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An Audit Report on
**Endowments at Selected Higher
Education Institutions**

August 2021
Report No. 21-033



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Overall Conclusion

The three higher education institutions audited had policies for overall endowment management that incorporated principles consistent with the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and Texas Education Code, Chapter 51.

Two of the three higher education institutions, University of Houston and Midwestern State University, complied with their endowment management and investment policies, including selecting investment managers, quarterly review of investment performance, and income payout policies. Additionally, the University of Houston's investment managers stayed within their targeted asset allocations. One of Midwestern State University's investment managers exceeded targeted allocations for three of five quarters, as reported during fiscal year 2020 and the first quarter of 2021.

The third higher education institution, University of North Texas at Dallas, uses the University of North Texas Foundation, Inc., to manage its investments. The institution reviewed quarterly investment performance; however, that review did not include performance measures, benchmarks, or changes in market values. Additionally, the institution had limited processes in place to verify the information that the foundation provided.

The three higher education institutions had documentation of donor agreements or equivalent support to record donor intent. The University of Houston and Midwestern State University used endowment funds in accordance with donor restrictions. The University of North Texas at Dallas did not monitor available balances for

Background Information on Endowments

An endowment is a contribution 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. Expendable funds are those funds that may be expended either for a stated purpose or for a general purpose as per the endowment gift terms.

- **Permanent endowments.** Also referred to as "true" or "pure" endowments, gifts for which donors have stipulated, as a condition of the gift, that the principal must never be spent. Only the income generated from the investment of these funds may be used as directed by the terms of the gift.
- **Term endowments.** Funds for which the donor has stipulated that the principal may be expended after a stated period or on the occurrence of a certain event.
- **Quasi-endowments.** Designated funds established by an institution's governing board to function as endowment funds but which may be totally expended at any time at the discretion of the board. The board will specify the use of the assets and spendable income, and set other terms and conditions relating to the fund.

Sources: The State Auditor's Office Report No. 06-059 and endowment policies for University of Houston System, Midwestern State University, and University of North Texas at Dallas.

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Hillary Eckford, Audit Manager, or Lisa Collier, First Assistant State Auditor, at (512) 936-9500.

expendable funds and did not expend those funds from September 2019 through January 2021.

Table 1 presents a summary of the findings in this report and the related issue ratings. (See Appendix 2 for more information about the issue rating classifications and descriptions.)

Table 1

Summary of Subchapters and Related Issue Ratings		
Subchapter	Title	Issue Rating ^a
1-A	The University of Houston Managed Its Endowments in Accordance With Its Policies	Low
1-B	The University of Houston Spent Its Endowment Income in Accordance With Donor Restrictions	Low
2-A	Midwestern State University Managed Its Endowments in Accordance With the Majority of the Requirements in Its Policy	Medium
2-B	Midwestern State University Spent Its Endowment Income in Accordance With Donor Restrictions	Low
3-A	The University of North Texas at Dallas Had Inadequate Processes and Related Controls to Help Ensure That Endowments Are Managed in Compliance With Applicable Requirements	High
3-B	The University of North Texas at Dallas Did Not Properly Account for Its Earned Distributed Income That Can Be Used to Fulfill Donor Intent	High

^a A subchapter is rated **Priority** if the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern and reduce risks to the audited entity.

A subchapter is rated **High** if the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern and reduce risks to the audited entity.

A subchapter is rated **Medium** if the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.

A subchapter is rated **Low** if the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

Auditors communicated other, less significant issues separately in writing to each higher education institution's management.

Summary of Management's Response

At the end of certain chapters in this report, auditors made recommendations to address the issues identified during this audit. The higher education institutions agreed with the recommendations in this report.

Audit Objective and Scope

The objective of this audit was to determine whether selected higher education institutions have processes and related controls to help ensure that endowment funds are managed and utilized in compliance with applicable requirements, including donor restrictions.

The scope of this audit focused on all endowments established at the institutions and expenditures for fiscal year 2020 through January 2021. The scope also included a review of significant internal control components related to determining whether the higher education institutions have processes and related controls in place to help ensure that endowment funds are managed and utilized in compliance with applicable requirements, including donor restrictions.

