

AUDITOR'S REPORT

HARRIS HEALTH SYSTEM INVESTMENT PROCEDURES



October 29, 2015

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HARRIS COUNTY AUDITOR

October 29, 2015

Mr. George Masi
President and Chief Executive Officer
Harris Health System
2525 Holly Hall
Houston, Texas 77054

RE: Procedures for Investment Transactions for the Harris Health System for the nine months ended November 30, 2014, as required by Texas Local Government Code §115.003(b) and Texas Government Code §2257.061

In accordance with Local Government Code §115.003(b) and Government Code §2257.061, the Audit Services Department performed procedures for investments managed by the Harris Health System (Harris Health) and the Financial Management Section (Financial Management) of the Harris County Budget Management Department, pursuant to the Harris Health Investment Policies effective during the nine months ended November 30, 2014.

Our procedures included the following:

- Selectively tested for compliance with the Harris Health Investment Policy.
- Selectively tested investment transactions to ensure consistency of information on the investment transaction forms with external third party information sources.
- Selectively compared purchases and sales activity with transactions in the Trade Reporting and Compliance Engine (TRACE) for the same day that had equivalent characteristics.
- Selectively tested investment purchases and sales to ensure investments were competitively bid.
- Selectively tested investment transactions to ensure that they were timely and accurately entered to the Advanced Portfolio System 2 (APS2) and that they are recorded accurately in Harris Health's financial records (PeopleSoft).
- Selectively tested investment purchases to ensure compliance with Harris Health's Investment Policy regarding investment types and maturities.
- Downloaded investment data from APS2 and performed analytical review procedures.
- Verified the Investment Officer's compliance with the Harris Health Investment Policy, Section 3.02, *Training*, and Section 4.03, *Disclosures of Relationships with Persons Selling Investments to Harris Health*.
- Selectively tested Harris Health depositories to the pledged collateral that secures deposits of Harris Health funds.
- Examined the 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 the Harris Health Board of Managers and the Commissioners Court during the nine months ended November 30,

Mr. George Masi
President and Chief Executive Officer

2014, and determined whether the investments included in the reports are accurately recorded in PeopleSoft and comply with the Public Funds Investment Act.

- Selectively examined Financial Institution concentration for the nine month period ended November 30, 2014, to determine whether there appeared to be any noticeable trends.
- Selectively tested compliance with the Interlocal Agreement for financial investment services between Harris County and Harris Health.

The engagement process included providing you with a combined engagement and scope letter, communicating issues with your personnel, as well as conducting entrance and exit conferences with your personnel. The purpose of the letter and conferences was to explain the process, identify areas of concern, describe the procedures to be performed, discuss issues identified during the engagement, and solicit suggestions for resolving the issues. A draft report was provided to you and your personnel for review.

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

The enclosed Auditor's Report presents the significant issues identified during our procedures, recommendations developed in conjunction with your staff, and any actions you have taken to implement the recommendations. Less significant issues and recommendations were verbally communicated to your staff.

We appreciate the time and attention provided by you and your staff during this engagement.

Sincerely,



Barbara J. Schott
County Auditor

cc: Harris Health System Board of Managers
District Judges
County Judge Ed Emmett
Commissioners:
R. Jack Cagle
El Franco Lee
Jack Morman
Steve Radack
Devon Anderson
Vince Ryan
William J. Jackson

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OVERVIEW

Investment and collateralization requirements for state and local governmental entities in Texas are established by the Texas Government Code, Chapter 2256 (Public Funds Investment Act) and Chapter 2257 (Public Funds Collateral Act). The requirements are applicable to entities with public funds such as Harris County and Harris Health. Harris Health’s investments as of November 30, 2014, had a market value of \$177,528,781 and a book value of \$176,375,135, and they were allocated by investment category as follows:

Investment Category	Market Value	Book Value
Money Market Funds	\$141,567,078	\$141,567,078
Federal Agencies	18,023,071	18,074,006
Municipal Bonds	17,351,611	16,147,030
Commercial Paper	574,137	574,137
Other	12,884	12,884
TOTAL	\$177,528,781	\$176,375,135

Source: Quarterly Investment Report

Financial Management provides investment services to Harris Health (for funds other than pension funds) pursuant to an Interlocal Agreement. Services provided to Harris Health through the Interlocal Agreement include buying and selling investment securities on behalf of Harris Health and providing Harris Health with quarterly and monthly investment reporting.

