John Keel, CPA
State Auditor

An Audit Report on

Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2005

March 17, 2006

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, as of August 31, 2005, the amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within the two limits applicable to the Program. One limit, prescribed by Section 45.053(a) of the Texas Education Code, protects the Fund by minimizing the risk of loss to the Fund. The other limit, which was established by an Internal Revenue Service (IRS) letter ruling, is intended to prevent reductions in federal tax receipts due to bond arbitrage (issuing tax-exempt bonds for the purpose of investing the proceeds at higher rates than the tax-exempt bonds).

As of August 31, 2005, the bond guarantee capacity of the fund was $46.2 billion. The total principal debt guaranteed by the Program on 2,189 outstanding bond issues was $35.2 billion. The guarantee saves school districts considerable money by eliminating the need for them to (1) purchase private bond insurance or (2) pay higher interest rates on bonds they sell. (Without the guarantee, the bonds would trade at the districts' underlying credit quality, which is typically not as favorable as the Fund's Aaa rate.)

The IRS Limit Increased in 2005

On March 31, 2005, the IRS issued a private letter ruling in response to a joint request from the Texas Education Agency (Agency) and the Katy Independent School District regarding the capacity of the Program to guarantee bonds. That letter ruling changed the Program's capacity calculations to the extent that the IRS limit on the maximum amount of bonds the Program can guarantee is now effectively the same as the limit in the Texas Education Code.

Objectives, Scope, and Methodology

The objectives of the audit were to:

- Determine whether the Agency and the Program are in compliance with the requirements of Texas Education Code, Section 45.053(a), which specifies that "The Commissioner may not approve bonds for guarantee if the approval would result in the total amount of outstanding guaranteed bonds exceeding an amount equal to 2-1/2 times the cost value or market value, whichever is less, of the permanent school fund, as estimated by the board and certified by the state auditor."
- Determine whether the Program is within the limitations set forth in the Internal Revenue Service letter ruling.
- Determine whether the Agency has addressed prior year findings.

The scope of this audit covered Fund valuation, all bonds guaranteed by the Fund during fiscal year 2005, and the controls related to the guarantee and recording processes.

The audit methodology included analyzing investment data obtained from the Agency and data originating at the Municipal Advisory Council, as well as information gathered during interviews. We conducted the audit in accordance with generally accepted government auditing standards.

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

- James Timberlake, CIA (Project Manager)
- Kristin Alexander
- J. Scott Killingsworth, CIA (Quality Control Reviewer)
- Carol Smith, CPA, CIA (Assistant State Auditor)

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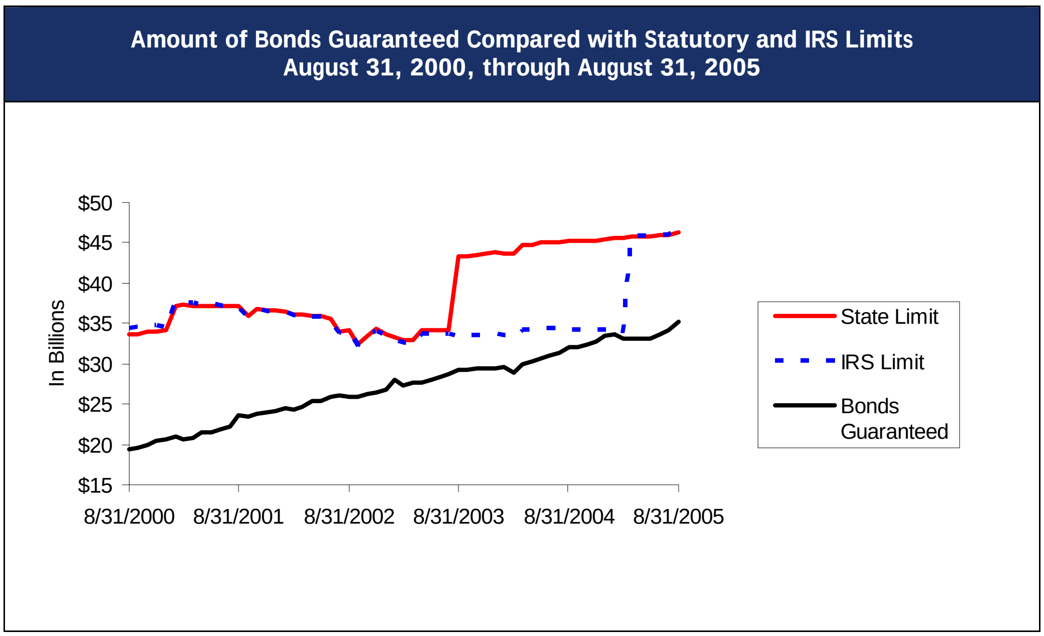
Prior to receiving the IRS letter ruling, the Agency had stopped guaranteeing new bond issues because it had reached the previous IRS limit. As a result, the Agency denied 85 applications totaling $3.8 billion in bond guarantee requests between September 2004 and February 2005.

Remaining Capacity Was $11.0 Billion at the End of Fiscal Year 2005

As of August 31, 2005, the amount of additional bonds the Program could guarantee before it reached the Texas Education Code and IRS limits was $11.0 billion. Fund management estimates the Program will meet those limits in two to three years (Figure 1 shows the trend in the amount of bonds guaranteed). The Agency is consulting with its legal counsel to explore approaching the U.S. Congress and the U.S. Department of the Treasury with scenarios that could increase the IRS limit.

Figure 1



Amount of Bonds Guaranteed Compared with Statutory and IRS Limits
August 31, 2000, through August 31, 2005

Source: Agency data used to calculate available bond guarantee capacity

In August 2005, Moody's Investor Services issued a special comment report titled *Moody's Affirms Aaa for Texas Permanent School Fund Guarantee*. That report stated that the increased capacity as a result of the March 2005 IRS private letter ruling and "the exceptionally strong paying ability on its guarantee" contributes to the Aaa affirmation of the Program's guarantee.

The Agency has fully addressed a prior recommendation originally made by the State Auditor's Office.[1] The State Auditor's Office recommended that (1) the Fund complete its planning and set a target date for systematic accounting for capital appreciation bond (CAB) accretion and (2) after the Fund quantifies outstanding accretion, disclose the amount in the notes to its financial statements. The Agency implemented an alternative solution by disclosing the difference between the principal

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[1] See *An Audit Report on Certification of the Permanent School Fund's Bond Guarantee Program* (SAO Report No. 02-038, April 2002) and *An Audit Report on Certification of the Permanent School Fund's Bond Guarantee Program* (SAO Report No. 05-032, April 2005).

amount of CABs guaranteed and the ultimate maturity value of the bonds guaranteed. This has resolved the issue.

We appreciate the Agency's cooperation during this audit. If you have any questions, please contact Carol Smith, CPA, CIA, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

cc: Members of the State Board of Education
Dr. Shirley J. Neeley, Commissioner of Education, Texas Education Agency
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Texas Permanent School Fund
Ms. Catherine A. Civiletto, CPA, Deputy Executive Administrator, Texas Permanent School Fund