



John Keel, CPA  
State Auditor

# An Audit Report on Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2011

April 24, 2012

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, for the fiscal year ended August 31, 2011, the amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within all three limits applicable to the Program. As of August 31, 2011, the total principal of the 2,536 outstanding bond issues guaranteed by the Program was \$52.7 billion (see the attachment to this letter for a summary of the Program's activity during fiscal year 2011). Also as of that date, the bond guarantee capacity of the Program under the State Board of Education (Board) limit was \$74.4 billion, and the Board held in reserve \$3.7 billion of that capacity. The bond guarantee capacity under the Internal Revenue Service (IRS) limit was \$117.3 billion.

The statutory limit prescribed by Texas Education Code, Sections 45.053(a) and (d), protects the Fund by minimizing the risk of loss to the Fund. The Board's rules set another limit by allowing the Board to hold guarantee capacity in reserve, as permitted by Texas Education Code, Section 45.0531(a), which the Board may use to award guarantees to school districts with emergencies that require renovation or replacement of school facilities. IRS Notice 2010-5, issued on December 16, 2009, establishes a third limit, which 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 rates paid on tax-exempt bonds).

The guarantee saves school districts money by enhancing their bond ratings to the highest possible rating. Without the guarantee of this Program, school districts would need to (1) purchase private bond insurance or (2) pay higher interest rates on the bonds they sell.

The guarantee approval process complies with state laws.

The bond guarantee approval process is adequately designed and operates effectively to comply with state laws and regulations. Before a guarantee application is recommended for approval, personnel within the Program review several sources to determine whether the school district is financially sound. They then verify guarantee eligibility and prioritize applications according to rules in Title 19, Texas Administrative Code, Section 33.65 (19 TAC 33.65).

## Objective, Scope, and Methodology

The objective of this audit was to determine whether the total amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program is within applicable limits.

The scope of this audit covered the Fund's valuation, all bonds guaranteed by the Fund during fiscal year 2011, and the controls related to the guarantee and recording processes.

The audit methodology included analyzing investment data obtained from the Texas Education Agency and bond data originating at the Municipal Advisory Council, as well as information gathered during interviews.

Audit fieldwork was conducted from February 2012 through March 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The following staff of the State Auditor's Office performed the audit:

- Michael O. Clayton, CPA, CISA, CIDA, CFE (Project Manager)
- Michelle DeFrance, MACy, CPA
- Mike Apperley, CPA (Quality Control Reviewer)
- Verma Elliott, MBA, CPA, CIA, CGAP (Audit Manager)

SAO Report No. 12-029

Each month, Fund personnel calculate the remaining capacity of the Program. Program personnel then ensure that applications recommended for approval will not cause the Program to exceed the amount of available capacity. To help ensure that the Fund accurately reports the amount of guaranteed bonds outstanding, Fund personnel regularly reconcile Program activity to the Municipal Advisory Council's records of guaranteed bonds.

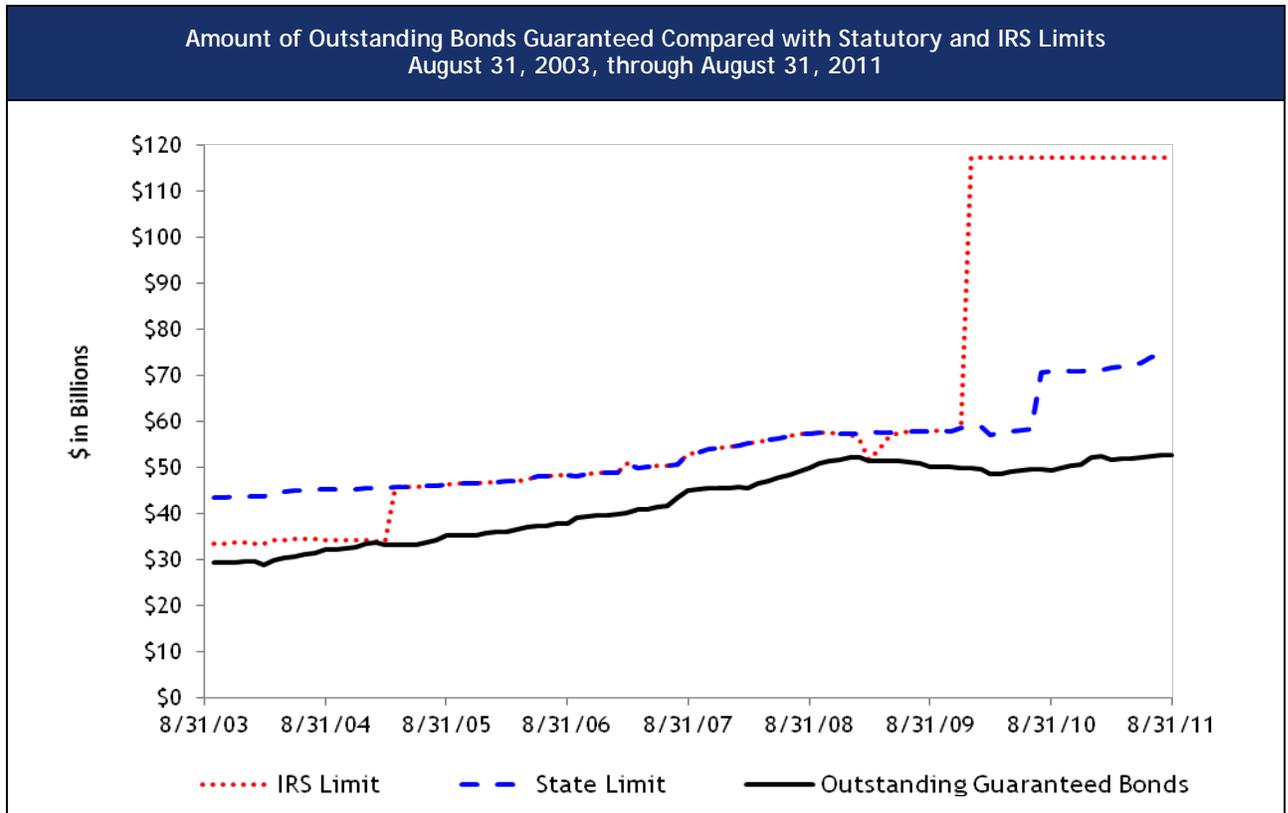
Recent changes have been made to Program statutes and rules.

