State Bar of Texas

Internal Audit Services
An Internal Audit of:

Public Funds Investment Act
Compliance Audit

Report #19-001
December 18, 2018

This report provides management with information about the condition of risks and internal controls at a specific point in time. Future changes in environmental factors and actions by personnel will impact these risks and internal controls in ways that this report cannot anticipate.
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December 18, 2018

Mr. Jarrod Foerster
State Bar of Texas
Audit & Finance Committee
1414 Colorado Street
Austin, TX 78701

Dear Audit & Finance Committee Chair:

Attached is Internal Audit Report #19-001 Public Funds Investment Act Compliance Audit. This audit was performed as part of the approved Annual Internal Audit Plan.

We assessed the State Bar of Texas’ (SBOT) compliance with Texas Government Code Chapter 2256 Public Funds Investment and determined that the agency was compliant with all requirements except obtaining evidence of required investment officer training for two individuals. Additionally, management’s internal controls for investment processes and reporting are effective and working as designed.

Please contact Darlene Brown at 281.740.0017 if you should have any questions about this audit report.

Sincerely,

Ira Wayne McConnell, CPA
Partner
1.0 INTRODUCTION

McConnell & Jones LLP (MJ), serving as the outsourced internal audit function (Internal Audit) for the State Bar of Texas (SBOT), performed an internal audit of SBOT’s compliance with Texas Government Code Chapter 2256 Public Funds Investment, commonly referred to as the Public Funds Investment Act (PFIA).

Government Code Chapter 2256 Section 2256.005 Investment Policies, Investment Strategies; Investment Officer subsection (n) requires that at least once every two years a state agency arranges for a compliance audit of management controls on investments and adherence to the agency’s established investment policies to be performed by their internal auditor or a private auditor. The resulting audit reports must be reported to the state auditor no later than January 1st of each even numbered year.

SBOT’s investment policy requires an annual audit of the investment funds’ records.

SBOT does invest public funds and therefore is required to comply with Texas Government Code Chapter 2256 Public Funds Investment. These funds are invested through SBOT’s investment manager (PFM Asset Management LLC). SBOT’s investment manager was selected through a formal bid process.

We performed this audit as part of the approved Annual Internal Audit Plan. This audit was conducted in accordance with generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

SBOT’s Investment Standard

The State Bar shall invest its funds in a manner in which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but to, in order of priority, preserve and safeguard the principal amount invested, provide liquidity to meet operating cash flow needs, and earn the highest yield possible considering the required safeguards.

SBOT’s Investment Principals

- Safety of Principal
- Diversification
- Yield

May 31, 2018 Investment Account Balances

The Texas State Bar has a total of $34.5 million in the following investment funds:

- General Fund $25,122,664
- Texas Law Center - $3,649,307
- Client Security Fund - $2,963,469
- Texas Board of Legal Specialization - $1,804,186
- Annual Meetings Fund - $451,121
- Texas Bar College - $302,455
- Hatton Sumners Grant - $255,611
We believe that the evidence obtained accomplishes that requirement.

Pertinent information has not been omitted from this report. This report summarizes the audit objectives and scope, our assessment based on our audit objectives and the audit approach.

**Objectives and Scope**

The purpose of this audit is to assess SBOT’s compliance with the PFIA’s specific requirements. In doing so, we also evaluated management controls in place to ensure that the agency’s funds are invested according to SBOT’s investment policy and that the investment reports are accurately compiled and distributed in a timely manner.

Texas Government Code Chapter 2256 Public Funds Investment sections applicable to SBOT are:

- ✔ Section 2256.005 Investment Policies, Investment Strategies; Investment Officer
- ✔ Section 2256.007 Investment Training; State Agency Board Members and Officers
- ✔ Section 2256.023 Internal Management Reports

The State Bar of Texas’ applicable investment policy requirements are based upon its investment standard to preserve and safeguard the principal amount invested, provide liquidity to meet operating cash flow needs, and earn the highest yield possible considering the required safeguards. SBOT’s investment policy is imbedded in the State Bar of Texas Board of Directors Policy Manual (September 2018). The investment policy contains the following components:

- ✔ Approved investment vehicles
- ✔ Investment concentrations
- ✔ Maturity periods
- ✔ Investment rating
- ✔ Reporting
- ✔ Training
- ✔ Investment principals
- ✔ Investment settlement
- ✔ Compliance with the Public Funds Investment Act
- ✔ Annual audit

The scope period was June 1, 2017 through May 31, 2018.

