 78765

January 2006

Public Funds Investment Act Audit

Audit Team

Thomas Brown, CIA

For additional copies of this report, please request 06-2



INTERNAL AUDIT DEPARTMENT

TO: Texas Youth Commission Board Members
Pete Alfaro, TYC Board Chair
Nicholas T. Serafy, Jr., TYC Board Vice Chair
Donald Bethel, TYC Board Member
Gogi Dickson, Ph.D., TYC Board Member
Steve Fryar, TYC Board Member
Patsy Reed Guest, TYC Board Member
Bill Mahomes, Jr., TYC Board Member

FROM: Karin Hill, Internal Audit Director

DATE: January 19, 2006

RE: Results of the Public Funds Investment Act Compliance Audit

Attached for your approval is our report on the Texas Youth Commission's (TYC's) Public Funds Investment Act Compliance Audit. The objective of this audit was to determine the agency's compliance with the Public Funds Investment Act (the Act) during fiscal years 2004 and 2005 in its administration of the John C. Wende and Parrie Haynes trust funds.

This audit was completed in December 2005, however was not released until TYC's Board approved the report.

To accomplish the objective of this audit; we reviewed relevant rules, regulations and laws, and selected a sample of expenditures from the two trusts for testing. We also compared TYC's investment policy and strategy with requirements in the Act, reconciled the trust bank accounts, reviewed reinvestments to ensure the best rates were obtained, and reviewed cash flows for reasonable revenues, expenditures, and investments.

The TYC complies with the Public Funds Investment Act. It has a Board approved investment policy and strategy, investments comply with policy, and controls are in place to ensure that expenditures from the trust funds are authorized, approved, and documented.

This audit meets the requirements of Chapter 2256 of the Texas Government Code.

cc: Linda Reyes, Ph.D., Deputy Executive Director

This report presents the results of our audit of the Texas Youth Commission's (TYC) compliance with the Public Funds Investment Act (the Act) in its administration of the Parrie Haynes and John C. Wende trusts.

Chapter 2256 of the Texas Government Code authorizes investments for governmental entities through the Public Funds Investment Act. State entities are tasked to ensure the preservation and safety of the principal; its liquidity and yield. To accomplish these objectives the governing body of each entity must have approved investment policies and strategies that assure the objectives are met. The Act also establishes the training requirements for Board members and entity investment officers and specifies the types of authorized investments. Although compliance with Chapter 2256 is not incumbent on TYC because neither trust was established for the benefit of TYC or the State, the Board has elected to adopt the Act requirements to strengthen investment oversight of its trusts.

TYC, as the successor to the State Orphan Home, is the trustee of the Parrie Haynes and John C. Wende trusts. As trustee, TYC reviews, and approves required educational assistance for qualified recipients, manages investments, and makes payments for repairs, maintenance, and capital improvements to the properties owned by the funds.

The objective of this audit was to determine if TYC's investment policy complies with the Act by evaluating compliance with investment policy and determining whether management has implemented effective controls over trust fund activities.

To accomplish this objective TYC's investment policies for fiscal years 2004 and 2005 were compared to agency practices and provisions of the Act. In addition, we compared actual investment activities to policy; reviewed bank statements and expenditures; and prepared cash flow and asset statements for the period of this report. Detailed schedules of assets and cash flows for the Parrie Haynes and John C. Wende trusts begin on page 3 of this report.

This audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing* and *Generally Accepted Government Auditing Standards*.

The Texas Youth Commission complies with the Public Funds Investment Act.

Five key areas of the Public Funds Investment Act provide the framework for developing and controlling authorized investments for governmental entities. The key areas, as well as an explanation of the agency's compliance are as follows:

TYC has appointed an investment officer and developed an investment policy and strategies. The Act requires that an investment policy and strategy be developed. The policy must be written, emphasize safety of principal, be liquid, and describe the types of investments authorized to be made. The strategy is an annual plan on how the agency will carry out its investment activities within policy. In addition to the policy, an

investment strategy must be developed for each fund and reviewed annually. A subcommittee of TYC's Board is briefed quarterly on the activities of the trust funds, and the Board approves the investment policy and strategies for each fund annually. The current Investment Officer was appointed in July 2005.

Investments are made with judgment and care. By complying with the agency's investment policy, TYC's Investment Officer ensures that the trust funds are managed to preserve the principal, remain liquid, and maximize yield through acting with prudence in the investment process. He is mindful of the safety of the investment as well as the potential for income from the investment.

Investment training is completed within the timeframe outlined in the Act. State statute requires that members of the governing board and investment officers attend at least one training session relating to their responsibilities. Three new board members were appointed to TYC's Board since the last Public Funds Investment Audit. All were trained as required. In addition, a new investment officer was appointed for TYC in July 2005 and has completed his training requirements.

TYC ensures safe and secure investments by limiting the diversity of its investments to Certificates of Deposits and U.S. Treasury Notes. Even though other categories of investments are available through the Act; TYC's Board has limited investment activities for the trust funds to the most conservative of investments: Certificates of Deposit or other fully insured securities, and U.S. Treasury Notes or other federal issues.