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Detailed Results

Chapter 1

The University of Houston Had Processes and Related Controls to Help Ensure That Endowment Funds Are Managed in Compliance With Applicable Requirements

The University of Houston’s (University) overall endowment policies were consistent with endowment management principles described in the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and requirements from Texas Education Code, Chapter 51. The endowment principles that the University incorporated into its policies included focusing on long-term growth of endowment principal (to maintain or increase purchasing power over time), paying out a prudent portion of income, and using outside investment managers to manage endowment assets. The University complied with those policies. The University also recorded donor intent within agreements and spent endowment income in accordance with donor restrictions.

Chapter 1-A

The University Managed Its Endowments in Accordance With Its Policies

**Chapter 1-A
Rating:**

Low ¹

The Board of Regents (Board) for the University of Houston System (System) annually reviews the System Endowment Fund policies, which the University follows (see text box for more information about the University’s endowments). The System’s policies were consistent with the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and Texas Education Code, Chapter 51. The policies establish long-term financial goals for the System’s endowments to preserve and enhance the real (inflation-adjusted) purchasing power of endowment assets and income after accounting for endowment spending, inflation, and costs of portfolio management. The policies make clear that any person responsible for supervising and managing System funds shall do

University of Houston Endowments

As of August 31, 2020, the University had 1,508 endowments with a total market value of approximately \$597 million. Endowments receive a specific percentage of the earnings to support the donor’s intention of giving. During fiscal year 2020, the University distributed approximately \$20 million of its endowment income that could be spent on endowment purposes. The University pools its endowment funds with University of Houston System endowment funds and follows the System’s policies.

Source: The University.

¹ The risk related to the issues discussed in Chapter 1-A is rated as Low because the audit identified strengths that support the audited entity’s ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity’s ability to effectively administer the program(s)/function(s) audited.

so in good faith and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.

The System's policies establish:

- The way the Board will select investment managers and establish the scope and terms of the investment delegations.
- A requirement for quarterly investment performance reporting.
- Targeted asset allocations that take into account risk and expected returns.

Investment Managers. The System contracted for advice from an investment consultant and contracted directly with investment managers recommended by the consultant. This contracting provides the System access to the investment expertise of external investment managers. Contracts with 11 investment managers tested and Board meeting minutes showed that the Board approved the investment managers and approved the statements of investment objectives and guidelines, as required by the System's policies.

Investment Performance Review. During each quarter in fiscal year 2020 and the first quarter of fiscal year 2021, the Endowment Management Committee (established by the Board as a standing committee to assist in fulfilling the Board's fiduciary responsibilities) reviewed investment performance information the investment consultant provided. The review included changes in market value, comparisons to market indices, and internal performance standards, helping the University understand how its portfolio performed against various market segments and its own objectives. Additionally, the System tracked investment performance by conducting a monthly reconciliation comparing market value from investment managers to records from the System's custodian bank and System records. The reconciliation control was working effectively. The System also hired an external auditor to perform an annual audit of the financial statements of its endowment fund.

Asset Allocation Review. The Board monitored asset allocations in quarterly meetings in fiscal year 2020 and the first quarter of fiscal year 2021. Asset allocations were within the targeted ranges. Adhering to target asset allocation is important because asset allocation is considered one of the most significant determinants of an entity's investment return. Based on the University's investment holdings as of August 31, 2020, the asset allocations were within range of the University's target allocations.

The University Spent Its Endowment Income in Accordance With Donor Restrictions

Chapter 1-B
Rating:

Low²

Endowment Distributed Income. Endowments receive a specific percentage of their investment earnings, known as the payout rate, to be spent according to donor intent. The System's objective in establishing the payout rate is to maintain the purchasing power of the endowment with the goal of providing a reasonable and sustainable level of income to support current needs. As determined by the System's policies, the payout rate is a percentage of the fiscal year end market value average over rolling 12-quarter periods. For fiscal year 2020, the policy specified a 4 percent payout. The System calculates the distribution annually.

The System accurately calculated the disbursement according to policy and deposited the income in each endowment's associated spending account to be used according to donor intent. In fiscal year 2020, the University distributed approximately \$20 million to be spent for endowment purposes.