The 82nd Legislature passed Senate Bill 1, which contained a provision that called for the inclusion of charter schools into the Program. That provision went into effect on September 28, 2011. In October 2011, the State of Texas requested an IRS ruling on whether the inclusion of charter schools in the Program might cause the Program to violate current arbitrage laws, which could result in the loss of the Program's tax-exempt status. The Fund will not make any guarantees for charter schools until the State receives assurance from the IRS that the inclusion of charter schools will not change the Program's current tax-exempt status.

In addition, Texas Education Code, Section 59.04, stipulates that the State's commissioner of education may not approve charter district bonds for guarantee if that guarantee would result in a lower bond rating for the Program. Based on this stipulation, the Program has indicated it will get updated rating letters from the bond rating agencies to determine whether the Program will maintain its current bond rating if charter schools are included in the Program.

Figure 1 shows the amounts of outstanding bonds guaranteed and the statutory and IRS guarantee limits from August 31, 2003, through August 31, 2011. The Board's additional reserve is not presented in the graph.

Figure 1



The Program's remaining statutory capacity, net of the Board's \$3.7 billion reserve, was \$18.0 billion at the end of fiscal year 2011.

The attachment to this letter provides additional information on the Program's fiscal year 2011 activity. As of August 31, 2011, the Program could guarantee an additional \$18.0 billion in bonds before reaching the limit imposed by the Board's reserve of 5 percent of the Program's total statutory limit.

We appreciate the Texas Education Agency's cooperation during this audit. If you have any questions, please contact Verma Elliott, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA  
State Auditor

Attachment

cc: Members of the State Board of Education

Mrs. Barbara Cargill, Chair  
Mr. Bob Craig, Vice Chair  
Mrs. Mary Helen Berlanga, Secretary  
Mr. Lawrence A. Allen, Jr.  
Mr. David Bradley  
Mr. George Clayton  
Ms. Marsha Farney  
Mr. Charlie Garza  
Ms. Patricia Hardy  
Mrs. Mavis B. Knight  
Ms. Terri Leo  
Mrs. Gail Lowe  
Mr. Ken Mercer  
Mr. Thomas Ratliff  
Mr. Michael Soto

Texas Education Agency

Mr. Robert Scott, Commissioner of Education  
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Permanent  
School Fund



This document is not copyrighted. Readers may make additional copies of this report as needed. In addition, most State Auditor's Office reports may be downloaded from our Web site: [www.sao.state.tx.us](http://www.sao.state.tx.us).

In compliance with the Americans with Disabilities Act, this document may also be requested in alternative formats. To do so, contact our report request line at (512) 936-9500 (Voice), (512) 936-9400 (FAX), 1-800-RELAY-TX (TDD), or visit the Robert E. Johnson Building, 1501 North Congress Avenue, Suite 4.224, Austin, Texas 78701.

The State Auditor's Office is an equal opportunity employer and does not discriminate on the basis of race, color, religion, sex, national origin, age, or disability in employment or in the provision of services, programs, or activities.

To report waste, fraud, or abuse in state government call the SAO Hotline: 1-800-TX-AUDIT.

# Attachment

## Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2011 activity for the Permanent School Fund's Bond Guarantee Program (Program). Tables 1 and 2 show the changes in the number and dollar amount of outstanding bonds guaranteed by the Program.

Table 1

Number of Guaranteed Bonds Outstanding	
Category	Number of Issues
Balance on August 31, 2010	2,452
Issued during fiscal year 2011	344
Issues that matured during fiscal year 2011	(156)
Issues that refunded during fiscal year 2011	(104)
<b>Balance on August 31, 2011</b>	<b>2,536</b>

Source: Permanent School Fund's Bond Guarantee Program *Fiscal Year-end Summary*.

Table 2

Dollar Amount of Guaranteed Bonds Outstanding	
Category	Dollar Amount of Issues
Balance on August 31, 2010	\$ 49,301,683,338
Issued during fiscal year 2011	7,340,621,873
Issues that matured during fiscal year 2011	(1,670,893,470)
Issues that refunded during fiscal year 2011	(2,315,801,196)
Other adjustments	(1,680,000)
<b>Balance on August 31, 2011</b>	<b>\$ 52,653,930,545</b>

Source: Permanent School Fund's Bond Guarantee Program *Fiscal Year-end Summary*.

Table 3 lists the school districts whose fiscal year 2011 applications for bond guarantees were denied.

Table 3

School Districts Whose Fiscal Year 2011 Bond Guarantee Applications Were Denied	
School District	Reason Application Denied
Texhoma Independent School District	Not Allowed <sup>a</sup> and Financial Status <sup>b</sup>
Higgins Independent School District	Not Allowed <sup>a</sup> and Financial Status <sup>b</sup>
<sup>a</sup> The purpose of the bonds was to build housing to increase available housing for teachers in the school districts. The Texas Constitution allows the Permanent School Fund to guarantee bonds only for the purposes of acquisition, construction, or improvement of instructional facilities. <sup>b</sup> These school districts did not meet the required criteria to be considered financially sound due to declining student populations.	

Source: Data provided by the Texas Education Agency.