State Auditor's Office

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State Auditor

An Audit Report on

Texas Southern University's Management Practices for Endowment Funds

August 2006

Report No. 06-055

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Overall Conclusion

> **Background Information**
>
> As of February 28, 2006, Texas Southern University (University) had 78 endowments with a total market value of $23 million.
>
> Most of these endowments were established for the purposes of awarding scholarships and professorships. The University spends approximately $700,000 of its endowment income for these purposes each fiscal year.

Texas Southern University (University) has not managed and protected its endowments adequately. The University's decision to distribute additional funds from its scholarship endowments in fiscal year 2004 caused it to (1) spend a portion of the principal of those endowments, (2) violate the purposes of those endowments, and (3) jeopardize the continued growth of those endowments. Auditors estimate that the University spent at least $285,934 from the principal of eight endowments. Exact amounts spent from principal cannot be determined because of the University's poor recordkeeping.

The University's monitoring of compliance with donor restrictions is not effective. First, the University does not have a central monitoring function to ensure that funds are spent in a timely manner and in accordance with donor restrictions. Second, the University does not have written, formal donor agreements for most of the endowments established prior to 2001. Third, the University's records regarding additional endowment contributions are inaccurate or significantly incomplete.

The University's investment practices also are not adequate to effectively manage its endowments. The University does not have a well diversified portfolio as required by its investment policy, appears to have unreasonably high investment return targets, and is not achieving those targets. The University is not monitoring the long-term performance of its endowment investments, and it does not ensure that it complies with established investment policies.

The University's calculation methodology for determining annual distributions from each endowment does not ensure equitable distributions from each endowment.

As a result of these issues, there is little assurance that each endowment's principal is protected, growth is ensured, or donor restrictions are met.

This audit was conducted in accordance with Texas Government Code, Sections 321.0131, 321.0132, and 321.0133.

For more information regarding this report, please contact Verma Elliott, Audit Manager, or John Keel, State Auditor, at (512) 936-9500.

Key Points

The University's decision to distribute additional income from endowments resulted in spending principal, reduced principal growth, and noncompliance with donor restrictions.

During fiscal year 2004, the University distributed an additional $1.3 million from 42 endowments for scholarships. Of that $1.3 million, auditors estimate that the University spent at least $285,934 from the principal of eight endowments (exact amounts cannot be determined because of the University's poor recordkeeping).

The University's monitoring of compliance with donor restrictions is not effective.

As of August 31, 2005, the University had amassed large accumulated fund balances totaling $2.7 million in the spending accounts of 71 endowments. The University does not have written, formal donor agreements (which specify donor restrictions) for endowments established prior to 2001. Eight of 15 endowments auditors tested did not have endowment agreements; all of these eight endowments were established before 2001. In addition, the University's records regarding additional endowment contributions are inaccurate or significantly incomplete.

University investment practices have not ensured endowment investment growth, and the University does not ensure compliance with investment policies.

Although investment performance has been consistently below the target rate, the University has continued to make distributions from endowments at a constant rate. For example, for the five-year period ended August 31, 2005, the annualized average investment rate of return was negative 1.4 percent; however, the University continued to distribute 5 percent of the market value of endowment investments every year.

The University's investment return target appears to be unreasonably high based upon its current investment mix of stocks and bonds. Under the current policy, the expected rate of return is approximately 9.5 percent. However, a report from the University's investment consultant estimated that the average expected rate of return for the current investment mix is 7.39 percent.

Actual asset allocation for the investment of endowment funds was outside the approved target ranges as of August 31, 2005, and February 28, 2006. These instances of noncompliance with policy were neither identified nor reported to the University's Board of Regents because the University's investment consultant was monitoring incorrect target ranges.

The University's accounting for and general administration of endowments are not effective and efficient.

The University's calculation methodology for determining annual distributions from each endowment does not ensure equitable distributions from each endowment. Although the fiscal year 2005 distribution rate from the pool of all endowments was 5 percent of the previous three years' average market values of investments, the effective distribution rate at the individual endowment level ranged from 0.46 percent to 6.53 percent.

The University has not been consistent in accounting for additional contributions to endowments and changes in the market value of endowment funds. In addition, the University categorizes its endowment spending accounts as designated funds, instead of as restricted funds.

Summary of Management's Response

The University agrees with the recommendations in this report.

Summary of Objectives, Scope, and Methodology

The objectives of this audit were to determine whether the University:

- Has endowment fund investment and annual distribution policies that are consistent with modern endowment management principles as embodied in the Uniform Management of Institutional Funds Act (Texas Property Code, Chapter 163).
- Is in compliance with its endowment management policies.
- Has adequate procedures to monitor and report endowment performance against stated objectives.
- Has controls that provide reasonable assurance of substantial compliance with donor restrictions.

