A Report on the Audit of

The Permanent School Fund's Fiscal Year 2004 Financial Statements

February 2005

Report No. 05-026

State Auditor's Office

John Keel, CPA
State Auditor

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Overall Conclusion

In our audit report dated January 14, 2005, we concluded that the Permanent School Fund's (Fund) basic **financial statements** for fiscal year 2004 **were materially correct** and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a report on compliance and internal control over financial reporting as required by auditing standards. Our procedures were not intended to provide an opinion on compliance with laws and regulations or to provide assurance on internal control over financial reporting. However, our procedures did not identify any noncompliance with laws or regulations that materially affected the financial statements or any material weaknesses in internal control over financial reporting.

The **major internal controls** that we tested in the process of forming our opinion on the financial statements **were generally operating effectively**.

Although it is not directly related to controls over financial reporting, we identified an issue that warrants action from Texas Education Agency (Agency) management and management of the Agency's Permanent School Fund Investment Office. Specifically, Investment Office management does not have evidence that members of the State Board of Education (Board) or the Board's service providers made required annual ethics disclosures in fiscal year 2004. In addition, the Board members did not obtain required annual ethics training in fiscal year 2004. The Board members received ethics training in fiscal year 2003 and are scheduled for ethics training during the spring of 2005. This issue is discussed in Chapter 1 of this report.

Background

The Permanent School Fund's fund balance as of August 31, 2004, was $19.9 billion, a $1.3 billion increase over the prior year.

The State Board of Education, assisted by staff of the Agency's Permanent School Fund Investment Office, oversees the Fund's financial investments. The School Land Board, assisted by General Land Office staff, oversees the Fund's land and mineral rights and can make real estate investments.

Furthermore, **Agency and Investment Office management may** consider whether conducting criminal background **checks on employees in certain positions** will help reduce the Agency's and the Fund's risk of fraud. This issue is discussed in Chapter 2 of this report.

Issue for Legislative Consideration

Constitutional language related to calculating the distribution to the Available School Fund is subject to interpretation. The Legislature may want to consider clarifying this language in statute. This issue is discussed in Chapter 3 of this report.

Discussion of Change to Total Return

A constitutional amendment that went into effect on September 29, 2003, now requires distributions from the Permanent School Fund to the Available School Fund to be paid from the cumulative total return of all investment assets. (Total return is the sum of investment gains and current income such as interest and dividends.) Previously, investment gains had to be retained, and current income had to be paid directly to the Available School Fund. This approach required an investment focus that delivered the desired level of annual current income for distribution. Because investments no longer have to be managed to produce high levels of current income, the asset allocation can be shifted to an investment mix intended to produce higher levels of total return.

In addition, the Agency's Investment Office's administrative and operating expenditures and the General Land Office's school land management expenditures are now paid from the Fund.

Table 1

Distributions to the Available School Fund Before and After the Change to Total Return (in millions)

	Fiscal Year 2003	Fiscal Year 2004
Current Income (prior to effective date of constitutional amendment)	$ 770	$ 55
Total Return Distribution (after effective date of constitutional amendment)	N/A	825
Regular Annual Distribution	**770**	**880**
One-time adjustment due to action by 78th Legislature, for fiscal year 2003 only	127	0
Total	**$ 897**	**$ 880**

Sources: Permanent School Fund Annual Reports

Summary of Information Technology Review

Overall, the 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 2004 financial statements, we performed limited general and application control review procedures for the Agency's major investment information systems related to the Fund.

Detailed Results

Chapter 1

The State Board of Education and Its Service Providers Did Not Fully Comply with the Fund's Code of Ethics in Fiscal Year 2004

The Texas Education Agency (Agency) and its Investment Office did not ensure that State Board of Education (Board) members and the Board's service providers fully complied with the Fund's Code of Ethics in fiscal year 2004. The Fund's Code of Ethics makes up Rule 33.5 in the Agency's portion of the Texas Administrative Code. Auditors noted the following instances of noncompliance:

- The Agency's Investment Office does not have evidence that Board members submitted **their annual ethics disclosures in fiscal year 2004**. The Code of Ethics requires the members to submit these disclosure reports, and it requires the Investment Office to retain the reports. (Texas Administrative Code, Title 19, Part 2, Chapter 33.5 [l][2] [M] and [o] [3])