**Results and Conclusion**

We determined that SBOT’s internal controls over investments are effective and operating as intended.

The State Bar of Texas is in compliance with two out of three of the applicable requirements of Texas Government Code Chapter 2256 Public Funds Investment. SBOT was unable to provide documentation demonstrating that two of the required individuals had completed their investment training within the required timeframe. It is important to note that this non-compliance does not impact SBOT’s internal controls over investment activities.
SBOT is in compliance with the State Bar of Texas Board of Directors Policy Manual Investment Policy Section 3.05.06. Additionally, management’s internal controls for investment activities and reporting are effective and working as designed.

We noted that the investment reports provided by the SBOT’s Investment Manager are comprehensive and provide summary level investment balances and transactions in addition to a significant amount of detailed analysis. The investment reports provided to the SBOT Audit & Finance Committee continue to be some of the most comprehensive investment reports we see provided to boards.

Figure 1 describes the internal control rating.

**Internal Control Rating**

<table>
<thead>
<tr>
<th>Rating Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Best Practices</strong></td>
<td>Observations indicate best practice opportunities identified during the course of the review that may add value to the function/department/organization. Best practices do not require management comments and do not require internal follow-up to validate implementation status.</td>
</tr>
<tr>
<td><strong>Effective</strong></td>
<td>Controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met.</td>
</tr>
<tr>
<td><strong>Some Improvement Needed</strong></td>
<td>A few specific control weaknesses were noted; generally however, controls evaluated are adequate, appropriate, and effective to provide reasonable assurance that risks are being managed and objectives should be met.</td>
</tr>
<tr>
<td><strong>Major Improvement Needed</strong></td>
<td>Numerous specific control weaknesses were noted. Controls evaluated are unlikely to provide reasonable assurance that risks are being managed and objectives should be met.</td>
</tr>
<tr>
<td><strong>Unsatisfactory</strong></td>
<td>Controls evaluated are not adequate, appropriate, or effective to provide reasonable assurance that risks are being managed and objectives should be met.</td>
</tr>
</tbody>
</table>

Figure 1 *Internal control rating description.*

## 2.0 COMPLIANCE AUDIT DETAILS

The State Bar of Texas maintains investments for seven funds. These funds are:

- ✓ General Fund
- ✓ Client Service Fund (CSF)
- ✓ Texas Board of Legal Specialization (TBLS)
- ✓ Texas Bar College (TBC), which includes an Endowment Fund
- ✓ Hatton Sumners Grants (HSG)
A. Investment Policy

The PFIA requires state organizations that invest public funds to have a written investment policy that is reviewed at least once per year by the governing body. Section 2256.005 Investment Policies, Investment Strategies; Investment Officer lists specific topics that must be included in the agency’s investment policy.

Audit procedures applied to determine compliance with these requirements included:

- Reviewed SBOT’s investment policy and compared it to requirements listed in Section 2256.005.

Figure IP1 compares Section 2256.005 requirements to SBOT’s investment policy.