Endowment Spending. Endowment spending accounts are assigned during their creation to a department, and administrative control over spending is identified within the endowment agreement. The University's Office of Advancement ensures that departments are aware of available endowment opportunities by (1) annually reviewing amounts available from endowments and (2) sending a report to each responsible department with the available amount and a summary of the donor requirements for spending. The Office of Advancement provided accurate summaries to each of the departments for each of the 29 sampled endowment agreements.

The System's policies require annual distributions to the endowments' associated spending accounts, but departments may not always spend down the funds immediately. As of August 31, 2020, the beginning balances in the spending accounts associated with endowments totaled \$36.7 million, which was 1.8 times the fiscal year 2020 distributed income for those endowments. The Office of Advancement explained that spending of endowment funds can be cyclical and that funds can be spent only for the exact purposes specified by the donors.

Auditors reviewed 20 endowment spending accounts that had large beginning balances compared to the accounts' fiscal year 2020 distributions.

² The risk related to the issues discussed in Chapter 1-B is rated as Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

The departments that were responsible for the endowments had reasonable explanations for accumulating the funds.

For 17 of the 20 endowments, the departments had plans in place for spending in the future, including established monetary goals and anticipated dates to reach those goals. Some of those endowments also experienced issues with spending during the COVID-19 pandemic; for example, some endowments cancelled conferences and travel.

The other three endowments were accumulating funds because of donor agreement impediments. Those endowments were under review by the University to determine appropriate action. Specifically:

- The University determined that one endowment did not have enough documentation to ensure that donor intent is followed.
- Donors intended two endowments be for a program and an organization that were no longer associated with the University.

Endowment Donor Agreements and Expenses. For 29 endowment donor agreements tested, the University documented donor restrictions to help ensure that funds were used according to donor intent. The University adopted templates for donor agreements to help ensure that required information is included. Although some of the older agreements tested predated the adoption of those templates, each agreement explained the purpose of its associated endowment.

For each donor agreement tested, auditors reviewed an associated expense. All 29 expenses tested were appropriate based on the donor agreements and were approved by the departments.

Midwestern State University Had Processes and Related Controls to Help Ensure That Endowment Funds Are Managed in Compliance With the Majority of Applicable Requirements

Midwestern State University's (University) overall endowment policies were consistent with endowment management principles described in the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and regulations from Texas Education Code, Chapter 51. The endowment principles that the University incorporated into its policies included focusing on long-term growth of endowment principal (to maintain or increase purchasing power over time), balancing the need to make spending distributions with preserving the purchasing power of the fund, and employing outside investment consultants to manage endowment funds. The University complied with the majority of those policies and spent endowment income in accordance with donor restrictions.

Chapter 2-A

The University Managed Its Endowments in Accordance With the Majority of the Requirements in Its Policy

**Chapter 2-A
Rating:
Medium³**

The University's Board of Regents (Board) established and annually reviews the University's Endowment Fund policies (see text box for more information about the University's endowments). The policies were consistent with the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and Texas Education Code, Chapter 51. The policies establish a long-term financial goal to preserve the intergenerational equity of the endowment while providing an appropriate current income distribution policy. They note that the growth of principal is necessary to meet the projected future needs for income. The policies explain that the University shall act with the judgment and care that a prudent person would exercise in the management of that person's own affairs. They also require the University to apply the policies in the context of individual transactions, as well as management of the overall portfolio. The Texas A&M University System (TAMUS) investment policies that are used to manage some of the University's endowments (see text box on next page) also provide for long-term financial goals consistent with the University's primary objective of safety and preservation of capital. Additionally, TAMUS's

Midwestern State University Endowments

As of August 31, 2020, the University had 92 endowments with a total market value of approximately \$27 million. Endowments receive a specific percentage of the earnings to support the donor's intention of giving. During fiscal year 2020, the University distributed approximately \$1 million of its endowment income that could be spent on endowment purposes.

Source: The University.

³ The risk related to the issues discussed in Chapter 2-A is rated as Medium because issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.

policy calls for the managing of funds in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

The University's endowment policies establish:

- The way the Board will select investment managers and review investment performance.
- A requirement for quarterly investment performance reporting.
- Targeted asset allocations that take risk and expected returns into account.

Investment Managers

The University uses Texas A&M University System (TAMUS) to manage endowment funds established after December 11, 2014. The investments and income distribution calculation for those endowments follow TAMUS investment policies. Endowment funds established before that date are managed by a different investment manager who follows Midwestern State University policies.