The scope of this audit covered all endowments established at the University and expenditure data for a sample of endowments for fiscal year 2005 and part of fiscal year 2006. Because review of information technology systems was not necessary to achieve the audit objectives, this audit did not include a review of any information technology systems.

The audit methodology included reviewing endowment policies, comparing endowment policies with industry best practices, testing compliance with policies, and testing a sample of endowment expenditures.

Recent SAO Work		
Number	**Product Name**	**Release Date**
06-026	A Review of State Entity and Community College District Compliance with the Public Funds Investment Act and Investment Reporting Requirements	March 2006

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Detailed Results

Chapter 1

The University's Decision to Distribute Additional Income from Endowments Resulted in Spending Principal, Reduced Principal Growth, and Noncompliance with Donor Restrictions

Texas Southern University's (University) decision to distribute additional funds from its scholarship endowments caused it to (1) spend a portion of the principal, (2) violate endowment purposes, and (3) jeopardize the continued growth of the endowments. Specifically:

Endowments

An endowment is a gift accepted with donor stipulations that (1) the principal be maintained intact in perpetuity, for a specified period, or until the occurrence of a specified event and (2) the income earned by investing the principal can be expended.

Higher Education Institution Endowments

Each higher education institution typically has numerous endowments, each of which is frequently restricted to funding very specific areas of the institution. The most common uses of endowments are for faculty chairs, student financial aid, acquisition of library materials and scientific equipment, and general support of designated programs.

Source: *Endowment Management: A Practical Guide* Jay A. Yoder, CFA Association of Governing Boards of Universities and Colleges 2004.

- During fiscal year 2004, the University distributed an additional \$1.3 million from 42 endowments for scholarships (in addition to its regular \$580,692 distribution from all endowments). Of that \$1.3 million, auditors estimate that the University spent at least \$285,934 from the principal of eight endowments. Because of conflicting records at the University, we estimate that either \$50,000 or \$125,000 was spent from the principal of one of those eight endowments; therefore, the amount spent from the principal of the eight endowments may have been as high as \$360,934.

- The \$1.3 million additional withdrawal the University made from 42 scholarship endowments compromised its ability to ensure that funds taken from those endowments would continue to be used only for the purposes specified for each endowment. The additional withdrawal was combined with other funds that the University used for fiscal year 2004 scholarships; therefore, the University could no longer demonstrate how it used the endowment funds. In at least one case (an endowment for athletic scholarships), the ultimate use of the endowment funds did not comply with the purpose of that endowment as specified in University documents.

- The University's spending of all accumulated growth ($1.3 million) from a majority of its endowments guaranteed that the purchasing power of each of these endowments declined since inception, regardless of how long ago each endowment was established. This means that future students will not receive the same dollar value of scholarships on an inflation-adjusted basis as past students might have received. For example, an endowment of $1 million established in 1978 grew to $1.32 million at the end of fiscal year 2003. However, the University withdrew $320,000 from that endowment, an action that disregards the fact that $1 million in 2003 dollars is worth significantly less than $1 million in 1978 dollars due to the effect of inflation over the 25-year time period.

The Importance of Growth for Endowment Funds

If endowment funds do not grow with inflation, then the benefits they can provide decline in value (purchasing power) over time. This, in effect, diminishes the value of the donor's gift.

The University's decision to distribute additional income from endowments was initiated by its former chief financial officer, who was also the chief investment officer, as part of the fiscal year 2004 budget process. The University had to find additional scholarship funds because the General Appropriations Act had required that a portion of the prior year's appropriations be endowed (instead of spent). The decision to make an additional distribution of income from scholarship endowments was formally approved by the Finance Committee of the University's Board of Regents on August 7, 2003. See Appendix 2 for an excerpt from the minutes of that meeting.

Recommendations

The University should:

- Ensure that the principal of each endowment is protected by maintaining accurate records of historical contributions from each endowment. If the University can determine the exact amount of principal spent from any endowment, it should consider restoring the value of endowments at least to the total contribution amount.

- Refrain from combining the income distribution from one endowment with another endowment. This will help ensure that funds taken from endowments continued to be used only for the purposes specified for each endowment.

- Ensure that it maintains the purchasing power of each endowment so that future income recipients can receive the same dollar value of scholarships on an inflation-adjusted basis that past recipients have received.