- Although the Investment Office made several attempts to obtain them, 37 of the Investment Office's 88 service providers (including brokers) who provided services during the year ended November 30, 2003, **did not submit their required annual ethics disclosure reports**. Many of the service providers were terminated during this fiscal year, which may have lessened their incentive to comply. The disclosure reports were due in January 2004; those providers who did submit reports submitted them between July 2004 and January 2005. (Texas Administrative Code, Title 19, Part 2, Chapter 33.5 [l][2] [J], [K] and [M] and [o] [3])

- Board members did not receive annual ethics training through the Texas Ethics Commission and the Agency's ethics officer during fiscal year 2004. Board members had ethics training on April 9, 2003, and are scheduled for ethics training during the spring of 2005. (Texas Administrative Code, Title 19, Part 2, Chapter 33.5[p])

Failure to obtain and file the annual disclosure reports could prevent violations from being reported, and it represents noncompliance with the Fund's Code of Ethics. If the Investment Office has difficulty receiving the reports, then it should withhold payments to service providers in accordance with Chapter 33.5(o) (5) of the Texas Administrative Code.

The Investment Office did not have a compliance officer on staff from December 2003 to April 2004 to follow up on these matters.

Recommendations

We recommend that Agency and Investment Office management:

- Ensure that all ethics disclosures are submitted annually as required.
- Assist Board members in meeting their annual training requirements.

Management's Response

Texas Permanent School Fund management filled the compliance officer vacancy on April 12, 2004 and also added a half time FTE to ensure this issue does not occur again. Since many external managers had been terminated, the compliance officer was unable to enforce submission of additional disclosures. Management currently ensures that all ethics disclosures are submitted annually as required and has scheduled ethics training for the State Board of Education Members during spring 2005.

Chapter 2: Issue for Agency and Investment Office Consideration

Agency and Investment Office Management May Consider Conducting Criminal Background Checks on Employees in Certain Positions

Agency and Investment Office management may consider conducting criminal background checks on employees whose job duties require them to have access to assets that could be subject to misuse, such as cash and investments. Employees of the Investment Office fall into this category because they oversee the management of the $22 billion in Fund assets. The Investment Office is a division of the Agency, and the Agency's Human Resources Office currently does not perform such background checks on employees. Other Agency employees may also be in positions that allow them access to cash or other assets.

Conducting criminal background checks is one way an entity can help reduce the risk of fraud. It is a recognized best practice in the investment industry: while they are not currently required to do so, **both the Teacher Retirement System and the University of Texas Investment Management Company perform criminal background checks on new hires with certain job duties**. Policies and procedures that address protecting employees' privacy and include criteria for acting on the results of the tests can help ensure that the results are used fairly and consistently. In addition, statutory authority similar to that granted to the Comptroller of Public Accounts in Government Code, Section 411.109(b), and covering investments might be needed to access national criminal history information through the Department of Public Safety.

Audit guidelines also indicate that conducting background checks can help reduce fraud. An audit and accounting guide from the American Institute of Certified Public Accountants (AICPA) states that not conducting background checks for employees who have "access to significant assets susceptible to misappropriation" can increase the likelihood that these assets will be misused. The AICPA's *Antifraud Programs and Controls: Guidance to Help Prevent and Deter Fraud* lists conducting background checks as one of several proactive hiring and promotion procedures (see text box). The Committee of Sponsoring Organizations of the Treadway Commission also issued *Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting* that indicates the strength of a company's control environment can be assessed considering such matters as "whether background checks are made before hiring new employees . . . ."

Industry Audit Guides Related to Conducting Criminal Background Checks

From Exhibit 5-1 in the AICPA's Audit and Accounting Guide, *Depository and Lending Institutions: Banks and Savings Institutions, Finance Companies and Mortgage Companies*:

Fraud Risk Factors - Misappropriation of Assets

2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, the misappropriation of assets may occur because there is the following:
   - b. Inadequate job applicant screening and/or monitoring of employees, such as:
     - (1) Federal Bureau of Investigation background checks, credit reports, and bonding eligibility screening are not incorporated into the hiring process for employees with access to significant assets susceptible to misappropriation.

From *AICPA Management Antifraud Programs and Controls: Guidance to Help Prevent and Deter Fraud*:

Proactive hiring and promotion procedures may include:

- Conducting background investigations on individuals being considered for employment or for promotion to a position of trust

Management's Response

Texas Education Agency and Fund management concur and are evaluating the feasibility of instituting background checks on new hires.

