



The Audit of the Permanent School Fund's Fiscal Year 2010 Financial Statements

John Keel, CPA
State Auditor

February 17, 2011

Members of the Legislative Audit Committee:

In our *Independent Auditor's Report* dated December 20, 2010, included in the Permanent School Fund's (Fund) fiscal year 2010 financial statements, we concluded that the Fund's basic financial statements for fiscal year 2010 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a *Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards*, as required by auditing standards, dated December 20, 2010. Our audit procedures were not intended to provide an opinion on the effectiveness of internal control over financial reporting or an opinion on compliance with laws and regulations, and we did not express such opinions in that report. We did not identify any deficiencies in internal control over financial reporting that we considered to be material weaknesses.

However, we identified the following instance of noncompliance that is required to be reported under *Government Auditing Standards*. Based on the use of a calculation methodology that incorrectly calculated the dollar amount of prior year total investment return¹ to assess compliance with one of the two annual distribution limits prescribed by the Texas Constitution, the Texas Education Agency's Permanent School Fund Investment Office's management recommended and the State Board of Education approved \$60.7 million in total distributions from the Fund to the Available School Fund during fiscal year 2010. If management's methodology had correctly calculated the dollar amount of those prior year total returns, management should have concluded that the distribution limit provision in the Texas Constitution prohibited making *any* distribution to the Available School Fund during fiscal year 2010. This issue is more fully discussed in the attachment to this letter.

Background Information

The Permanent School Fund (Fund) is a permanent endowment fund established in the Texas Constitution for the purpose of supporting the State's public schools. The Fund holds land appropriated to it by law, other properties, and the reinvested revenue derived from the sale of that land or other properties.

The School Land Board, assisted by the General Land Office, manages the Fund's land, mineral rights, and certain investments in real assets. The State Board of Education, assisted by the Texas Education Agency's Fund Investment Office, manages the remaining Fund investments in various asset classes such as public and private equity, fixed income, real estate, and absolute return.

The Texas Constitution specifies the method under which the Fund makes distributions to the Available School Fund from the total return on Fund investments. In addition, the Fund is authorized to guarantee school district bonds.

The Fund had a fund balance of \$24.4 billion as of August 31, 2010. During fiscal year 2010, the Fund distributed \$60.7 million to the Available School Fund. The State Board of Education approved a distribution of almost \$1.1 billion to the Available School Fund during fiscal year 2011. As of August 31, 2010, the Fund was guaranteeing a total of \$49.3 billion in school district bonds.

¹ This calculation of the *dollar amount* of total return would not affect the accuracy of the Fund's time weighted *rate* of return, which is reported as a *percentage* rate, by the external entity that calculates the Fund's official investment performance results.

Although the fiscal year 2010 distribution should not have been made, improved investment returns earned in fiscal year 2010 would have allowed the State Board of Education to distribute the \$60.7 million during fiscal year 2011 in addition to the \$1.093 billion distribution it approved for fiscal year 2011. As a result, the same total amount (approximately \$1.154 billion) will be distributed during the 2010-2011 biennium.

The major internal controls over financial reporting that we tested for the purpose of forming our opinion on the financial statements were operating effectively. As required by professional auditing standards, we have also communicated to the State Board of Education and the School Land Board certain matters related to the conduct of a financial statement audit.

Fund Financial Highlights

The following information is based on audited and unaudited information in the Fund's annual reports for fiscal years 2009 and 2010.

During fiscal year 2010, the Fund's fund balance increased by \$1.8 billion (8.0 percent) to \$24.4 billion compared with a decrease in the fund balance of \$2.6 billion (10.4 percent) to \$22.6 billion during fiscal year 2009.

Year-to-year changes in fund balance are significantly affected by annual investment performance. Fund investments are managed for the State Board of Education by the Texas Education Agency (TEA) and for the School Land Board by the General Land Office (GLO).

During the year ending August 31, 2010, TEA reported that the investments it manages earned 7.51 percent compared with a loss of 8.47 percent during the year ending August 31, 2009. The investment portfolio, including cash, totaled approximately \$22.1 billion as of August 31, 2010.

During the year ending June 30, 2010, GLO reported that the discretionary real asset investments it manages (including cash held in the State Treasury but excluding sovereign land, certain other land, and the Fund's mineral interests) lost 2.85 percent compared with a loss of 17.63 percent during the year ending June 30, 2009. The discretionary real asset investment portfolio, including cash, totaled approximately \$2.2 billion as of August 31, 2010.

The Fund distributed \$60.7 million to the Available School Fund during fiscal year 2010 compared with total distributions of \$716.5 million during fiscal year 2009.

The Fund's Bond Guarantee Program pledges the Fund's assets to guarantee bonds issued by Texas school districts. This guarantee helps the school districts obtain the highest possible bond rating, thereby lowering

Objective, Scope, and Methodology

The objective of the audit was to issue an opinion on the Permanent School Fund's (Fund) fiscal year 2010 financial statements.