Sources: The University and the contract between the University and TAMUS.

Investment Managers. The University contracted with a financial institution and TAMUS to serve as investment managers (see text box). This contracting provides the University access to the investment expertise of external investment managers. The University complied with its policies for selecting investment managers, and the contracts allowed for sharing of investment performance information. The Board approved both investment managers and received information to monitor performance and compliance with the contracts.

Investment Performance Review. During each quarter in fiscal year 2020 and the first quarter of fiscal year 2021, the University prepared investment performance reports and presented them to the Board. The reports included changes in market value, weighted benchmarks, and performance measures, helping the University understand how the portfolio performed against various market segments and its own objectives. Additionally, the University performed a quarterly reconciliation of investment performance by comparing the University's financial records to the market value the investment managers provided. The reconciliation process worked effectively for two quarterly reconciliations tested.

Asset Allocation Review. The Board monitored asset allocations in quarterly meetings in fiscal year 2020 and the first quarter of fiscal year 2021. Asset allocations were within the targeted ranges for investments held at TAMUS; the other investment manager exceeded the maximum percentages for U.S. equities and global equities for three of the five quarters tested. The University did not document a resolution for the excess target asset allocation. Adhering to target asset allocations is important because asset allocation is considered one of the most significant determinants of an entity's investment return. Based on the University's investment holdings as of August 31, 2020, the asset allocations presented to the Board were consistent with the detailed investment holdings.

Recommendation

The University should implement appropriate remedies when investment managers are out of compliance with the University's policies.

Management's Response

Management agrees with the recommendation and will review quarterly asset allocations to ensure compliance with targeted ranges included in MSU Policy 4.196, "Investment Policy Endowment Funds." If such asset allocations are not in compliance with the policy, investment managers will be asked to review and adjust allocations appropriately and within a reasonable timeframe to ensure compliance.

Chapter 2-B

The University Spent Its Endowment Income in Accordance With Donor Restrictions

Chapter 2-B
Rating:
Low⁴

Endowment Distributed Income. Endowments receive a specific percentage of investment earnings, known as the payout rate, to be spent according to donor intent. The University uses two investment managers to manage its endowment funds. Each manager's policy takes into account the need to preserve endowment capital. Table 2 shows the payout rate and frequency of distribution for each policy.

Table 2

Payout Rate and Frequency of Distribution for Midwestern State University Endowments		
Investment Manager	Payout Rate	Frequency of Distribution
TAMUS	5 percent of the 20-quarter average market value	Quarterly
Other	4 to 5 percent of the endowment fund	Annually

Sources: TAMUS's investment policy and the University's investment policy.

The distributions for both investment managers were accurately calculated in accordance with policy, and the University deposited the income in each endowment's associated spending account to be used according to donor

⁴ The risk related to the issues discussed in Chapter 2-B is rated as Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

intent. In fiscal year 2020, the University distributed approximately \$1 million to be spent for endowment purposes.

Endowment Spending. The University's policies require distributions to the endowments' associated spending accounts; but departments, which have authority over the funds, may not always spend down the funds immediately. As of August 31, 2020, the beginning balances in the associated spending accounts for endowments totaled \$931,000, which was 0.86 times the fiscal year 2020 distributed income for those endowments.

Auditors reviewed five endowment spending accounts that had large beginning balances compared to the fiscal year 2020 distributions. The departments that were responsible for the endowments had reasonable explanations for accumulating the funds. For four endowments, the departments had plans in place for spending in the future; including established monetary goals and anticipated dates to reach those goals. The other endowment experienced issues with spending during the COVID-19 pandemic due to the cancelation of annual events.

Endowment Donor Agreements and Expenses. For 22 endowment donor agreements or equivalent supporting documentation tested, the University documented donor restrictions to help ensure that funds were used according to donor intent. The University adopted templates for donor agreements to help ensure that required information is included. Although some of the older agreements tested predated the adoption of those templates, each explained the purpose of its associated endowment.

For each donor agreement tested, auditors reviewed an associated expense. All 22 expenses tested were appropriate based on the donor agreements and were approved by the departments.

