



Lawrence F. Alwin, CPA
State Auditor

A Report on
The Permanent School Fund

February 17, 2004

Members of the Legislative Audit Committee:

In our audit report dated February 6, 2004, we concluded that the financial statements of the Permanent School Fund (Fund) for the fiscal year ended August 31, 2003, were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. We did not identify any instances of noncompliance with certain provisions of laws and regulations that would have a material effect on the Fund's financial statements or any material weaknesses in internal control over financial reporting.

In addition, Fund management has implemented a recommendation we made in 2001 to improve procedures for monitoring and reporting compliance with Board ethics rules and investment policies. Fund management has implemented automated compliance monitoring systems, designated a compliance officer, and reported instances of non-transaction-related noncompliance to the Board. However, the compliance officer resigned in December 2003. We encourage Fund management to continue following the improved procedures for monitoring and reporting compliance.

The State Board of Education (Board) adopted new ethics rules for the Fund in November 2003. The Texas Education Code, Section 43.0031(c), requires that the State Auditor's Office review and comment on any revisions to the Fund's ethics rules. The State Auditor's Office reviewed the proposed rule changes and concluded that they excluded certain requirements of Senate Bill 1059 (78th Legislature, Regular Session). Senate Bill 1059 was not in effect during fiscal year 2003, so these exclusions did not affect the Fund's compliance with state law for the period covered by this audit. However, it is possible that the exclusions could cause the Fund to be noncompliant with Senate Bill 1059 for fiscal year 2004. In addition, the Board did not take advantage of its opportunity to address previous comments regarding the Fund's ethics rule that were suggested by the State Auditor's Office, the Texas Ethics Commission, and Cortex Applied Research, Inc. (author of a recent fiduciary review of the

Permanent School Fund Selected Financial Information (in millions)		
	FY 02	FY 03
Fund Balance as of August 31	\$ 17,274	\$ 18,559
Changes in Fund Balance During the Fiscal Year		
Gain on Sale of Land	\$ 1	\$ 1
Net Increase/(Decrease) in Fair Value of Investments	(1,970)	1,010
Land Endowment Revenues	161	275
Settlement of Claims	—	13
Transfer to Available School Fund	(10)	(14)
Net Change in Fund Balance	\$ (1,818)	\$ 1,285
Investment and Land Income Paid to the Available School Fund During the Fiscal Year		
By Texas Education Agency	\$ 754	\$ 763
By General Land Office	11	7
Adjustment to Convert Income to Accrual Basis	—	127
Total	\$ 765	\$ 897
<p>The \$1.3 billion increase in fund balance between fiscal years 2002 and 2003 can be attributed to improved market conditions.</p> <p>The School Land Board controls the Fund's land and mineral rights, while the General Land Office oversees the related administrative duties. The State Board of Education controls the Fund's financial assets, and the Permanent School Fund Investment Office, a division of the Texas Education Agency, oversees the related administrative duties.</p>		

Source: Permanent School Fund Annual Reports, Article 7 of the Texas Constitution, and the Texas Natural Resources Code, Chapter 51

SAO Report No. 04-022

Fund). We summarized our comments to the Board in *A Summary of the State Auditor's Comments on Proposed Changes to the State Board of Education's Permanent School Fund Ethics Rules* (SAO Report No. 04-010, November 2003).

Other Issues of Legislative Interest

Proposition 9: Total Return. We followed up on concerns we expressed in the past four financial statement audits related to the negative effects of a constitutional restriction that required the Fund to retain all investment gains and distribute only dividends and interest to the Available School Fund (ASF). However, these concerns were addressed when the Legislature passed House Joint Resolution 68, which created Proposition 9. In September 2003, Texas voters approved Proposition 9, which amends the Texas Constitution (Article 7, Section 5) to allow the Fund to base its distributions to the ASF on the total return of all investment assets. This change went into effect on September 29, 2003, when the Governor certified the election.

Allowing the Board to base distributions on total return gives it the ability to:

- Maintain a long-term asset allocation strategy intended to maximize the long-term growth of the Fund and its distributions to the ASF. Because the Fund no longer has to manage its investments to produce high interest and dividend income, it can reduce its allocation to those income-producing investments that do not tend to grow in principal value over time.
- Periodically restore the asset allocation to within limits mandated by the Board's investment policy (a process known as rebalancing). In the past, Fund staff indicated that rebalancing would reduce distributions to the ASF during the fiscal year. However, under the total return distribution method, rebalancing should not affect the Fund's distributions for the year.
- Consistently meet levels of projected distributions to the ASF. Under the total return distribution method, the distribution amount for the next biennium can be determined as soon as the Fund's distribution percentage rate and ending asset values are known. In the past, the Fund had to adjust its projected distribution as market conditions changed.

To implement Proposition 9, Fund management now deposits investment and related income earned from Fund assets into the Fund rather than the ASF. Each month, the Fund transfers an amount to the ASF using estimated income based on a formula established by the 78th Legislature.

Summary of Information Technology Review

Overall, the Texas Education Agency information systems that support the Fund appeared to be working properly and enabled the Fund to report financial results accurately. Tests of reconciliations and financial transactions processed by the information systems indicated that amounts reported in the financial statements were accurate. As part of obtaining an understanding of internal control relevant to the audit of the fiscal year 2003 financial statements, we performed limited general and application control review procedures for the Fund's major investment information systems.

Objective, Scope, and Methodology

The objective of the audit was to express an opinion on the Fund's financial statements for the fiscal year ended August 31, 2003.

The scope of this audit included expressing an opinion on the Fund's financial statements in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

We gained an understanding of the Fund's overall control environment and internal controls over financial reporting to the extent necessary to plan the audit. We tested internal controls and significant accounts as deemed necessary to support our opinion. Tests of accounts primarily included tests of support for recorded transactions, confirmations of investments and related accounts, and analytical review. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts.

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Changes to Portfolio Management. Recent changes to the Fund's portfolio management will reduce external management fees from more than \$14 million in fiscal year 2003 to a maximum of \$3.5 million in fiscal year 2004. The Legislature reduced the amount of appropriations for external management fees for fiscal years 2004 and 2005. Cortex recommended in 2003 that the Fund reduce its external portfolio management to reduce costs. Over the past two years, the Board reduced the number of the Fund's external money managers from 26 to 2, and the Texas Education Agency recently shifted a large amount of the investment management duties in house to the Investment Office. However, the Investment Office had four vacant positions as of January 2004, including the Deputy Executive Administrator. This situation has the potential to affect the Investment Office's ability to manage the Fund.

We appreciate the cooperation of the Fund's staff. If you have any questions, please call Carol Smith, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

cc: Members of the State Board of Education
Texas Education Agency
Dr. Shirley Neeley, Commissioner of Education
Mr. Holland Timmins, Executive Administrator, Permanent School Fund