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, 2002

March 12, 2003

Members of the Legislative Audit Committee:

In our audit report dated January 31, 2003, we concluded that the financial statements of the Permanent School Fund (Fund) for the fiscal year ended August 31, 2002, 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.

Permanent School Fund Selected Financial Information (in millions)		
	FY 02	FY 01
Fund Balance	$ 17,274	$ 19,092
Changes in Fund Balance		
Gain on Sale of Land	$ 1	$ 3
Net Increase/(Decrease) in Fair Value of Investments	(1,970)	(3,538)
Land Endowment Revenues	161	272
Transfer to Available School Fund	(10)	(9)
Net Change in Fund Balance	**$ (1,818)**	**$ (3,272)**
Investment and Land Income Paid to the Available School Fund (Cash Basis)		
By Texas Education Agency	$ 754	$ 780
By General Land Office	11	14
Total	**$ 765**	**$ 794**

Source: Permanent School Fund Annual Reports

We continue to observe potential negative effects because of the State Board of Education's (Board) inability to distribute any capital gains on the Fund's investments to the Available School Fund (ASF). The Constitution requires instead that the Fund distribute to the ASF only interest and dividend income and that it perpetually retain all investment gains. Investment interest, dividends, and net capital gains (price increases) constitute the Fund's cumulative total return. This restriction on the Fund's spending policy impedes the Board's ability to do the following, which the attachment discusses in detail:

- Maintain a long-term asset allocation strategy intended to maximize the long-term growth of the Fund and its annual distributions
- Periodically restore the asset allocation to within limits mandated by the Board's investment policy (a process known as rebalancing)
- Consistently meet levels of projected distributions to the ASF

Fund management at the Texas Education Agency (TEA) has fully implemented two of the three prior year recommendations and is in the process of implementing the third. As a result:

- Fund staff at TEA worked with the Comptroller of Public Accounts and the General Land Office to improve the Fund's financial reporting process.
- The Board's ethics policy now applies to the Commissioner of Education and to Fund staff at TEA.
- Fund staff at TEA have taken steps to improve their procedures for monitoring and reporting compliance with Board ethics rules and investment policies.

SAO Report No. 03-024

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The State Auditor's Office (SAO) will continue to work with the Board and with Fund staff at TEA to ensure the Board has an opportunity to consider the SAO's comments regarding its ethics policy, which would help the Board clarify and further strengthen the policy. The SAO provided the comments in November 2002 at the Board's request. At the November meeting, the Board chairwoman, who is no longer a Board member, stated that the Board would address the SAO's comments at a later date. The Board then adopted all of its proposed ethics policy changes. The Board has not met since that time, and it has six newly elected members.

Some of the SAO's suggestions address what appears to be the existing policy's noncompliance with portions of the Education Code (Code). If implemented, these suggestions would bring the Board's ethics policy in compliance with the Code by making the policy apply to investment brokers and by requiring the disclosure of certain expenditures made by brokers on behalf of Board members or TEA employees. Brokers do not work under contract and are currently excluded from the ethics policy's provisions.

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

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Attachment

cc: Members of the State Board of Education
Texas Education Agency
Dr. Felipe T. Alanis, Commissioner of Education
Mr. Holland Timmins, Acting Executive Administrator, Permanent School Fund

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 2002 financial statements, we performed the following information technology-related procedures:

- Performed general and application control review procedures for the Fund's major investment information systems and analyzed the investment trading system
- Determined whether the Fund had properly deactivated access to automated investment accounting and trading systems for terminated employees
- Analyzed reviews of information systems conducted by other parties, such as the Department of Information Resources

Objective, Scope, and Methodology

The objective of the audit was to express an opinion on the Permanent School Fund's (Fund) financial statements for the fiscal year ended August 31, 2002.

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.

Total Return Spending Issue

We continue to observe potential negative effects because of the State Board of Education's (Board) inability to distribute any capital gains on the Permanent School Fund's (Fund) investments to the Available School Fund (ASF). The Constitution requires instead that the Fund distribute to the ASF only interest and dividend income and that it perpetually retain all investment gains. Investment interest, dividends, and net capital gains (price increases) constitute the Fund's cumulative total return. This restriction on the Fund's spending policy impedes the Board's ability to do the following:

- **Maintain a long-term asset allocation strategy intended to maximize the long-term growth of the Fund and its annual distributions.** Maximizing the long-term growth of the Fund—which would call for a larger amount of assets to be invested in stocks than the Fund currently has—would help ensure the long-term growth of distributions to the ASF. However, because the Fund must distribute its interest and dividend income to the ASF, reverting to the Board's previous higher allocation to stocks would result in a significant short-term decline in funding to public education.