The University of North Texas at Dallas Had Inadequate Processes and Controls to Help Ensure That Endowment Funds Are Managed in Compliance With Applicable Requirements

The University of North Texas at Dallas (University) did not have adequate processes and controls in place to manage its endowment funds in compliance with applicable requirements. Specifically:

- The University had limited processes to verify the information that the entity responsible for managing its investments, the University of North Texas Foundation, Inc. (Foundation), provided (see text box below for relationship).
- Quarterly reviews of University investments did not adequately address performance measures, benchmarks, or changes in market value.
- The University did not have a formal investment management agreement with the Foundation until December 1, 2020.

In addition, the University did not use earned income on donor intent from September 2019 through January 2021 during the scope of the audit and was not adequately accounting for income distributed as expendable funds.

Chapter 3-A

The University Had Inadequate Processes and Related Controls to Help Ensure That Endowments Are Managed in Compliance With Applicable Requirements

The University's policy for endowment management is consistent with the Uniform Prudent Management of Institutional Funds Act (Texas Property Code, Chapter 163) and Texas Education Code, Chapter 51 (see text box for more information about the University's endowments). The policy established long-term financial goals to preserve the real (inflation-adjusted) purchasing power of principal and income after accounting for endowment spending, inflation, and costs of investment management. The University's

University of North Texas at Dallas Endowments

As of August 31, 2020, the University had six endowments with a total market value of \$975,306. Endowments receive a specific percentage of the earnings to support the donor's intention of giving. During fiscal year 2020, the University received \$32,069 of its endowment income that could be spent on endowment purposes. The University's endowments value increased substantially in fiscal year 2021 with the establishment of a \$10.8 million quasi-endowment.

The University's endowments are invested alongside all other endowments managed by the University of North Texas Foundation, Inc. (Foundation) in its investment pool. The Foundation is a private, independent, not-for-profit corporation that is not under the control of or affiliated with the University.

Sources: The University and the Foundation.

**Chapter 3-A
Rating:**

High⁵

⁵ The risk related to the issues discussed in Chapter 3-A is rated as High because they present risks or results that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.

endowment policy and current agreement with the Foundation states that the manager will follow the prudent person standard, exercising the care that persons of ordinary prudence, discretion, and intelligence exercise in the management of their affairs in regard to the investments of their funds.

However, the University had limited processes in place to verify the investment management information that the Foundation provided, and the University did not always follow its policy.

Investment Performance Review. The University relied on information from the Foundation on investment performance. The University had limited processes in place to verify the information or monitor performance. The University reviewed investment reports for its endowments the Foundation provided on a quarterly basis; however, the quarterly reports did not include performance measures and benchmarks, as required by the University's policy, or changes in market values, as required by policy and Texas Education Code, Section 51.0032(c)(2). Benchmarks were included in an annual review, but the information provided did not specify the type of benchmark. Benchmarks, performance measures, and changes in market value could assist the University in understanding how its portfolio is performing against internal objectives and against various market segments.

Asset Allocation Review. The University's endowment policy states that investments will follow the Foundation's allocation targets and that the asset allocations shall be monitored on an ongoing basis and reviewed on a yearly basis or as needed during the fiscal year. The University received information on investment allocations on a yearly basis only. The annual information the Foundation provided included only percentages; there was not adequate information to enable the University to monitor the detailed asset allocations on an on-going basis as required by its policy. Adhering to target asset allocations is important because the University must invest under prudent person standards and asset allocation is considered one of the most significant determinants of an entity's investment return. Texas Property Code, Section 163.004, requires higher education institutions to make a reasonable effort to verify facts relevant to the management and investment of the fund.

Agreement with Investment Manager. The University's endowment policy establishes that the endowment funds shall be invested in the Foundation's endowments investment pool for the duration of any existing investment management agreement between the University and the Foundation. In 2015 the University assumed responsibility for its endowments, which were managed by the Foundation; however, the University did not establish a formal agreement with the Foundation until December 1, 2020. The Foundation asked to formalize the agreement when the University

established a large quasi-endowment.⁶ The delegation of asset management responsibilities to outside parties allows the University to have access to the investment expertise of external investment managers. However, it is important to have a formal agreement in place to help ensure that both parties have a clear understanding of requirements and expectations, and it helps the University monitor the investment manager services.