Harris Health has its own Investment Policy (Policy) which states Harris Health’s investment policies and investment strategies. The Policy is formally reviewed and approved by Harris Health’s Board of Managers and includes exhibits that list approved Financial Institutions, including broker/dealers. Broker/dealers included in the Policy are the broker/dealers adopted by Harris County and approved by Commissioners Court.

The Policy also includes an exhibit that lists Harris Health and Harris County personnel authorized to invest Harris Health funds and appoints the Harris Health Chief Financial Officer as the Investment Officer. In accordance with the Interlocal Agreement, authorized Financial Management personnel buy or sell investment securities on behalf of Harris Health based on written instructions provided by authorized Harris Health personnel.

Authorized Harris Health personnel provide instructions based on cash flow projections prepared. The instructions include the specific Harris Health fund group (i.e., general fund, bond reserved fund, etc.) for which the transaction is requested and instructions for the custodial depository account where the investment securities are to be delivered or retrieved. All investment securities are delivered or retrieved on the “Delivery vs. Payment” method whereby cash is exchanged for the security simultaneously.

Financial Management obtains at least three bids for each investment security transaction and provides documentation to Harris Health via a Purchase of Security Form or Sale of Security Form after each transaction is executed. The documentation includes information necessary to

record the transactions in Harris Health's financial records and to monitor compliance with the Public Funds Investment Act and the Policy.

Harris Health funds that are not invested in investment securities through Financial Management are held in money market funds or in depository accounts at Harris Health's bank. Through a contractual arrangement with the bank, funds are automatically transferred from depository accounts to money market funds at the end of each business day to ensure that depository account balances do not exceed the maximum Federal Deposit Insurance Corporation (FDIC) coverage.

Financial Management prepares reports for Harris Health that show the detail investment positions of Harris Health at the end of each month and quarter. The reports show each investment's book value, market value, the maturity date, and the fund group for which the investment was acquired. A statement is included with quarterly reports certifying that Harris Health is in compliance with the provisions of Government Code 2256 and with the Policy to the best of the knowledge of management personnel in Financial Management.

RESULTS

Based on procedures performed for investments managed by Harris Health and Financial Management pursuant to the Public Funds Investment Act, the Public Funds Collateral Act, and Policies that were in place during the nine months ended November 30, 2014, controls should be improved to ensure that:

- Broker/dealers certify in writing they have read Harris Health's Policy and implemented reasonable procedures and controls to preclude unauthorized investment transactions before they are allowed to perform any transactions.
- The Harris Health's Board of Managers reviews the Policy and investment strategy not less than annually and adopts a resolution documenting the review and approval of any changes.
- The Investment Officer receives training that is required by the Public Funds Investment Act and by Section 3.02, *Training*, of the Policy.
- The requirements of the Public Funds Investment Act and the Policy for testing of investment controls are satisfied.

The issues above are discussed in more detail in the following "Issues and Recommendations" section that includes management's responses to the recommendations presented in the Auditor's Report.

The procedures performed also determined that controls were in place and functioning appropriately during the nine months ended November 30, 2014, for the following areas:

- Information on the investment transaction form agreed with external third party information sources.
- Purchases and sales activity had characteristics that were equivalent with transactions in TRACE for the same day which provides evidence they were obtained at a fair market value price.
- Investment purchases and sales tested were competitively bid.
- Investment transactions were timely and accurately entered into APS2 and recorded accurately in PeopleSoft.
- Investment purchases complied with the Policy regarding investment types and maturities.
- The Investment Officer has complied with the Policy, Section 4.03, *Disclosures of Relationships with Persons Selling Investments to Harris Health*.
- Pledged collateral was not required because Harris Health funds held in depository accounts were covered by FDIC.
- Investments reported in Quarterly Investment Reports presented to the Harris Health Board of Managers and the Commissioners Court were accurately recorded in PeopleSoft and are in compliance with the Public Funds Investment Act.
- There were no noticeable trends in Financial Institution concentration (no one Financial Institution won an unusually high number of competitive bids compared to the other participating Financial Institutions).