Management's Response

The University concurs with the recommendations. Applicable university managers will develop procedures to ensure the following:

- *Accurate records of each endowment participant are obtained and maintained for future periods; and*
- *The values for all endowments are restored to their total contribution amounts; and*
- *Income distributions are allocated only to each applicable endowment; and*
- *Income distributions are limited to ensure each endowment maintains its future purchasing power based upon an inflation-adjusted basis each year.*

Responsible parties: Personnel from the Office of Research and Development and the Office of Business and Finance

Target date for completion: February 1, 2007

Chapter 2

The University's Monitoring of Compliance with Donor Restrictions Is Not Effective

The University's monitoring of compliance with donor restrictions is not effective for three primary reasons. First, the University does not have a central monitoring function to ensure that funds are spent in a timely manner and also in accordance with donor restrictions. Second, the University does not have written, formal donor agreements for most endowments established prior to 2001. Third, the University's records regarding additional endowment contributions are inaccurate or significantly incomplete.

The University has amassed large balances in endowment spending accounts.

The University has amassed large accumulated fund balances (as compared to the annual distributions) in the spending accounts of 71 endowments. This has occurred because the University made annual distributions to endowment spending accounts but did not always spend all of those funds. These funds can be spent only for the exact purposes specified by the donors.

As of August 31, 2005, these balances totaled $2.7 million, which is more than four times the fiscal year 2005 income distribution amount. The University does not have a central monitoring function to ensure that these funds are spent in a timely manner and according to donor restrictions. Instead, the University relies on each department and college to monitor the use of funds in the spending accounts.

After funds are transferred to the spending accounts, the accounts do not earn any interest income because they are no longer invested as part of the investment pool for the endowment funds. Therefore, these funds are not working to earn additional income for the endowments.

The University does not have donor agreements and records for additional contributions to endowments.

The University does not have written, formal donor agreements for most endowments established prior to 2001. Without formal donor agreements, it would be difficult for user departments and colleges to know the specific restrictions regarding use of funds that come with each endowment. Eight of 15 endowments auditors tested did not have endowment agreements; all eight endowments were established before 2001.

The University's records regarding additional endowments contributions are inaccurate or significantly incomplete. For example, additional contributions for one endowment were not accurately tracked in appropriate accounts established for this purpose. In addition, the University could not provide historical contribution information for many older endowments. Having the contribution records would help the University ensure compliance with restrictions on spending those contributions.

Auditors noted unusual fluctuations in the market values of nine endowments (as compared to fluctuations in the market values of other endowments) between fiscal years 1995 and 1999. The University could not provide historical contribution records to determine whether these fluctuations were due to additional contributions the University received or increases in market values of these endowments.

Audit testing identified one instance in which expenditures from an endowment were not consistent with the donor's restrictions. The endowment agreement clearly stated that this grant was to be used to establish three endowed professorships for the School of Business, but the college used the endowment to pay wages to student workers. The annual reporting requirement for this endowment also required the University to report the name of the recipient, area of specialization, research and/or publications, and amount of distribution during the year. The University did not comply with this reporting requirement.

Recommendations

The University should:

- At least semi-annually, monitor the balances of the spending accounts for all endowments to determine whether funds are being accumulated and not spent in a timely manner.
- Ensure that it has written donor agreements for all endowments (regardless of how long ago the endowments were established) that clearly specify donor restrictions.
- Research its endowment and accounting records to ensure the accuracy and completeness of records regarding the contributions to each endowment. If necessary, the University should contact the donors to obtain this information.
- Spend endowment funds only for the specific purposes requested by donors. In addition, the University should comply with each endowment's reporting requirements.

Management's Response

The University concurs with the recommendations. Applicable university managers will develop procedures to ensure the following:

- *Endowment spending accounts are monitored and spent in a timely manner; and*

- *The university has a written donor agreement for each endowment which includes any specific donor restrictions; and*

- *Endowment and accounting records are adequately researched to verify the accuracy and completeness of records relating to all contributions made to each endowment; and*

- *Endowment funds are used only for the purposes specified by the donors; and*

- *Full compliance with each endowment's reporting requirements.*

Responsible parties: Personnel from the Office of Research and Development and the Office of Business and Finance

Target date for completion: February 1, 2007

University Investment Practices Have Not Ensured Endowment Investment Growth, and the University Does Not Ensure Compliance with Investment Policies

The University's investment practices are not adequate to effectively manage its endowments. The University appears to have unreasonably high investment return targets and is not achieving those expected returns. Additionally, the University does not have a well diversified portfolio. The University also is not monitoring the long-term performance of its endowment investments, and it does not ensure that it complies with established investment policies. The following issues could hinder investment performance and, therefore, negatively affect the long-term growth of the endowment funds.