Recommendations

The University should:

- Monitor the Foundation to ensure that quarterly performance reports include all required information including allocations, performance measures, benchmarks, and changes in market value.
- Establish processes to verify information provided by the Foundation.

Management's Response

- *UNTD agrees with the recommendations and will implement them by May 31, 2022 (Q3 FY2022).*
- *Owners: UNTD Controller, UNTD AVP Finance, and UNTD EVP Administration & CFO*

Chapter 3-B

The University Did Not Properly Account for Its Earned Distributed Income That Can Be Used to Fulfill Donor Intent

Chapter 3-B
Rating:
High ⁷

Endowment Distributed Income. Endowments receive a specific percentage of their investment earnings, known as the payout rate, to be spent according to donor intent. The University's endowment policy included an income distribution policy that reflected an objective to pay out as much of the total return as is consistent with overall investment objectives while protecting the real value of the endowment principal. For the University, the distributed payout rate is 3.75 percent of the average market value of the University's

⁶ The University of North Texas System Board of Regents invested historic tax credit proceeds (\$10.8 million) to establish a quasi-endowment for the University of North Texas at Dallas. The historic tax credit proceeds were from the sale of tax credits related to the renovation of the historic municipal building for the College of Law.

⁷ The risk related to the issues discussed in Chapter 3-B is rated as High because they present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.

investments for the preceding 12-quarters. The Foundation calculates and provides the distributions to the University quarterly.

The Foundation calculated the distributions according to policy; however, the University had no formal review process in place to ensure that the information was accurate before it was recorded into the financial system.

In fiscal year 2020 and the first quarter of fiscal year 2021, the University received \$40,212 in distributed income. The University recorded the income distributions quarterly into each endowment's fund and categorized the amounts as expendable; however, according to the University, it did not complete the accounting entries necessary to make those funds available for spending. The University informed auditors that the year-end close-out for distributed income had not occurred in the last two to three years, and that because it was in the process of fixing this, it could not verify the balances at the time of the audit. The University asserted that it was working toward (1) establishing a process and assigning process owners to identify available balances and (2) providing balances to key stakeholders and the scholarship committee that awards endowed scholarships.

Endowment Spending. The six endowments that received payout distributions during fiscal year 2020 were created for scholarships. For those six endowments, the University documented donor restrictions in the donor agreements or equivalent supporting documentation, in accordance with applicable requirements.

The University did not spend any of the endowments' payout distributions toward the scholarships from September 2019 through January 2021. According to the University's Office of Advancement, the University suspended spending from endowments for donor purposes⁸ in 2016 to accumulate funds in the expendable endowment balances. The University did not establish a goal or timeline to re-establish the scholarships.

From September 2019 through January 2021, the University did not monitor the accounts for expendable balances. While reviewing accounting records the University identified a combined deficit of \$226,478 for two endowments with the same purpose, which the University asserted resulted from an over-award of scholarships in fiscal years 2017 and 2018. The accuracy of this balance could not be verified by the University because the year-end close-out accounting process had not occurred in the last two to three years. The University should monitor to ensure that balances are correct and not in deficit. Deciding to grow expendable balances to ensure that the University has enough funds for meaningful awards, and that the endowment principal

⁸ From September 2019 through January 2021, the only expenses paid were endowment management fees.

is preserved, is appropriate according to applicable requirements. However, the University should be able to account for those decisions and have support for its accounts to ensure that deficits are avoided and available funds are used as intended by donors. Not monitoring the balances or having a plan in place to re-establish scholarships limits the amount of funds available to students and risks not fulfilling donor intent.

Recommendations

The University should:

- Finish updating and adopting processes to monitor available spending balances, ensuring that the accounting entries necessary to make those funds available for spending are completed, and provide reports to stakeholders and the scholarship committee in charge of administering scholarships at least annually.
- Establish targets and timelines for spending endowment balances in accordance with donor intent.

Management's Response

- *UNTD agrees with the recommendation and will implement them by May 31, 2022 (Q3 FY2022). UNTD will also formalize governance for UNTD Scholarship Committee to ensure available funds are reviewed and awarded periodically.*
- *Owners: UNTD Controller, UNTD AVP Finance, and UNTD EVP Administration & CFO*

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The objective of this audit was to determine whether selected higher education institutions have processes and related controls to help ensure that endowment funds are managed and utilized in compliance with applicable requirements, including donor restrictions.