Chapter 3: Issue for Legislative Consideration

Constitutional Language Related to Total Return Distribution to the Available School Fund Is Subject to Interpretation

Article 7, Section 5(g), of the Texas Constitution

Notwithstanding Subsection (a) of this section, the total amount distributed from the permanent school fund to the available school fund for the state fiscal years beginning September 1, 2003, and September 1, 2004, must be an amount equal to 4.5 percent of the average of the **market value of the permanent school fund, excluding real property belonging to the fund** that is managed, sold, or acquired under Section 4 of this article, on the last day of each of the 16 state fiscal quarters preceding the regular session of the 78th Legislature. *(emphasis added)*

The constitutional language describing how to calculate the distribution to the Available School Fund states that the base for the calculation is the **"market value of the permanent school fund, excluding real property belonging to the fund"** (see text box for full quote).

When the Investment Office calculated the distribution for fiscal year 2004, it used as the base amount for the distribution the total of its investments, cash, and investment receivables less payables. While this approach excludes real property as required by the Texas Constitution, **it also excludes other Fund assets and liabilities.** Most significantly, it excludes cash that the General Land Office maintains for investment in real property.

While the fiscal year 2004 distribution was based on a reasonable interpretation, other interpretations could result in higher base amounts and distributions. The following two hypothetical examples of future distributions are based on data from one quarter, which may not be representative of all 16 actual quarterly amounts required for the calculation. However, they are presented to provide an idea of the potential effect of using different interpretations:

- One approach would be to interpret "market value of the permanent school fund excluding real property" as the total fund balance less investments in real estate. Total fund balance is the difference between all the Fund's assets and all its liabilities. Based on data from one quarter (August 31, 2004), this approach would result in a $498 million increase in the base amount. Hypothetically, if this one quarter were representative of the 16 quarters required for the calculation, then the higher base amount would result in a $22 million increase in future annual distributions to the Available School Fund. The difference amounts to less than 3 percent of the recent distributions to the Available School Fund.

  One downside to using this approach is that the Investment Office and the General Land Office would incur additional cost because they would need to prepare financial statements each quarter that are comparable to those currently required only at year end.

- Another approach would be to include the cash managed by the General Land Office in the base amount that the Investment Office used for the distribution. The value of this cash is available on a quarterly basis. As of the end of fiscal year 2004, this cash totaled $359 million. While recognizing that this amount fluctuates throughout the year—in this hypothetical example—if it were the same for all 16 quarters needed for the calculation, the base amount would increase by $359 million. Sixteen quarters later, this change in the base amount would result in a $16 million increase in a total return distribution.

Because the interpretation of the calculation methodology could result in higher distribution amounts, clarifying whether other assets managed by the General Land Office should be included would help ensure that future distributions are not subject to question.

Recommendation

The Legislature may want to consider clarifying in statute the constitutional language regarding the market value of the Permanent School Fund.

Management's Response

Fund management believes that cash escrowed for real estate purposes is considered part of the real property that is excluded from the calculation. The calculation used by the Fund for fiscal year 2004 includes only investment assets under the control of the State Board of Education, including receivables and payables directly related to the purchases and sales of investments. The calculation excludes real estate assets and all receivables and payables related to those real estate assets. This is the methodology Fund management currently uses to calculate the total return distribution from the Fund to the Available School Fund.

As such, Fund management believes this methodology is in line with the original intent of the Legislature when the constitutional amendment language was drafted and approved. However, Fund management concurs that Article 7, Section 5(g) of the Texas Constitution may be subject to interpretation and should be clarified through an official interpretation.

Other Information

Objective, Scope, and Methodology

Objective

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, 2004.

Scope

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.

Methodology

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.

Project Information

We conducted fieldwork from November 2004 to January 2005. The following members of the State Auditor's staff performed this audit:

- Ron Zinsitz, CPA, CIDA (Project Manager)
- Hugh Ohn, MBA, CPA, CFA, CIA (Assistant Project Manager)
- Michael Clayton, CPA
- Roger Ferris, CPA
- Hillary Hornberger
- Jacqueline Shelby
- Jim Timberlake
- Alan Walton, MBA
- Michael Yokie, CISA
- Worth Ferguson, CPA (Quality Control Reviewer)
- Carol A. Smith, CPA, CIA (Audit Manager)

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Jim Keffer, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

State Board of Education

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Ms. Mavis B. Knight
Ms. Terri Leo
Ms. Gail Lowe
Mr. Don McLeroy
Mr. Dan Montgomery
Mr. Rene Nuñez

Texas Education Agency

Dr. Shirley Neeley, Commissioner of Education
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Texas Permanent School Fund

General Land Office and School Land Board

The Honorable Jerry Patterson, Land Commissioner and Chairman of the School Land Board
Mr. Todd Barth, Member of the School Land Board
Mr. David S. Herrmann, Member of the School Land Board