- Harris County and Harris Health complied with the Interlocal Agreement for investment services during the nine months ended November 30, 2014.

During the engagement period, there were only three investment transactions that were required to be competitively bid, all relating to purchases. This was determined after excluding commercial paper, calls, maturities, demand deposit accounts, time deposits, loans, and money market investment activity, as they are not normally subject to competitive bidding. A presentation of Financial Institution concentration was prepared based on an analysis of these transactions. The analysis was performed for both dollar values and transaction counts and for investment transaction types subject to competitive bidding (Purchases, Sales, and Partial Sales) and is presented as Tables 1-2 below.

Table 1 below presents the total dollar and percentage value of all transaction types (Purchases, Sales, and Partial Sales) that occurred during the audit period for each Financial Institution. As presented in Table 1 below, Daiwa Capital Markets was awarded the highest dollar value/percentage of purchase transactions (\$52.5M or 88% of purchases) (blue bar below). There were no sales or partial sales transactions.

TABLE 1

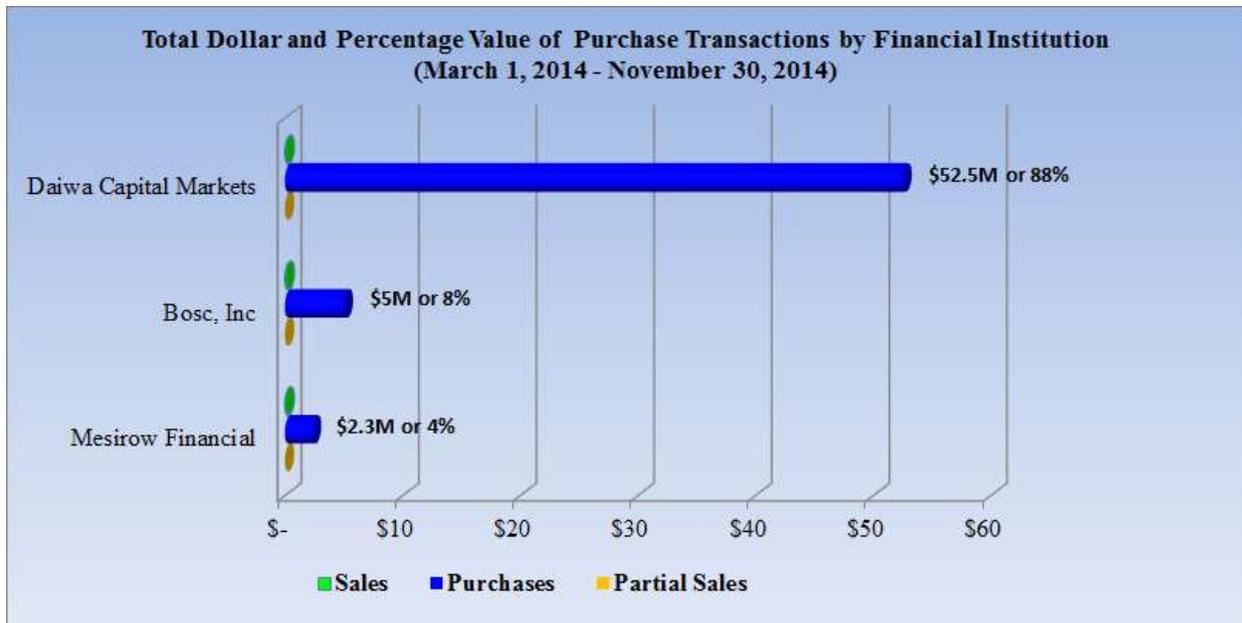


Table 1 – Due to minor rounding, some of the totals for each pricing group (Purchases, Sales, and Partial Sales) may not equal 100%.