The audit scope covered the Fund's basic financial statements for fiscal year 2010.

The audit methodology included reviewing and testing internal controls over financial reporting; performing analytical review of material account balances; testing transactions; confirming investment holdings and fair values; and testing compliance with laws and regulations.

The audit was conducted 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.

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

- Roger Ferris, CPA (Project Manager)
- Michael O. Clayton, CPA, CFE, CIDA, CISA (Assistant Project Manager)
- Ben Carter
- Joe Curtis, CPA, CIA
- Darrell Edgar, CFE
- Carl Ela
- Amadou N'gaide, CFE, MBA, CIDA
- Michele Pheeny, CPA, MBA
- Michael Yokie, CISA
- Leslie Ashton, CPA (Quality Control Reviewer)
- Verma Elliott, CPA, MBA, CIA, CGAP (Audit Manager)

their interest costs. The Bond Guarantee Program was temporarily closed to new guarantees in March 2009 due to a drop in the Fund's value, but it was reopened in February 2010. Certain statutory and federal restrictions limit the maximum principal amount of school district bonds that the Bond Guarantee Program can guarantee. Actions during fiscal year 2010 by both the State Board of Education and the Internal Revenue Service increased those limits. As of August 31, 2010, the Fund was guaranteeing approximately \$49.3 billion in outstanding school district bonds. As of that date, the limit under state law was approximately \$71.0 billion and the federal limit was approximately \$117.3 billion.

The Fund's management agreed with the recommendations in this report. Management's detailed response is presented in the attachment to this letter. We appreciate the cooperation of TEA and GLO during this audit. If you have any questions, please contact Verma Elliott, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the State Board of Education

Mrs. Gail Lowe, Chair
Mr. Bob Craig, Vice Chair
Mrs. Mary Helen Berlanga, Secretary
Mr. Lawrence A. Allen, Jr.
Mr. David Bradley
Mrs. Barbara Cargill
Mr. George Clayton
Dr. Marcia Farney
Mr. Charlie Garza
Ms. Pat Hardy
Mrs. Mavis B. Knight
Ms. Terri Leo
Mr. Ken Mercer
Mr. Thomas Ratliff
Dr. Michael Soto

Texas Education Agency

Mr. Robert Scott, Commissioner of Education
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer,
Texas Permanent School Fund

General Land Office and Members of the School Land Board

The Honorable Jerry Patterson, Land Commissioner and Chairman of the School Land Board
Mr. David S. Herrmann, School Land Board Member
Mr. Thomas Orr, Jr., School Land Board Member
Mr. Larry L. Laine, Deputy Land Commissioner and Chief Clerk



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Attachment

The Texas Education Agency's Permanent School Investment Office Incorrectly Calculated the Dollar Amount of Prior Year Total Return When Assessing Compliance with a Distribution Limit Provision in the Texas Constitution and Permitted an Unallowable Distribution to the Available School Fund to Occur

The Texas Education Agency's Permanent School Fund Investment Office's management (management) used a calculation methodology that incorrectly calculated the dollar amount of prior year total return¹ on the Permanent School Fund's (Fund) investments controlled by the State Board of Education (SBOE investments). The calculation of the dollar amount of prior year total returns is needed to assess the maximum dollar amount that the Fund could distribute to the Available School Fund in any fiscal year without exceeding one of the two annual distribution limits prescribed by the Texas Constitution. Based on the erroneous calculation, management requested and obtained SBOE approval for a \$60.7 million distribution from the Fund to the Available School Fund during fiscal year 2010. That distribution was not in compliance with one of the distribution limits specified in the Texas Constitution because that constitutional limit would have prohibited making *any* fiscal year 2010 distribution if management had correctly calculated the dollar amount of total return for the nine prior fiscal years.

Although the fiscal year 2010 distribution should not have been made, improved investment returns earned in fiscal year 2010 would have allowed the SBOE to distribute the \$60.7 million during fiscal year 2011 in addition to the \$1.093 billion distribution the SBOE approved for fiscal year 2011. As a result, the same total amount (approximately \$1.154 billion) will be distributed during the 2010-2011 biennium.

Article VII, Subsection 5(a)(2), of the Texas Constitution requires that the total amount distributed from the Fund to the Available School Fund "over the 10-year period consisting of the current state fiscal year and the nine preceding state fiscal years may not exceed the total return on all investment assets of the permanent school fund over the same 10-year period" (this is referred to as the 10-year test).

¹ This calculation of the *dollar amount* of total return would not affect the accuracy of the Fund's time weighted *rate* of return, which is reported as a *percentage* rate, by the external entity that calculates the Fund's official investment performance results.

Management's methodology for calculating the dollar amount of total return on SBOE investments when assessing compliance with the 10-year test was not consistent with the methodology submitted to the Office of the Attorney General.