Scope

The scope of this audit focused on all endowments established at the institutions and expenditures for fiscal year 2020 through January 2021. The scope also included a review of significant internal control components related to determining whether the higher education institutions have processes and related controls in place to help ensure that endowment funds are managed and utilized in compliance with applicable requirements, including donor restrictions (see Appendix 3 for more information about internal control components).

Methodology

The audit methodology included selecting three higher education institutions to audit based on a risk assessment. The three institutions were:

- University of Houston.
- Midwestern State University.
- University of North Texas at Dallas.

Additionally, the audit methodology included interviewing staff at the higher education institutions to gain an understanding of controls and processes related to endowment management; reviewing criteria, investment holdings, investment performance information, income disbursements, and endowment agreements and expenditures; and performing selected tests and other procedures.

In addition, auditors reviewed appropriate user access for accounting and donor tracking software and reviewed groups and cost centers created for the sampled endowments in the accounting systems to verify whether endowment accounts were set up appropriately.

Data Reliability and Completeness

Auditors reviewed financial and investment data related to endowments. Auditors performed procedures to assess the reliability of those data sets, including (1) observing data extracts and reviewing query parameters used to extract the data, (2) verifying understanding of key fields with the higher education institutions, (3) comparing totals to other reports, and (4) tracing data to supporting documentation. Auditors also received investment holding information from third parties. Auditors determined that the data at each higher education institution was complete and sufficiently reliable to use to answer the audit objectives.

Sampling Methodology

Auditors selected a nonstatistical sample of endowments with expenditures primarily through random selection. In some cases, auditors selected additional endowments with expenditures for testing based on risk. This sample design was chosen to ensure that the sample included a cross section of endowments with expenditures and/or addressed specific risk factors identified in the population. Auditors reviewed expenditure descriptions associated with the donor agreements to identify whether the description aligned with the donor agreement purpose; additionally, auditors identified one expenditure for each sampled endowment based on risk factors to test additional support and approvals. The test results as reported do not identify which items were randomly selected or selected using professional judgment; therefore, it would not be appropriate to project the test results to the population.

Auditors selected a nonstatistical sample of 11 investment managers at the University of Houston through random selection. This sample design was chosen so the sample could be evaluated in the context of the population of 103 investment managers. The test results may be projected to the population, but the accuracy of the projection cannot be measured.

Auditors selected a nonstatistical sample of 2 quarters of reconciliations completed at Midwestern State University for testing based on risk. This sample design was chosen to address specific risk factors identified in the population, and items were selected because they had a high potential for error. The sample items were generally not representative of the population; therefore, it would not be appropriate to project those test results to the population.

Auditors selected a nonstatistical sample of 20 endowment spending accounts at the University of Houston and 5 endowment spending accounts at Midwestern State University for testing; this sample design was chosen to ensure that the sample included items with specific characteristics: large

endowment balances compared to fiscal year 2020 payout distributions. The sample items were not necessarily representative of the population; therefore, it would not be appropriate to project the test results to the population.

Auditors tested the entire population of endowments for the University of North Texas at Dallas.

Information collected and reviewed included the following:

- Statutes and each higher education institution's policies and procedures relevant to endowments.
- Board of Regents meeting minutes to include investment performance reports.
- Investment manager contracts/agreements and investment policies.
- Investment holdings of each higher education institution's endowments.
- Population of each higher education institution's endowments and the associated spending accounts.
- Endowment donor agreements.
- Support for endowment expenditures.
- Access permissions for finance modules and donor tracking systems.

Procedures and tests conducted included the following:

- Interviewed management and key personnel at the higher education institutions audited.
- Tested the donor agreements and expenditures associated with the higher education institutions' endowments.
- Tested and recalculated distributions made to the endowments from income earned from investments.
- Tested key controls.
- Tested compliance with statutes and policies and procedures.
- Reviewed investment manager contracts for compliance with policies and procedures regarding externally delegated investment functions.

- Reviewed endowment spending accounts with large accumulated balances.
- Tested asset allocations of investments.
- Tested user access controls in the finance modules and donor tracking systems.