Table 2 below presents the count and percentage value of all transaction types (Purchases, Sales, and Partial Sales) that occurred during the audit period for each Financial Institution. As presented in the Table 2 below, Daiwa Capital Markets, Mesirow Financial, and Bosc. Inc, were each awarded one purchase transaction (blue bar below). There were no sales or partial sales transactions.

TABLE 2

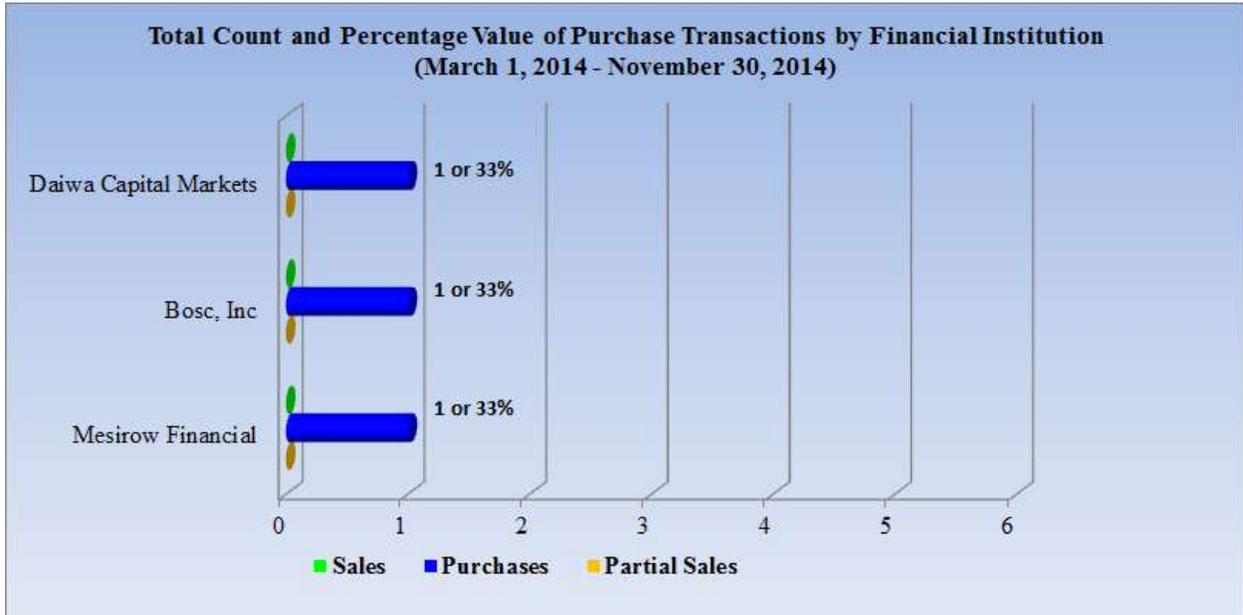


Table 2 – Due to minor rounding, some of the totals for each pricing group (Purchases, Sales, and Partial Sales) may not equal 100%.

ISSUES AND RECOMMENDATIONS

Obtaining Certifications from Broker/Dealers

Background

It appears that Texas statutes require Financial Management to obtain Certificates from the Financial Institution they are seeking to purchase an investment from prior to executing an investment purchase transaction with that respective Financial Institution. Financial Management provides the Policy to and obtains Certificates from Financial Institutions on behalf of Harris Health.