The University's investment return target appears to be unreasonably high based upon its current asset allocation (percent of investments in stocks and bonds). Under the current policy, the expected rate of return is a 6.5 percent real rate of return (the rate after adjusting for inflation), which translates into approximately a 9.5 percent nominal rate of return (the rate before adjusting for inflation). According to the University's investment consultant, the expected rate of return under the current asset allocation should be approximately a 7.39 percent nominal return. However, the University's actual annualized five-year nominal return was negative 1.4 percent as of the end of fiscal year 2005.

The Importance of Asset Allocation

Asset allocation is the process of dividing investments among several classes of assets, such as stocks and bonds, to limit risk and increase returns.

Asset allocation is considered the most significant determinant of an entity's total investment return. Selecting an asset allocation strategy is one of the most important investment-related tasks the Board of Regents or University management performs.

Although investment performance has been consistently below the target rate specified in its investment policy, the University has continued to distribute 5 percent of the market value of endowment investments every year. The University's investment policy states that, to ensure short-term economic strength and flexibility, the Board of Regents is authorized to change the distribution percentage on a year-to-year basis. However, the distribution percentage has not been changed during the past five years, despite poor investment results.

Actual asset allocation for the investment of endowment funds was outside the approved target ranges as of August 31, 2005, and February 28, 2006.

For these time periods, the asset allocation ranges approved by the University's Board of Regents were:

- 50-60 percent for equities.
- 40-50 percent for fixed income securities.

However, actual allocations as of August 31, 2005 were:

- 70 percent for equities.
- 30 percent for fixed income securities.

Equities and Fixed Income Securities

Equities refer to securities that represent ownership (equity in a company) in other words, stocks.

Fixed income securities are investments with specified payment dates and amounts, primarily bonds.

Actual allocations as of February 28, 2006, were:

- 75.2 percent for equities.
- 24.8 percent for fixed income securities.

These instances of noncompliance with investment policy were neither identified nor reported to the Board of Regents because the target asset allocation ranges in the investment consultant's written reports were not consistent with the ranges approved by the Board of Regents. Specifically, the consultant's report included a range of 40 percent to 80 percent for equities and a range of 20 percent to 60 percent for fixed income as allowable asset allocation ranges.

The University's investments are not adequately diversified. The University's entire equity portfolio is allocated only to "growth-oriented" large capitalization stocks. However, the University's investment policy requires that the investment portfolio be "well diversified." Investing only in growth stocks is generally more volatile than investing in a well diversified stock portfolio and, therefore, could produce lower returns during a down market or higher returns during an up market. In addition, limiting investments only to the large capitalization segment excludes many stocks in the overall population.

The quarterly investment reports prepared by the University's consultant contain inaccurate or incomplete policy information. In addition to the incorrect target asset allocation ranges discussed above, investment performance reports specify that an objective of the investment policy is to have only a maximum loss of 2 percent in one year. However, this information is not in the University's investment policy.

The University and its investment consultant do not report 10-year or 15-year investment performance. The University's policy states that, in making investment decisions and in evaluating long-term investment returns, the endowment pool will focus on a long-term investment time horizon of fifteen years. However, the longest investment performance data the University's investment consultant provides to the Board of Regents as part of quarterly reporting is five-year performance data.

Policy-related issues could hinder long-term investment performance.

The University has no separate investment policy for endowments. A large portion of its only investment policy mirrors the requirements of the Public Funds Investment Act (PFIA, codified in Texas Government Code, Chapter 2256), which does not focus on endowments. The PFIA puts more emphasis on liquidity and safety of the funds, rather than on long-term growth of the funds. In addition, the University's investment policy does not include certain key elements recommended by industry best practices, such as independent evaluation of investment performance, monitoring of activities performed by delegated parties, and portfolio rebalancing (the act of adjusting asset allocations close to the target ranges after the drift caused by market value changes over time).

The University's investment policy also lacks safeguards to ensure that the principal of newly established endowments is protected. For example, in fiscal year 2005, the University made distributions from three endowments that were established during fiscal year 2004. This did not allow sufficient time for the investment of endowment funds to generate enough income.

The University approved the investment policy with an incorrect performance benchmark for equities. Specifically, in June 2004 the Finance Committee of the University's Board of Regents approved changing the benchmark from Standard & Poor's Barra Growth Index to the Russell 1000 Growth Index. However, when the Board approved a revised investment policy in February 2005, an outdated benchmark (Standard and Poor's Barra Growth Index) was included in this policy. The quarterly investment report shows the correct Russell 1000 Growth Index as the benchmark.

The University did not ensure that its investment service providers complied with statutory ethics disclosure requirement for calendar year 2004. Specifically, service providers did not submit ethics disclosure statements to the University and the State Auditor's Office as required by Chapter 2263 of the Texas Government Code.