<table>
<thead>
<tr>
<th>Texas Government Code Sec. 2256.005 Section</th>
<th>PFIA Investment Policy Requirements</th>
<th>SBOT Investment Policy Meets Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b)(1)</td>
<td>The investment policies must be written.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(2)</td>
<td>Primarily emphasize safety of principal and liquidity.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(3)</td>
<td>Address investment diversification, yield, and maturity and the quality and capability of investment management.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(4)(A)</td>
<td>Include a list of the types of authorized investments in which the investing entity’s funds may be invested.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(4)(B)</td>
<td>Include the maximum allowable stated maturity of any individual investment owned by the entity.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(4)(C)</td>
<td>Include for pooled fund groups, the maximum dollar weighted average maturity allowed based on the stated maturity date for the portfolio.</td>
<td>N/A SBOT does not invest in pooled fund groups.</td>
</tr>
<tr>
<td>(b)(4)(D)</td>
<td>Include methods to monitor the market price of investments acquired with public funds.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(4)(E)</td>
<td>Include a requirement for settlement of all transactions, except investment pool funds and mutual funds, on a delivery versus payment basis.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(4)(F)</td>
<td>Include procedures to monitor rating changes in investments acquired with public funds and the liquidation of such investments consistent with the provisions of Section 2256.021.</td>
<td>✓</td>
</tr>
<tr>
<td>(d)</td>
<td>As an integral part of an investment policy, the governing body shall adopt a separate written investment strategy for each of the funds or group of funds under its control. Each investment strategy must describe the investment objectives for the particular fund using the following priorities in order of importance: (1) understanding of the suitability of the investment to the financial requirements of the entity;</td>
<td>✓</td>
</tr>
</tbody>
</table>
Figure IP1 Section 2256.005 requirements and SBOT’s compliance.

Legend:

- Green checkmark: Internal controls are effective and SBOT is in compliance with requirement; no observations noted.
- Red X: Internal controls are not in compliance with requirements; observation noted and discussed in this report.

### Conclusion

SBOT is in compliance with Section 2256.005 Investment Policies, Investment Strategies; Investment Officer. Our audit procedures resulted in no exceptions noted.

### Management’s Response

Management response is not required as no observations were noted for this compliance requirement.

### Recommendation

No recommendations are made for this compliance requirement.

### B. Investment Officer, State Agency Board Member and Officer Training

The PFIA section 2256.007 lists specific training requirements for the agency investment officers, board members and officers.
Audit procedures applied to determine compliance with these requirements included:

- Reviewed SBOT’s investment training records to determine compliance with the requirements of section 2256.007.
- Reviewed quarterly investment reports and reports on Subchapter A, Chapter 2256.

Figure IT1 compares section 2256.007 training requirements to SBOT’s records of investment officer training taken.

<table>
<thead>
<tr>
<th>Texas Government Code Sec. 2256.007 Section</th>
<th>INVESTMENT TRAINING; STATE AGENCY BOARD MEMBERS AND OFFICERS.</th>
<th>SBOT Investment Officer and Officers Training Meet Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Each member of the governing board of a state agency and its investment officer shall attend at least one training session relating to the person’s responsibilities under this chapter within six months after taking office or assuming duties.</td>
<td>❌</td>
</tr>
<tr>
<td>(b)</td>
<td>The Texas Higher Education Coordinating Board shall provide the training under this section.</td>
<td>N/A</td>
</tr>
<tr>
<td>(c)</td>
<td>Training under this section must include education in investment controls, security risks, strategy risks, market risks, diversification of investment portfolio, and compliance with this chapter.</td>
<td>✔</td>
</tr>
<tr>
<td>(d)</td>
<td>An investment officer shall attend a training session not less than once each state fiscal biennium and may receive training from any independent source approved by the governing body of the state agency.</td>
<td>✔</td>
</tr>
<tr>
<td>(d)</td>
<td>The investment officer shall prepare a report on this subchapter and deliver the report to the governing body of the state agency not later than the 180th day after the last day of each regular session of the legislature.</td>
<td>✔</td>
</tr>
</tbody>
</table>

Figure IT1 Texas Government Code training requirements compared to SBOT’s training taken.

Legend:
✔️ Internal controls are effective and SBOT is in compliance with requirement; no observations noted.
❌ Internal controls are not in compliance with requirements; observation noted and discussed in this report.

**Conclusion**

SBOT was in compliance with PFIA section 2256.007 training with the exception of section 2256.007 (a). SBOT did not have training completion certificates on file for two individuals to demonstrate that training had been taken.

SBOT’s investment officer has completed all training required to perform the role of an investment officer.