Criteria used included the following:

- Texas Property Code, Chapter 163 – Uniform Prudent Management of Institutional Funds Act.
- Texas Government Code, Chapter 2256 – Public Funds Investment Act.
- Texas Education Code, Chapter 51 – Higher Education, Provisions Generally Applicable to Higher Education.
- Each institution’s investment and endowment policies, and applicable business administration policies.
- Texas A&M University System investment policy and endowment agreement.
- University of North Texas Foundation investment policy and investment management agreement.

Project Information

Audit fieldwork was conducted from February 2021 through July 2021. We conducted this performance audit in accordance with generally accepted government auditing standards. 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

- Anna Howe, CFE (Project Manager)
- Teri Lynn Incremona, CFE (Assistant Project Manager)
- Alexander Grunstein, CFE, CFCS
- Christina Ljuca
- Jessica I. Prieto, CPA

- Michael Ross
- Dana Musgrave, MBA (Quality Control Reviewer)
- Hillary Eckford, CIA, CFE (Audit Manager)

Issue Rating Classifications and Descriptions

Auditors used professional judgment and rated the audit findings identified in this report. Those issue ratings are summarized in the report chapters/sub-chapters. The issue ratings were determined based on the degree of risk or effect of the findings in relation to the audit objective(s).

In determining the ratings of audit findings, auditors considered factors such as financial impact; potential failure to meet program/function objectives; noncompliance with state statute(s), rules, regulations, and other requirements or criteria; and the inadequacy of the design and/or operating effectiveness of internal controls. In addition, evidence of potential fraud, waste, or abuse; significant control environment issues; and little to no corrective action for issues previously identified could increase the ratings for audit findings. Auditors also identified and considered other factors when appropriate.

Table 3 provides a description of the issue ratings presented in this report.

Table 3

Summary of Issue Ratings	
Issue Rating	Description of Rating
Low	The audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited <u>or</u> the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.
Medium	Issues identified present risks or effects that if not addressed could <u>moderately affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.
High	Issues identified present risks or effects that if not addressed could <u>substantially affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.
Priority	Issues identified present risks or effects that if not addressed could <u>critically affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity.

Internal Control Components

Internal control is a process used by management to help an entity achieve its objectives. The U.S. Government Accountability Office's *Government Auditing Standards* require auditors to assess internal control when internal control is significant to the audit objectives. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) established a framework for 5 integrated components and 17 principles of internal control, which are listed in Table 4.

Table 4

Internal Control Components and Principles		
Component	Component Description	Principles
Control Environment	The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.	<ul style="list-style-type: none"> ▪ The organization demonstrates a commitment to integrity and ethical values. ▪ The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control. ▪ Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. ▪ The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives. ▪ The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.
Risk Assessment	Risk assessment is the entity's identification and analysis of risks relevant to achievement of its objectives, forming a basis for determining how the risks should be managed.	<ul style="list-style-type: none"> ▪ The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. ▪ The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. ▪ The organization considers the potential for fraud in assessing risks to the achievement of objectives. ▪ The organization identifies and assesses changes that could significantly impact the system of internal control.
Control Activities	Control activities are the policies and procedures that help ensure that management's directives are carried out.	<ul style="list-style-type: none"> ▪ The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. ▪ The organization selects and develops general control activities over technology to support the achievement of objectives. ▪ The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

Internal Control Components and Principles		
Component	Component Description	Principles
Information and Communication	Information and communication are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.	<ul style="list-style-type: none"> ▪ The organization obtains or generates and uses relevant, quality information to support the functioning of internal control. ▪ The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control. ▪ The organization communicates with external parties regarding matters affecting the functioning of internal control.
Monitoring Activities	Monitoring is a process that assesses the quality of internal control performance over time.	<ul style="list-style-type: none"> ▪ The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. ▪ The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

Source: Internal Control - Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission, May 2013.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Dan Patrick, Lieutenant Governor, Joint Chair
The Honorable Dade Phelan, Speaker of the House, Joint Chair
The Honorable Jane Nelson, Senate Finance Committee
The Honorable Robert Nichols, Member, Texas Senate
The Honorable Greg Bonnen, House Appropriations Committee
The Honorable Morgan Meyer, House Ways and Means Committee

Office of the Governor

The Honorable Greg Abbott, Governor

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