Recommendations

The University should:

- Work with its investment consultant to determine a more reasonable expected rate of return for its current asset allocation. If necessary, the University may need to change its asset allocation target to achieve the current expected rate of return.
- Consider the long-term investment performance of its endowment funds before deciding the annual income distribution percentage.
- Ensure that it complies with the asset allocation target ranges approved by its Board of Regents. The University also should develop policies regarding rebalancing assets if actual asset allocation is outside the target allocation ranges.
- To minimize risk, work with its investment consultant to achieve adequate diversification of the equity portfolio.
- Ensure that its investment consultant's quarterly performance reports include accurate policy information on items such as approved asset allocation ranges and maximum loss percentage in one year.
- Ensure that its investment consultant's quarterly investment reports include information regarding 10-year or 15-year investment performance to enable it to better evaluate its long-term performance as specified in its investment policy.
- Develop a separate investment policy for endowment funds and ensure that the policy includes important elements such as portfolio rebalancing, independent evaluation of investment performance, and monitoring of activities performed by delegated parties.
- Ensure that its investment policy includes correct, up-to-date information about performance benchmarks for equities.
- Ensure that its investment service providers file ethics disclosure statements with the University and the State Auditor's Office as required by statute.

Management's Response

The University concurs with the recommendations. Applicable university managers will develop procedures to ensure the following:

- *Applicable personnel from the University work with our investment consultant to determine a more reasonable expected rate of return for its current asset allocation; and*

- *Our Investment consultants maintain compliance with asset allocation targets approved by the Board of Regents; and*

- *Investment consultants achieve adequate diversification of the equity portfolio to minimize risk; and*

- *Specific investment policies are developed for annual income distributions which include consideration of long-term investment performance of the endowment funds; and*

- *Investment consultants quarterly performance reports include accurate policy information on items such as approved asset allocation ranges and maximum loss percentage in one year; and*

- *Investment consultants quarterly investment reports include information regarding 10-year or 15-year investment performance to allow for better evaluation of long-term performance as specified in our investment policy; and*

- *Development of a separate investment policy for our endowment funds to include elements such as portfolio rebalancing, independent evaluation of investment performance, required monitoring activities to be performed by delegated parties, and correct, up-to-date information about performance benchmarks for equities; and*

- *Investment service providers file required ethics disclosure statements with the University and the State Auditor's Office.*

Responsible parties: Personnel from the Office of Research and Development and the Office of Business and Finance

Target date for completion: February 1, 2007

Chapter 4

The University's Accounting for and General Administration of Endowments Are Not Effective and Efficient

The University's calculation methodology for determining annual distributions from each endowment does not ensure equitable distributions are made from each endowment.

The University's Current Calculation Methodology for Income Distribution

Each fiscal year, the University calculates funds that are distributed from each endowment based on the average investment value for the three preceding fiscal years. The distribution amount for each endowment is calculated by multiplying the individual endowment's **proportion** by the **total amount** of money to be distributed from all endowments.

Each endowment's **proportion** is determined by dividing the balance of the individual endowment as of the prior year end by the sum of almost all of the endowments' balances for the prior year end.

The **total amount** to be distributed is determined by dividing the sum of almost all of the endowments' balances for each of the prior three years' ends by three (to get an average balance) and then multiplying the result by 5 percent.

Although the fiscal year 2005 distribution rate from the pool of all endowments was 5 percent of the previous three years' average market values of investments, the effective distribution rate at the individual endowment level ranged from 0.46 percent to 6.53 percent.

This variability occurred because the University calculates the distribution amounts for individual endowments based on each endowment's share of all endowments combined instead of applying the distribution rate at the individual endowment level. Because each endowment represents a separate contract, the same distribution rate should be applied to each endowment. For example, if the University had calculated the distribution amount at the individual endowment level, the distribution from one endowment for fiscal year 2005 would have been $60,436. Instead, the actual distribution was $43,197.

The University's current calculation methodology also results in higher distributions from the endowments that either (1) were not in existence during the entire previous three-year measurement period or (2) received additional contributions during the measurement period.

The University's accounting for endowment transactions has not been adequate in certain areas.

Although the University has two separate accounts for endowment principal and market value adjustments, it has been inconsistent in accounting for contributions and market value changes. Proper accounting could enable the University to track cumulative donor contributions separately from undistributed investment income and, therefore, would help prevent the University from spending a portion of the principal from any endowments (as discussed in Chapter 1).