**Recommendation**

SBOT’s Finance Division Director should continue tracking required board member training and ensure that all completion
certificates are provided to SBOT for retention in the appropriate files. Additionally, the Finance Division Director should report instances of non-compliance to the SBOT’s Audit & Finance Committee.

**Managements Response**

Management agrees with this recommendation and has implemented a tracking sheet to ensure that all completion certificates are provided to SBOT. This tracking sheet has been in place for the past 3 years; however, findings related to 2 board members who attended New Director’s Orientation from fiscal year 15-16 and were serving as board members during the FY 17-18 fiscal year.

Those officers received the training, but the certification of training was not retained, and had to be requested of the officers at the time of audit.

**C. Management Reports**

The PFIA requires state agencies that invest public funds provide investment management reports to its governing body. Section 2256.023 Internal Management Reports lists specific information that must be included in the investment management reports.

SBOT’s Finance Division Director works with SBOT’s investment manager, PFM Asset Management LLC, to prepare detailed investment reports. The investment reports are signed/certified by the SBOT Executive Director, Finance Division Director and PFM. The investment reports are provided to the SBOT Audit & Finance Committee each quarter.

Audit procedures applied to determine compliance with Section 2256.023 requirements included:

- Reviewed quarterly investment reports for completion and content compliance with Section 2256.023.
- Compared quarterly investment reports to SBOT Balance Sheets and trail balance report to determine completeness and accuracy.

**Figure MR1** compares the Section 2256.023 investment management report requirements to SBOT’s investment reports.

<table>
<thead>
<tr>
<th>Texas Government Code Sec. 2256.023 Section</th>
<th>Internal Management Reports</th>
<th>SBOT Investment Management Reports Meet Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Not less than quarterly, the investment officer shall prepare and submit to the governing body of the entity a written report of investment transactions for all funds covered by this chapter for the preceding reporting period.</td>
<td>✓</td>
</tr>
<tr>
<td>(b)(1)(2)(3)</td>
<td>The report must: (1) describe in detail the investment position of the entity on the date of the report; (2) be prepared jointly by all investment officers of the entity; (3) be signed by each investment officer of the entity;</td>
<td>✓</td>
</tr>
<tr>
<td>Texas Government Code Sec. 2256.023 Section</td>
<td>Internal Management Reports</td>
<td>SBOT Investment Management Reports Meet Requirements</td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td>----------------------------</td>
<td>-------------------------------------------------</td>
</tr>
<tr>
<td>(b)(4) contain a summary statement of each pooled fund group that states the: (A) beginning market value for the reporting period; (B) ending market value for the period; and (C) fully accrued interest for the reporting period;</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(b)(5) state the book value and market value of each separately invested asset at the end of the reporting period by the type of asset and fund type invested;</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(b)(6) state the maturity date of each separately invested asset that has a maturity date;</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(b)(7) state the account or fund or pooled group fund in the state agency or local government for which each individual investment was acquired;</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(b)(8) state the compliance of the investment portfolio of the state agency or local government as it relates to: (A) the investment strategy expressed in the agency's or local government's investment policy; and (B) relevant provisions of this chapter.</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(c) The report shall be presented not less than quarterly to the governing body and the chief executive officer of the entity within a reasonable time after the end of the period.</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>(d) If an entity invests in other than money market mutual funds, investment pools or accounts offered by its depository bank in the form of certificates of deposit, or money market accounts or similar accounts, the reports prepared by the investment officers under this section shall be formally reviewed at least annually by an independent auditor, and the result of the review shall be reported to the governing body by that auditor.</td>
<td></td>
<td>✔</td>
</tr>
</tbody>
</table>

**Figure MR1** Texas Government Code reporting requirements compared to SBOT's management reports.

Legend:

- ✔ Internal controls are effective and SBOT is in compliance with requirement; no observations noted.
- ❌ Internal controls are not in compliance with requirements; observation noted and discussed in this report.

**Conclusion**

SBOT’s investment reports are in compliance with Section 2256.023. Additionally, the monthly investment reports were complete and accurate.

**Recommendation**

No recommendations are made for this compliance requirement.
Management’s Response

Management response is not required as no observations were noted for this compliance requirement.