Members of the Charitable Trust Committee are provided quarterly bank account and investment statements. The Charitable Trust Committee of the TYC Board meets as needed or at least annually to review and approve the investment policy, strategy, and budget as well as other business related to either of the trust funds. Information reviewed in the committee meeting is reported to the Board.

Detailed Schedules of Assets and Cash Flows

TYC accounts for the assets of the Parrie Haynes and John C. Wende trusts as either nonexpendable – the principal can be invested but must remain intact, or expendable – the principal and income can be invested or expended for trust activities. The cash flows to fund the Educational Assistance Program and other operating expenses for the trusts are from income earned on nonexpendable assets (primarily land income) and principal and interest income from expendable assets.

Increased income levels and decreases in the use of the Educational Assistance Program have resulted in increased cash balances for both trust funds. This was most noticeable for the Parrie Haynes trust, which almost tripled its lease and rental income between fiscal years 2004 and 2005, but had a 53 percent decrease in expenditures for educational assistance. In response, the Investment Officer increased investments in fiscal year 2005 for this fund. Asset schedules and statements of cash flows for the Parrie Haynes and John C. Wende trusts for fiscal years 2004 and 2005 follow.

FY 2004 Assets and Cash Flows:

Assets as of 8/31/2004	Parrie Haynes Trust		John C. Wende Trust	
	Nonexpendable	Expendable	Nonexpendable	Expendable
Cash in Bank		\$65,838		\$77,826
Short Term Investments		99,000		578,577
Non-Current Short Term Investment			\$14,423	
Accounts Receivable				
Land	\$187,187		93,894	
Buildings	860,425			
Facilities	Depreciation	(122,274)		
	Depreciation	136,253		
		(3,613)		
Total	\$1,057,978	\$164,838	\$108,317	\$656,403

Source: TYC's FY 2004 Comprehensive Annual Financial Report

Statement of Cash Flows for the year ended August 31, 2004	Parrie Haynes Trust	John C. Wende Trust
Beginning cash balance (as of 8/31/2003)	\$44,552	\$54,773
<u>Available Revenue</u>		
Lease & Rental Income	\$50,000	\$74,714
Interest Income	2,943	12,386
Total Available Revenue	\$52,943	\$87,100
<u>Less: Expenditures</u>		
Insurance Premiums	10,937	
Fees & other charges	154	60
Art Projects		2,400
Educational Assistance	18,966	51,837
Young Parent Assistance		1,750
Maintenance and Repair	600	
Total Expenses	(30,657)	(56,047)
Cash from Operations	22,286	31,053
<u>Investment Activity</u>		
CDs Reaching Maturity	98,000	585,000
Less: Reinvestments	(99,000)	(593,000)
Cash from Investment Activities	(1,000)	(8,000)
Ending Cash Balance (as of August 31, 2004)	\$65,838	\$77,826

Source: TYC's Quarterly Financial data to Board

Audit of Public Funds Investment Act

FY 2005 Assets and Cash Flows:

Assets as of 8/31/2005	Parrie Haynes Trust		John C. Wende Trust	
	Nonexpendable	Expendable	Nonexpendable	Expendable
Cash in Bank		\$23,010		*\$94,800
Short Term Investments		272,250	\$14,423	604,327
Non-Current Short Term Investments				
Accounts Receivable				
Land	\$187,187		93,894	
Buildings	860,425			
Depreciation	(154,731)			
Facilities	136,253			
Depreciation	(9,806)			
Total	\$1,019,328	\$295,260	\$108,317	\$699,127

Source: TYC's FY 2005 Draft Schedules for Comprehensive Annual Financial Report

*Differs from Statement of Cash Flows: Ending as of 8/31/2004, by \$1 due to rounding.

Statement of Cash Flows for the year ended August 31, 2005	Parrie Haynes Trust	John C. Wende Trust
Beginning cash balance (as of 8/31/2004)	\$65,838	\$77,826
<u>Available Revenue</u>		
Lease & Rental Income	\$144,961	\$79,872
Interest Income	5,195	15,919
Total Available Revenue	\$150,156	\$95,791
<u>Less: Expenditures</u>		
Insurance Premiums	9,404	
Fees & other charges	155	
Art Projects		8,456
Educational Assistance	10,175	43,028
Young Parent Assistance		1,582
Maintenance and Repair		
Total Expenses	<u>(19,734)</u>	<u>(53,066)</u>
Cash from Operations	130,422	42,725
<u>Investment Activity</u>		
CDs Reaching Maturity	99,000	593,000
Less: Reinvestments	(272,250)	(618,750)
Cash from Investment Activities	<u>(173,250)</u>	<u>(25,750)</u>
Ending Cash Balance (as of August 31, 2005)	\$23,010	*\$94,801

Source: TYC's Quarterly Financial data to Board

*Differs from Assets: Cash in Bank, by \$1 due to rounding.