The University also categorizes its endowment spending accounts as designated funds instead of as restricted funds. This could impair its ability to accurately report on the restricted portion of fund balances. According to the National Association of College and University Business Officers' (NACUBO) *Financial Accounting and Reporting Manual for Higher Education*, the fund balances of endowment and term endowment funds are, by definition, restricted and include donations for endowment purposes, income required to be added to the endowment, and gains and losses on investments that are restricted for endowment purposes (see text box).

Difference Between Restricted Current Funds and Designated Current Funds

The restricted current funds group consists of those funds expendable for operating purposes but restricted by donors or other outside agencies as to the specific purpose for which they may be expended. Such externally imposed restrictions are to be contrasted with internally created designations imposed by the governing board on unrestricted funds. The distinction between the balances of externally restricted and internally designated, but otherwise unrestricted funds, must be maintained in the accounts and disclosed in the financial reports.

Current restricted funds include restricted income from endowment funds and gifts restricted for operating purposes, such as scholarship grants, gifts for purchase of library books, and salary stipends for faculty (professorships).

Source: National Association of College and University Business Officers (NACUBO) *Financial Accounting and Reporting Manual for Higher Education*, Section 311.1.

Auditors could not determine whether endowment terms have expired on one endowment because the University could not provide documentation for the beginning date of the endowment term. In the case of this endowment, when the endowment terms expire, the University can choose to spend the endowment's principal by moving it into restricted or unrestricted current funds or by creating a quasi endowment.

The University does not categorize its endowments according to the types of endowments as recommended in the publications of the Association of Governing Boards (AGB) of Universities and Colleges and the National Association of Colleges and Universities Business Officers (NACUBO). These three types of endowments are true endowment, term endowment, and quasi endowment (see text box). The University currently categorizes its endowments as general purpose, student aid, or term endowments. In addition, the University misclassified one faculty chair endowment as a scholarship endowment. If endowments are misclassified, their income could be spent for purposes not intended by donors.

Three Types of Endowments

Three distinctly different types of endowment exist, although they usually are referred to collectively as "endowment." These three types of endowments are true endowment, term endowment, and quasi endowment. *A true endowment* is a permanent fund with provisions that prohibit spending the corpus, or principal, of that fund. Only investment income generated by the fund (which today is usually defined to include capital gains) may be used to support the activities originally directed by its donor. *A term endowment* is a fund with provisions that state the principal may be spent at a specified rate, after a specific date, or upon the occurrence of a specific event. *A quasi endowment* (which is also called "a fund functioning as endowment) is a fund the institution's governing board chooses to treat as endowment, but the board is not subject to any legal prohibitions against spending the principal.

Source: *Endowment Management: A Practical Guide* Jay A. Yoder, CFA Association of Governing Boards of Universities and Colleges 2004.

Recommendations

The University should:

- Ensure that annual distributions from endowments are equitable for each endowment by applying the same distribution rate to each endowment. For the endowments that either (1) were not in existence during the entire previous three-year measurement period or (2) received additional contributions during the measurement period, the University should calculate the average market value based on the time period these new endowments or contributions were in existence.

- Consistently use correct accounts to record transactions that affect endowment principal separately from the transactions that result from market value adjustments.
- Categorize its endowment spending accounts as restricted funds.
- Research its records to determine whether the terms of some endowments have expired.
- Review all endowments and properly classify them as (1) true endowments, term endowments, or quasi endowments and (2) restricted or unrestricted endowments. Under each endowment type, the University should further classify each endowment by its purpose (such as scholarship or professorship).

Management's Response

The University concurs with the recommendations. Applicable university managers will develop procedures to ensure the following:

- *Annual distributions from endowments are equitable for each endowment. (This will be accomplished using the methodologies outlined in the recommendation above); and*
- *Correct accounts are consistently used to separately record transactions affecting endowment principal and those transactions that result from market value adjustments; and*
- *Endowment spending accounts are categorized as restricted funds; and*
- *Applicable records are researched to determine whether the terms of some endowments have expired; and*
- *All endowments are reviewed and properly classified according to those in the recommendation above.*

Responsible parties: Personnel from the Office of Research and Development and the Office of Business and Finance

Target date for completion: February 1, 2007

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether Texas Southern University (University):

- Has endowment fund investment and annual distribution policies that are consistent with modern endowment management principles as embodied in the Uniform Management of Institutional Funds Act (Texas Property Code, Chapter 163).
- Is in compliance with its endowment management policies.
- Has adequate procedures to monitor and report endowment performance against stated objectives.
- Has controls that provide reasonable assurance of substantial compliance with donor restrictions.

Scope

The scope of this audit covered all endowments established at the University and expenditure data for a sample of endowments for fiscal year 2005 and part of fiscal year 2006. Because review of information technology systems was not necessary to achieve the audit objectives, this audit did not include a review of any information technology systems.