Pursuant to Public Funds Investment Act §2256.005(k), “A written copy of the investment policy shall be presented to any person offering to engage in an investment transaction with an investing entity or to an investment management firm under contract with an investing entity to invest or manage the entity's investment portfolio. For purposes of this subsection, a business organization includes investment pools and an investment management firm under contract with an investing entity to invest or manage the entity's investment portfolio. Nothing in this subsection relieves the investing entity of the responsibility for monitoring the investments made by the investing entity to determine that they are in compliance with the investment policy. The qualified representative of the business organization offering to engage in an investment transaction with an investing entity shall execute a written instrument in a form acceptable to the investing entity and the business organization substantially to the effect that the business organization has: (1) received and reviewed the investment policy of the entity; and (2) acknowledged that the business organization has implemented reasonable procedures and controls in an effort to preclude investment transactions conducted between the entity and the organization that are not authorized by the entity's investment policy, except to the extent that this authorization is dependent on an analysis of the makeup of the entity's entire portfolio or requires an interpretation of subjective investment standards.”

Pursuant to Public Funds Investment Act §2256.005(l), “The investment officer of an entity may not acquire or otherwise obtain any authorized investment described in the investment policy of the investing entity from a person who has not delivered to the entity the instrument required by Subsection (k).”

County Attorney’s Office Informed Us of the Following

If an investment is authorized by the investment policy, and an investing entity has acknowledged in writing that it has received such policy and agreed to abide by the policy, the County may continue to invest through that financial institution after the policy is modified as long as the modification does not alter in any material way either the type or the method of making that type of investment. For example, if the original policy authorized investments in US government issued securities of certain amounts with certain maturity dates and that the investment must be made in accordance with certain procedures, these provisions are not modified in any way, and an investing entity has agreed in writing to abide by the previous policy, then the County may continue to make investments of that type through the investing entity pending an acknowledgement of the modified policy. Such a situation would not

constitute a violation of § 2256.005. However, if the type of investment or procedure for making the investment has been altered by the adoption of a new policy, then the investment may not be made (even if the modified policy would allow it) using an investing entity that has not agreed to abide by the new guidelines. The County Attorney recommends that going forward the County should seek approval of a modification to the policy in advance of the date upon which it would go into effect. This would give the Financial Institutions time to review and approve the new policy beforehand and remove any question of compliance.

Issue

Financial Management's procedures for monitoring the providing of the Policy and obtaining Certificates from authorized Financial Institutions before executing investment purchase transactions could be improved. Three purchase transactions during the audit period with three Financial Institutions were tested. Of the 3, 2 (66.7%) had not provided a Certificate when the purchases occurred. Before providing a Certificate, one Financial Institution purchased a security for \$2.3 million and another purchased a security for \$52.5 million. As such, it appears that Harris Health may not be in compliance with the Public Funds Investment Act or the Policy.

Recommendation

Financial Management, in conjunction with Harris Health, should implement procedures to monitor compliance with the Public Funds Investment Act and the Policy as they apply to this issue. In developing the procedures, Financial Management should consider seeking approval of a modification to the Policy in advance of the date upon which it would go into effect. This would give the investing entities time to review and approve the new policy beforehand and remove any question of compliance.

Management Response

Financial Management Response

As noted in the Background section above, the current process for Broker/Dealer certification is acceptable as there were no significant changes to the Investment Policy that might cause a Broker/Dealer to not return the certification. Nevertheless, Financial Management will review the process and consider changes as recommended. The current Broker/Dealer selection process is at a stage that most likely will not allow a change in the upcoming adoption/certification process.

County Attorney Response

The remarks contained in the draft accurately reflect the opinion of the Office of the County Attorney.

Reviewing Harris Health’s Investment Policy and Strategy

Background

The Public Funds Investment Act, §2256.005(e) requires no less than an annual review of the Policy and investment strategy by the Board of Managers and an adoption of a resolution stating that the Policy and investment strategy were reviewed and any changes are documented in the resolution.

Issue

The Board of Managers adopted a resolution stating the Policy and investment strategy were reviewed and any changes to the Policy were documented on October 30, 2014, which was 18 months after the date of the last such resolution adopted on January 31, 2013. Eighteen months exceeds the statutory requirement of an annual review.

As a result, Harris Health was not in compliance with the Public Fund Investment Act or the Policy.