Texas Youth Commission		
Summary of Investments		
Investment Type	August 31, 2005 Book Value	August 31, 2005 Market Value
Equity Securities		
U.S. Common Stock		
Equity Mutual Funds		
Other Equity Securities (list)		
Total Equity Securities		
Other Investments		
Real Estate		
Private Equity		
Annuities		
Collective Endowment Funds		
Commodities		
Collectibles		
Other (list)		
Total Other Investments		
Debt Investments > 1 year		
U.S. Government		
U.S. Government Agency		
Mortgage Pass-Throughs		
CMOs:		
Interest Only Strips		
Principal Only Strips		
Inverse Floaters		
Stated Maturities longer than 10 years		
PFIA Compliant CMOs		
Other Asset-Backed Bonds		
Foreign Issued Obligations		
Municipal Obligations		

Texas Youth Commission		
Summary of Investments, page 2		
Investment Type	August 31, 2005 Book Value	August 31, 2005 Market Value
Corporate Obligations:		
Highly Rated (AAA/AA)		
Investment Grade (A/BBB)		
NR/High Yield (<BBB)		
GICs		
Bond Mutual Funds		
Other (list)		
Total Debt Investments >1 year		
Short Term Investments		
U.S. Government		
U.S. Government Agency		
CDs/BAs	\$891,000	\$891,000
A1/P1 Commercial Paper		
Repurchase Agreements		
TexPool		
Other Money Market Funds and Pools		
Bank Deposits	\$117,811	\$117,811
Cash Held at State Treasury		
Other (list)		
Total Short Term Investments		
TOTAL INVESTMENTS	\$1,008,811	\$1,008,811

Explanations of Asset Classes

A1/P1 Commercial Paper	Commercial paper rated A1, P1, or F1 (or higher). Lower rated commercial paper should be listed under "other" short-term investments.
Annuities	A type of investment sold by insurance companies. Includes fixed and variable annuities.
Bank Deposits	Money held in bank, savings bank, or credit union accounts.
Bond Mutual Funds	Funds that invest in debt securities with a variable net asset value per share.
CDs/BAs	Certificates of deposit with a maturity under one year and banker's acceptances.
CMO (Collateralized Mortgage Obligations)	Prohibited CMOs listed as noncompliant. (Institutions may hold noncompliant CMOs that were purchased prior to September 1, 1995.)
Cash Held at State Treasury	All balances held in the State Treasury or the Texas Treasury Safekeeping Trust Company.
Collectibles	Items such as art, stamps, coins, historic documents, and memorabilia.

Collective Endowment Funds	Long-term endowment funds managed by a third party that combines investments from multiple investors (the Common Fund and the Permanent Higher Education Fund are examples).
Commodities	Includes things such as oil and gas, timber land, and precious metals.
Corporate Obligations	All non-governmental debt issues classified by rating. For issues with split ratings, lower ratings are reported. Equivalent ratings from other rating agencies such as Fitch may be used.
Equity Mutual Funds	Mutual funds that invest in stocks. Includes balanced funds (which include a mix of stocks and bonds).
Equity Securities	Stocks.
Fair Market Value	The value based on Governmental Accounting Standards Board Statement 31 (GASB 31).
Foreign Issued Obligations	Securities that are issued outside of the U.S. by non-U.S. issuers (in U.S. dollars or foreign currency). Includes U.S. issued securities that are in foreign currencies.
GICs	Guaranteed investment contracts issued by insurance companies.
Highly Rated Corporate Issues	Issues rated AAA or AA by Standard & Poor's or Aaa or Aa by Moody's.
Investment Grade Corporate Issues	Issues rated A or BBB by Standard & Poor's or A or Baa by Moody's.
Mortgage Pass-Throughs	Residential mortgage securities pooled together and marketed by governmental agency issuers such as GNMA, FNMA, FHLMC. (Does not include private issues, which should be included with CMOs, and pooled commercial real estate mortgages, which should be included with other asset-backed bonds.)
Municipal Obligations	State, county, municipality, or public authority issues.
NR/High Yield	Non-Rated (NR rated) issues and issues rated BB or lower by Standard & Poor's and Ba or lower by Moody's.
Other Asset-Backed Bonds	Securities backed by pools of assets such as credit card loans, commercial real estate loans, and auto loans.
Other Equity Securities	Preferred stocks, foreign stocks, and non-publicly traded stocks.
Other Money Market Funds and Pools	Money funds and pools with a constant \$1.00 per share net asset value objective.
Private Equity	Includes venture capital, hedge funds, leveraged buyout, mezzanine, and strategically traded securities held directly or through investment vehicles such as limited partnerships.
Real Estate	Includes real estate held for investment directly or through investment vehicles such as limited partnerships.
Repurchase Agreements	Short-term investments secured by marketable securities.
Short-Term Investments	Includes all debt investments with a maturity (as of purchase date) of less than one year and all cash and bank deposits.
TexPool Investments	Investments in TexPool. Includes other Texas pool investments with other money market funds.
U.S. Common Stocks	Includes only publicly traded stocks.
U.S. Government Agency Securities	Securities issued by U.S. Government-sponsored agencies or corporations such as FNMA, FHLMC, or FHLB that do not have full faith and credit guarantees from the U.S.
U.S. Government	Includes Treasuries and any other investment with an affirmative full faith and credit guarantee of the U.S. Government.