The audit scope did not include the University's fundraising activities or the activities performed by the foundations established at the University.

Methodology

The audit methodology included conducting a survey and conducting interviews with University management, staff, and service providers to gain an understanding of controls and processes related to endowment management. The methodology also included the collection, review, and analysis of policies, procedures, and other documentation of the University. Testing of compliance with policies and testing of a sample of endowment expenditures was also performed.

Information collected and reviewed included the following:

- Texas Statutes (Property Code, Education Code, and Government Code)

- University Investment Policy Statement
- Minutes of the meetings of the Board of Regents
- Account statements prepared by custodial banks.
- Service provider disclosure forms
- Correspondence from service providers
- Quarterly investment performance reports
- Historical investment performance data
- Historical income distribution data
- Population of University endowments as of August 31, 2005 and February 28, 2006
- Endowment donor agreements
- Fiscal year 2005 and 2006 year to-date general ledger transaction activity for the sample of endowments and associated expenditure accounts
- Chart of accounts and funds
- Documentation supporting expenditures from the endowment expenditure accounts

<u>Procedures and tests conducted</u> included the following:

- Survey of management practices of endowment funds
- Interviews of management, staff. and external service providers
- Testing of asset allocation of investments
- Review and testing of compliance with the University's spending policy.
- Gaining an understanding of how external managers are monitored.
- Review of investments for disallowed investments or activities
- Testing of compliance with components of the Investment Policy Statement.
- Testing of compliance with ethics disclosure requirements
- Verification of the population of University endowments

- Testing of a sample of endowments for compliance with donor restrictions.

- Review of general ledger balances as of August 31, 2005 for the endowment expenditure accounts

Criteria used included the following:

- State laws and regulations
  - Uniform Management of Institutional Funds Act (UMIFA)
  - Texas Education Code, Chapter 51
  - Texas Government Code, Chapter 2263
- Internal policies
- University endowment and investment management best practices:
  - Endowment management practices of the University of Texas at Austin
  - National Association of College and University Business Officers (NACUBO)
  - Association of Governing Boards of Universities and Colleges (AGB)
  - Government Finance Officer's Association (GFOA)
  - Commonfund Institute
  - CFA (Chartered Financial Analyst) Institute

Project Information

Audit fieldwork was conducted from May 2006 through June 2006. This audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit:

- Hugh Ohn, CFA, CPA, CIA (Project Manager)
- Roger Ferris, CPA (Assistant Project Manager)
- Hillary Hornberger
- Alan Walton, CIA

- Charles P. Dunlap, Jr., CPA (Quality Control Reviewer)
- Verma Elliott, MBA, CGAP (Audit Manager)

Excerpt from the Minutes of the August 7, 2003, Meeting of the Finance Committee of the Texas Southern University Board of Regents

The italicized text below is an excerpt from the minutes of the August 7, 2003, meeting of the Finance Committee of the Texas Southern University Board of Regents. This excerpt includes discussion of endowment income for scholarships.

. . . Endowment Income for scholarships, a million dollars and here's what's going on with that. In the 78th Legislative Session the State allocated a million dollars for scholarships to the University but they made us endow those funds. We weren't able to spend those funds as a regular operating expense so what we had to do is go to our endowment and we took a look at the current market value of our endowment versus its historical value. And currently right now, it's approximately $2.6 million so we're able to use that additional money; we're able to use a million dollars out of that to fund our scholarships and auxiliary enterprises… Regent Diaz replied, run that by again. Regent Wilson stated that $2.6 million is the increase in the endowment. That's the market value above the historical cost. Is that after you've assumed an inflation factor? Mr. Wiggins replied, I haven't assumed an inflation factor yet. Dr. Slade replied, this is actually realized income. Mr. Wiggins confirmed, right, realized and unrealized. Regent Williams stated, so I assume all of the assets that we hold in the endowment are probably held in securities of some sort. Mr. Wiggins replied, right, securities, stocks and bonds. Regent Williams asked, so has there been an event or sale or what have you to generate that $1 million dollars? Dr. Slade asked, now don't they hold some kind of cash? Mr. Wiggins replied, right, yes they hold cash. We haven't directed them to do that yet. Regent Williams asked, so what are we holding in cash? Regent Ziedman asked, is this cash or cash equivalent? It's a market value of a security as of… Dr. Slade responded, we'll have to make that realized income. We're going to have realized income. Regent Ziedman asked, so are you anticipating some market performance to make that number real since it's a year from now? Mr. Wiggins replied, no I'm not. As a matter of fact when we did the calculations to see what excess earnings we had we looked at Fiscal Year 2002 and now our endowment has increased by over 20 percent, the actual performance of our endowment has increased to over 20 percent since Fiscal Year 2002. So that $2.6 million that I quoted is actually much higher. Regent Ziedman replied, it's all due to performance; it's not any additional. Regent Wilson replied, but it's not one-year performance. What he has, the schedule that I saw is a historical summation of the amounts that were donated which is about $11 million. Am I remembering the numbers right? Mr. Wiggins replied, right. Regent Wilson stated, about $11 million historically was donated to TSU that's in the endowment. The market value of that is around $13 or $14 million. That's where the $2.6 million comes. There's been no event that has happened as a result of this budget to trigger