The SBOE is charged with determining the appropriate methodology for calculating the dollar amount of total return on SBOE investments for purposes of applying the 10-year test. In a letter dated November 4, 2008, to the Office of the Attorney General, the SBOE described its methodology for calculating the dollar amount of total return and complying with the 10-year test and requested an Attorney General Opinion. The described methodology included:

- Calculating the dollar amount of total return as the net appreciation or decline in value, plus income (including interest, dividends, and income from securities lending and litigation awards).
- Deducting transfers from the General Land Office (GLO) of funds representing the proceeds from the sale of GLO land or income generated by GLO land from investment income when calculating the dollar amount of total return.
- Not deducting investment management fees and other Fund administration expenses from investment income when calculating the dollar amount of total return.

The Attorney General, in Opinion No. GA-0707 dated April 13, 2009, concluded that, "Based on the industry definition and the Legislative Council's description of the term 'total return,' we believe a court would likely conclude that the SBOE's construction of total return is reasonable."

However, the calculation methodology that management used to calculate the dollar amount of total return on SBOE investments during the nine fiscal years preceding fiscal year 2010 did not produce results that were consistent with the total return calculation methodology described in the November 2008 letter. Auditors determined that management's methodology for calculating the dollar amount of total return for the nine fiscal years through 2009 inadvertently included approximately \$1.311 billion of transfers from the GLO as a component of total return on SBOE investments. As a result, management overstated the dollar amount of total return by \$1.311 billion when it concluded that the 10-year test would allow the SBOE to approve a limited distribution of \$60.7 million during fiscal year 2010. If management's methodology had excluded the GLO transfers, the 10-year test would have resulted in a conclusion that there was an approximate \$1.25 billion shortfall when comparing the relevant dollar amount of total return to the prior nine years of distributions, precluding any fiscal year 2010 distribution.

Management's methodology also did not account for prior year Fund administrative costs consistent with the methodology described in the

November 2008 letter. This issue resulted in a slight understatement of the dollar amount of prior year calculated total return when compared with the methodology described in that letter. However, adjusting for this understatement would not have permitted any distribution in fiscal year 2010.

Management stated to auditors that it sent information about its proposed calculation methodology for assessing compliance with the 10-year test to outside parties, and it asserted that it received no negative feedback from those parties about the methodology. However, there was no documentation provided to auditors showing that management's methodology had been reviewed internally by accounting or other personnel to ensure that the methodology accurately calculated the dollar amount of prior year total returns and was consistent with the methodology described in the November 2008 letter. To ensure compliance with the 10-year test, it is incumbent on management to include controls that ensure that its total return calculation methodology produces results consistent with the methodology on which the Attorney General opined.

Recommendations

Fund management should improve its procedures to ensure the accurate, reliable calculation of the dollar amount of prior year total investment return on SBOE investments for use in the 10-year test. Specifically, it should:

- Develop a new methodology, or modify its existing methodology, to calculate the dollar amount of prior year total return that produces results that are consistent with the methodology described in the November 2008 letter to the Office of the Attorney General.
- Ensure that its calculation methodology is (1) adequately reviewed, (2) thoroughly documented to ensure consistent future application, and (3) periodically reassessed to determine whether new investments or circumstances require modification to the methodology to remain reliable.

Management's Response

Permanent School Fund management notes that the application of the ten year test was required due to extreme volatility in the financial markets in 2008 and 2009 which resulted in a decline in the value of the Fund of approximately \$9 billion during the period. Fund management agrees that the methodology utilized to calculate the total dollar return of the Fund for the purpose of complying with the 10-year test required in Article VII, Subsection 5(a)(2) of the Texas Constitution, did not specifically exclude transfers from the General Land Office or investment management/administrative expenses.

Management agrees the distribution of \$60.7 million to the Available School Fund during fiscal year 2010 should have not been made. However, vastly improved financial markets will allow a full distribution of \$1.1 billion during fiscal year 2011. The payment for the biennium will be precisely the amount approved by the SBOE and in compliance with Article VII, Subsection 5(a)(1) of the Texas Constitution.

Total return is a sophisticated calculation performed by the Fund's performance consultant expressed as a percentage return on the assets of the Fund. The calculation of total dollar return as required by the Texas Constitution is not an industry standard application of the concept of total return. It is a complex calculation that relies on assumptions and estimates. Texas Attorney General Opinion No. GA-0707 states, in part, that "Based on the industry definition and the Legislative Council's description of the term 'total return,' we believe a court would likely conclude that the SBOE's construction of total return is reasonable"; it does not address other methodologies that might also be reasonable.

Fund management agrees to modify its existing methodology or develop a new methodology to calculate the total dollar return that produces results that are consistent with the methodology described in the November 2008 letter to the Office of the Attorney General. Fund management also agrees with the recommendation by the State Auditor's Office to ensure that appropriate review and testing of the methodology to calculate the total dollar return is implemented within the internal controls of the Fund.