Recommendation

Fiscal Administration Management should implement control procedures to ensure compliance with the Public Funds Investment Act and with the Policy with respect to the annual review and the adoption of a resolution regarding the Policy and investment strategy.

Management Response

Management Agrees.

In February 2015 an annual review schedule was implemented to coincide with the beginning of the Harris Health System fiscal year. Harris Health and Harris County representatives will continue to work closely to coordinate any interim reviews required due to changes in brokers/dealers etc., made by the County that affect Harris Health.

Obtaining Required Training

Background

The Public Funds Investment Act §2256.008(a) & (c) and the Policy requires the Investment Officer to attend at least ten hours of instruction within 12 months of assuming their duties, and to attend at least ten hours of training not less than once every two fiscal years. The training must be provided by an independent source approved by the Board of Managers and include education in investment controls, security risks, strategy risks, market risks, diversification of investment portfolios, and compliance with the Public Funds Investment Act.

Issue

The Harris Health Investment Officer has not attended required training.

Not obtaining the required training does not comply with the Public Funds Investment Act or the Policy and increases the risk the Investment Officer has not received adequate training in investment controls, security risks, strategy risks, market risks, diversification of investment portfolios, or compliance with the Public Funds Investment Act.

Recommendation

Fiscal Administration Management should implement controls to ensure the Investment Officer receives the training required by the Public Funds Investment Act and the Policy.

Management Response

Management agrees.

The Harris Health System Investment Officer has completed the Texas Public Funds Investment Act training. Effective February 2016, a status report of required training will be presented to the Board of Managers at the time of the annual Investment Policy review.

Reviewing Investment Controls

Background

Section 4.04, *Internal Accounting Controls*, of the Policy states that the “Investment Officer with the help of such Designees as he or she requests shall prepare a system of internal accounting controls that shall be documented in writing. The internal accounting controls shall be reviewed by Harris Health’s independent auditors in connection with the annual examination of the Harris Health financial statements to the extent deemed necessary to evaluate the system as required by generally accepted auditing standards.”

In addition, the Public Funds Investment Act §2256.005(m) states that “an investing entity other than a state agency, in conjunction with its annual financial audit, shall perform a compliance audit of management controls on investments and adherence to the entities established investment policies.”

Pursuant to the Interlocal Agreement, Financial Management buys and sells investment securities for Harris Health and provides quarterly investment compliance reporting. The Harris County Auditor’s Office Audit Services Department selectively performs procedures quarterly to determine whether Financial Management is in compliance with Harris County’s investment policy.

Issue

Harris Health has not prepared written internal accounting controls for investments in accordance with Section 4.04 of the Policy, and has informed us they believe that the written investment controls documented and followed by Financial Management for services provided pursuant to the Interlocal Agreement satisfy the requirements of the Policy. However, the Policy and the Interlocal Agreement are silent on Harris Health’s reliance on Financial Management’s written investment controls. In addition, Harris Health has not performed a compliance audit of Financial Management’s management controls on investments and adherence to established investment policies in conjunction with its annual financial audit.

As a result, Harris Health’s compliance with the requirements of the Policy is not adequately documented with respect to written internal accounting controls for investments. In addition, Harris Health is not in compliance with the Public Funds Investment Act with respect to performing a compliance audit of management controls on investments.

Recommendation

Harris Health Management should consult with Financial Management and the County Attorney’s Office to determine whether the written investment controls for services provided pursuant to the Interlocal Agreement satisfy the requirements of the Policy. If it is determined that they do not, Harris Health should implement a plan to achieve compliance. Harris Health Management should also perform compliance audits of investment controls and adherence to the Policy in conjunction with its annual financial audit.

Management Response

Management accepts recommendations. Harris Health Management will review the process and consider changes and clarifying documentation as recommended. An overview of current management controls and procedures for Harris Health System investments has been prepared. Further requirements, including the requirements for annual compliance audits, and/or practice clarifications will be documented in the Investment Policy or Inter-local Agreement with Harris County and brought to the Board of Managers for approval.