that gain but what it is assuming in the process is that if it goes securities there will be a million dollars that can be withdrawn from the endowment fund that would not happen with the original corpus. Regent Ziedman asked, so the original corpus would remain? Regent Wilson replied, the original corpus would remain $11 million. So in effect for us not to be able to get this million dollars the endowment would have to come off of historical… , so 20 percent. Mr. Wiggins stated, we would have to have a 20 percent decline within the next twenty days. Regent Williams replied, I think I understand how you are getting there however my issue is how we are treating the endowment. I mean typically you want to use real earnings from the endowment as opposed to contributions that increase the endowment and you want to have a formula that allows you to take from the earnings some amount less whatever inflation is. So that in absolute numbers you don't end up with a situation where the endowment is actually depleting. Regent Wilson stated, the point I made is one; you can't do this every year. You may not be able to do it next year. Regent stated, so we ought to call it what it is I mean it's some type of special assessment because that's a dangerous maneuver if you were to look to tap the endowment for other situations like that in the future. Dr. Slade replied, you're absolutely right. There is a methodology that we use to ensure that the corpus in the endowment fund plus some inflation factor is never touched. That when we withdraw from the foundation from the endowment, it's always earnings and keeping the corpus in tact, that's one of our investment policies associated with withdrawals. So we maintain the integrity of that and I concur with Regent Wilson stated, that this is not a practice that we can use. Now number one this is an endowment for scholarships so we can't use it for anything else. But the fact of the matter is also we can't take a million dollars out of the endowment fund every year and still keep the corpus in tact we would violate our own rules. So this became necessary because the bill pattern for TSU's Appropriation this year said that the million dollars that they gave for scholarships had to be put in an endowment. Last Session they didn't make that stipulation but this time the Coordinating Board made sure…specified endowment. But we could not leave the students hanging because there were students who were given scholarships last year who deserve to have those continuing scholarships this year because of their performance. So, we began to look at creating, well Mr. Wiggins did and hats off to him, to make sure that we maintain the integrity of our scholarships and so we were able to do this, this time. So, that just points out the need for the Regents, my bosses, if I may very respectfully say to help us raise the million dollars for next year which you are so quite capable of doing. Regent Williams stated, and I would assume that we could anticipate this budget change or policy relevant to the budget to be continued. Dr. Slade replied, yes sir, most definitely. It's a Board Policy we can't change it; you're the only ones who can change it. Regent Wilson asked, if the budget that we're referring to is that the million dollars that we got through State funds. Mr. Wiggins replied, yes the way the state treated that. I'm assuming that's going to be something I mean that won't change. I mean you won't… Dr. Slade *stated, it won’t change for the next two years. It’s in the bill pattern for the next two years. Regent Wilson asked, now what happens and correct me if I’m wrong, what happens though is that, what happened last year is that the million dollars that we got, we spent? What happens this year is that the millions dollars that we get goes in the endowment? So in effect you’ve got a million dollar asset that you get to earn off going forward. However, you have to address whether how you are going to fund the million dollars from last year and those earnings. You took it out of appreciation not necessarily earnings both realized and unrealized. Ultimately, he’s going to have to sell something in order to realize those gains at which time we’re going to have million dollars less in corpus. In sells, we’re going to have a million dollars more from what the state is giving us. The real issue in my view is not necessarily this year but is what is historically going to happened because you cannot; you know we’ve got the benefit of $2.6 million that’s accumulated over some time. That isn’t going to happen next year so we’ve got to figure out what we’re going to do for next year’s budget. Mr. Wiggins replied, and hopefully with the increase in enrollment, we will be able to fund additional scholarships without having to go back and tax the students because our ultimate goal is that we didn’t want to come back and tax the students . . .*

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas "Tommy" Williams, Member, Texas Senate
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Jim Keffer, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Texas Southern University

Members of the Texas Southern University Board of Regents
Dr. Bobby Wilson, Interim President