  Under typical total return spending methods, in which an endowment fund distributes each year a predetermined percentage of its asset value (or average asset value) at the end of the prior year, changing asset allocation during the year has no effect on that year's distribution. (A change in the asset allocation could cause future growth or decline in the fund's asset value, which would affect the level of future distributions).

- **Periodically restore the asset allocation to within limits mandated by the Board's investment policy (a process known as rebalancing).** Investment literature emphasizes the importance of periodic rebalancing. Rebalancing problems for the Fund occur when the level of stock investments falls below the Board's long-term allocation policy range. Fund staff recently indicated that complying with the Board's rebalancing policy could decrease distributions to the ASF by between $7 million and $24 million during the remainder of fiscal year 2003. Under the typical total return spending method described in the first bullet, rebalancing during the year would have no immediate effect on a fund's distributions for the year.

- **Consistently meet levels of projected distributions to the ASF.** Providing the expected level of distributions to the ASF is especially difficult for the Fund during periods of declining interest rates and/or below-average stock market returns, both of which have occurred recently. In March 2002, six months after the Board committed that the Fund would distribute $1.733 billion to the ASF for the 2002–2003 biennium, Fund staff projected a shortfall of as much as $78 million below that level. In February 2003, staff lowered the estimated distribution to $1.575 billion, which is $158 million below the amount the Board had promised 17 months earlier. (The projected shortfall does not include the additional $7 million to $24 million effect of the proposed rebalancing described in the second bullet.)

Under the typical total return spending method, the distribution amount for the next year could be determined as soon as the fund's distribution percentage rate and the current year-end asset value were known. Because a board typically does not often change the distribution percentage rate, the only factor that would normally determine the next period's payout is the asset value at the end of the prior period.

The distribution percentage rate typically does not change often because it reflects a rate that will help protect the fund from inflation given the estimated long-term total investment return and estimated rate of inflation. For the Permanent School Fund, decision makers would need to determine the applicable definition of inflation. As shown in Table 1, inflation could be defined as the projected increase in the cost of educating a single student, or it could also include the projected growth in student population. (The growth of the Consumer Price Index could be a proxy for the growth in the cost of educating a single student if a better measure were unavailable.)

Protecting an Endowment Fund From Inflation

When using a total return spending policy, an endowment fund can maintain its purchasing power over time if its distribution rate is lower than its total investment return by an amount equal to the rate of inflation.

The following table shows two scenarios that could be used to estimate a sustainable annual distribution rate for the Permanent School Fund using a total return spending policy. The percentage rates in the table are hypothetical, but the distribution rate would be based on expectations for the future rather than on historical results.

The distribution rate in the first scenario allows the Fund to keep pace with increases in the general cost of education (shown as the Consumer Price Index, or CPI). The rate in the second scenario shows what the Fund could distribute if it wanted to keep pace with rising education costs and growth in student population. In the second scenario, if the assumptions proved accurate, the Fund would be able to provide a constant amount of money in perpetuity, on an inflation-adjusted basis, for every student.

Table 1

	Scenario 1	Scenario 2
Total Return	7.5%	7.5%
+ Mineral Income	1.0%	1.0%
- Fund Expenses	0.2%	0.2%
- CPI Growth	3.0%	3.0%
- Student Population Growth	N/A	1.8%
= Maximum Distribution Rate	5.3%	3.5%

The following State Auditor's Office (SAO) reports released previously also discuss how the constitutional prohibition on distributing any of the Fund's cumulative net gains has hindered management of the Fund:

- *An Audit Report on the Financial Statements of the Permanent School Fund for the Fiscal Year Ended August 31, 2001* (SAO Report No. 02-046, May 2002)
- *A Follow-Up Report on Two Reviews of Controls Over Investment Practices at State Investing Entities* (SAO Report No. 01-017, January 2001)
- *A Review of Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996)