State Auditor's Office

Lawrence F. Alwin, CPA
State Auditor

An Audit Report on

The Financial Statements of the Permanent School Fund for the Fiscal Year Ended August 31, 2001

May 29, 2002

Members of the Legislative Audit Committee:

In our audit report dated January 16, 2002, we concluded that the Permanent School Fund's (Fund) fiscal year 2001 financial statements are materially correct and presented in accordance with accounting principles generally accepted in the United States of America. Our audit opinion was included in the financial statements section of the *Fund's Annual Report Fiscal Year Ending August 31, 2001*, which the Texas Education Agency (TEA) released on February 28, 2002. 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.

Key Financial Results

Total Return Spending Issue. We continue to observe negative effects (see attachment) because of the State Board of Education's (Board) inability to use the Fund's total return (interest, dividends, and net capital gains) to make distributions to the Available School Fund. The Constitution requires the Fund to distribute only interest and dividends (current income). This distribution method puts the Board's need to earn enough interest and dividends to generate adequate current distributions at odds with its long-term need to earn high total return to help ensure that the Fund grows at least as fast as inflation.

Effects of Stock and Energy Market Changes. Recent changes in the stock and energy markets had the following effects on the Fund:

- The August 31, 2001, value of cash and investments was $19.0 billion compared with $22.3 billion at the end of the prior fiscal year. This 14.8 percent decline occurred largely because of adverse stock market conditions. TEA reported a total rate of return (including interest, dividends, and market value changes) of negative 12.6 percent compared with positive returns of 16.0 percent and 23.8 percent in fiscal years 2000 and 1999, respectively.

- The Fund distributed $794 million to the Available School Fund in fiscal year 2001 compared with $698 million during fiscal year 2000, which represents a 13.8 percent increase. The increase occurred largely because of the effects of portfolio rebalancings in fiscal year 2000 through which the Board sold stock holdings, which had grown to significantly exceed the Board's long-term allocation target because of the long bull market, and invested the proceeds in bonds.

- The Fund's land endowment earned $270 million in fiscal year 2001, primarily from oil and gas interests managed by the General Land Office (GLO), compared with $186 million in fiscal year 2000, a 45.2 percent increase. During fiscal year 2001, the average price for natural gas increased substantially and average crude oil prices increased moderately. The 77th Legislature passed House Bill 3558, effective September 1, 2001, permitting GLO to retain most of this land endowment income and invest it in real property interests. Prior to September 1, 2001, GLO distributed this income to the Board for investment in stocks and bonds.

SAO Report No. 02-046

Compliance and Financial Reporting Issues

While our audit did not identify any serious problems with the Fund's internal controls or reported financial amounts, we did note three less significant issues that we reported to TEA in a separate letter (SAO No. 02-348). To correct these issues, we recommend that TEA do the following:

- Improve procedures for monitoring and reporting compliance with Board ethics rules and investment policies by enhancing automated compliance monitoring systems, designating a compliance officer, and including in reports to the Board instances of non-transaction related noncompliance.

- Help the Board eliminate its ethics policy's technical noncompliance with Sections 43.0031 (a) and (b) of the Texas Education Code by extending that policy to cover the Commissioner of Education and TEA staff who are now covered only by TEA's ethics policy. Legislative action might be required to fully resolve this issue because Section 43.0031 (a) also requires the Board to enforce its policy. However, it is our understanding that prior legislation placed the Commissioner and TEA staff outside of the Board's control.

- Work with GLO and the Comptroller of Public Accounts (Comptroller) to improve the Fund's financial reporting process by changing some accounting and reporting responsibilities related to TEA's and GLO's administration of Fund assets.

TEA management agreed with all three issues; GLO and Comptroller management agreed to address the third issue. We commend TEA's Investment Office for implementing our prior year recommendation to obtain and report more information from GLO regarding the Fund's land that GLO manages.

We appreciate the cooperation of the management and staff of TEA, GLO, and the Comptroller. If you have any questions, please call Carol Smith, Audit Manager, at (512) 936-9500. If you would like a copy of the management letter (SAO No. 02-348) please call (512) 936-9880.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

Attachment

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cc: Chair and members of the State Board of Education
Texas Education Agency
Dr. Felipe Alanis, Commissioner of Education
Mr. Paul B. Ballard, Executive Administrator, Permanent School Fund

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, 2001.

Our audit scope included testing evidence supporting the amounts and disclosures in the Fund's financial statements. The scope also included testing compliance with laws and regulations that could have a material effect on the financial statements.

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 details, supporting entries, confirmations, and analytical review. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts.

Total Return Spending Issue

We continue to observe negative effects because of the State Board of Education's (Board) inability to use the Permanent School Fund's (Fund) total return (interest, dividends, and net capital gains) to make distributions to the Available School Fund. The Constitution requires the Fund to distribute only interest and dividends (current income). This distribution method puts the Board's need to earn enough interest and dividends to generate adequate current distributions at odds with its long-term need to earn high total return to help ensure that the Fund grows at least as fast as inflation.

Between May 2001 and January 2002, in an attempt to meet the higher distribution targets in the General Appropriations Act for the 2002–2003 biennium, the Board changed its investment strategy three times. The net effect of these changes was that the Board increased the Fund's target percentage of bonds from 35 percent to 45 percent and decreased its target percentage of stocks from 65 percent to 55 percent. Nevertheless, in March 2002, management projected that the Fund will miss the biennium's distribution targets by $45 million to $90 million. Furthermore, with the reduced stock allocation, the Fund is projected to earn a lower total return, which may allow inflation to erode the Fund's long-term purchasing power. Current and prior consultants have recommended maintaining a 65 percent stock allocation to help protect the Fund and its distributions from inflation.

Most endowment fund boards nationwide, including most endowment fund boards in Texas (based on prior legislative action), can make distributions from a prudent portion of their funds' long-term cumulative total return. As a result, those boards are able to maintain investment mixes that rely less on bonds, which generate comparatively high interest but lower total return, and more on investments that generate higher total return but perhaps less current income. By achieving higher total returns, those boards can more effectively ensure growth of both their funds and their annual distributions. Similarly, if the Board had the constitutional authority to set a long-term distribution rate that resulted in spending a prudent portion of the Fund's cumulative total return while reinvesting the rest, the Board might have found that retaining its higher-growth strategy and meeting the State's budget for the current biennium were no longer incompatible. Our January 2001 report explains the total return issue in more detail (see *A Follow-Up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities*, SAO Report No. 01-017, pages 14-19).