



A Report on

The Audit of the Permanent School Fund's Fiscal Year 2016 Financial Statements

January 13, 2017

Members of the Legislative Audit Committee:

In our audit report dated December 20, 2016, we concluded that the Permanent School Fund's (the Fund) basic financial statements for fiscal year 2016 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. The Fund published our audit report as part of its basic financial statements, which it intends to post on its Web site at www.tea.texas.gov.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards (that report, including responses from management, is presented in the attachment to this letter). In that report, auditors identified a deficiency in the General Land Office's segregation of duties over its processing of transactions for alternative investments.

Our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting or on compliance with laws and regulations.

Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the Fund's management.

As required by auditing standards, we will also communicate to the State Board of Education and School Land Board certain matters related to the conduct of a financial statement audit.

We appreciate the Fund's cooperation during this audit. If you have any questions, please contact Michael O. Clayton, CPA, CISA, CFE, CIDA, Audit Manager, or me at (512) 936-9500.

Sincerely,

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

Attachment

SAO Report No. 17-019

cc: The Honorable Greg Abbott, Governor
Members of the State Board of Education
Ms. Donna Bahorich, Chair
Mr. Lawrence A. Allen, Jr.
Ms. Erika Beltran
Mr. David Bradley
Ms. Barbara Cargill
Mr. Ruben Cortez, Jr.
Mr. Keven Ellis
Ms. Patricia Hardy
Mr. Tom Maynard
Ms. Sue Melton-Malone
Mr. Ken Mercer
Ms. Geraldine Miller
Ms. Georgina C. Pérez
Ms. Marisa Perez
Mr. Marty Rowley
Texas Education Agency
Mr. Mike Morath, Commissioner of Education
Mr. Holland Timmins, Executive Administrator and Chief Investment Officer, Permanent School Fund
General Land Office and School Land Board
The Honorable George P. Bush, Land Commissioner and Chairman of the School Land Board
Mr. Gil Burciaga, School Land Board Member
Mr. David S. Herman, School Land Board Member
Ms. Anne Idsal, Chief Clerk



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Attachment

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters as Required by Auditing Standards



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

Independent Auditor's Report

Members of the State Board of Education
Members of the School Land Board

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Permanent School Fund (Fund) as of and for the year ended August 31, 2016, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements and have issued our report thereon dated December 20, 2016.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statement, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control described in the accompanying schedule of findings and responses that we consider to be a significant deficiency.

Summary of Findings and Responses
Finding Number
2016-1

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the Fund's management.

The Fund's Response to Findings

The Fund's response to the finding identified in our audit is described in the accompanying schedule of findings and responses. The Fund's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control over financial reporting and compliance. Accordingly, this communication is not suitable for any other purpose.

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

December 20, 2016

Schedule of Findings and Responses

Section 1

The General Land Office Should Continue to Improve Its Segregation of Duties and Validation of Fair Market Values for Alternative Investments

Reference No. 2016-1

Type of finding: Significant Deficiency

The General Land Office (Land Office) should continue improving its implementation of sufficient segregation of duties over its processing of transactions for externally-managed alternative investments by moving responsibility for setting up new external manager accounts to its financial management division. Additionally, it should continue increasing its accounting staff's oversight of the recording of alternative investment valuations.

The prior year audit report¹ noted that the employee primarily responsible for the processing of and accounting for capital calls and distributions, as well as communication with the custodian bank, reported to the Land Office's chief investment officer.

Definitions

A capital call is a request from the external investment manager for additional money required of investors of a fund.

A distribution is an allocation of income and expenses to investors of a fund from the external investment manager.

Source: *Dictionary of Business Terms*, Barron's Business Guide, Third Edition.

In May 2016, Land Office management moved the processing and accounting of the cash distribution and capital call process for the externally-managed alternative investments to the agency's financial management division. Initiation of those transactions still begins within the investment management division. Land Office accounting staff members increased their role in reviewing alternative investment valuations by participating in the annual conference call discussions of fair value that had traditionally taken place between investment staff and the various external fund managers. Although members of the financial management staff increased their direct communications with the custodian bank during fiscal year 2016, investment staff continued to set up new investment accounts.

¹ See *A Report on the Audit of the Permanent School Fund's Fiscal Year 2015 Financial Statements* (State Auditor's Office Report No. 16-012, January 2016).

The lack of segregation of duties between the authorizing and recording of transactions increases the risk of transactions for alternative investments being inaccurately processed and recorded.

Auditors first communicated this segregation of duties issue to the Land Office during fiscal year 2014.

Recommendation

The Land Office should complete the segregation of duties over its processing of transactions for alternative investments by moving all responsibility for setting up new accounts to its accounting function.

Management's Response

The General Land Office agrees to move the responsibility for setting up new external manager accounts to its Financial Management program area.