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An Audit of the Financial Statements of the Permanent School Fund for the Fiscal Year Ended August 31, 1999

March 8, 2000

Members of the Legislative Audit Committee:

The Permanent School Fund's (Fund) fiscal year 1999 financial statements are materially correct in accordance with generally accepted accounting principles. Our audit opinion dated January 14, 2000, will be included in the financial statement section of the Fund's *Annual Report for Fiscal Year Ending August 31, 1999*. We also reported that the Fund had no instances of noncompliance with certain provisions of laws and regulations and no weaknesses in internal controls that would significantly affect the Fund's financial statements.

The Fund has fully implemented our prior-year recommendation to collateralize deposits held by the custodian. To implement the recommendation, the Fund's management has established cash management arrangements with its new custodian. The other prior-year recommendation on reconciling the market values of securities at the individual security level is currently being implemented.

During our audit work, an issue for further study came to our attention. In fiscal year 1999, the market value of the Fund's investments increased by $3.3 billion (20.2 percent) from $16.3 billion to $19.6 billion. However, the Fund's interest and dividend income, which it must distribute to the Available School Fund in accordance with the Texas Constitution, decreased by $28.9 million to $662 million. Without a constitutional change allowing the Fund to use a total-return spending rule instead of distributing only its interest and dividend income, it will be difficult for the Fund to maintain the purchasing power of its distributions to the Available School Fund while increasing the market value of its principal. (The attachment contains more information on this topic.)

We appreciate the cooperation of the Fund's management and staff during this audit. Please see the attachment for our objective, scope, and methodology as well as a list of those receiving copies of this letter. If you have any questions, please call Carol A. Smith, CPA, Audit Manager, at (512) 479-4700.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

Attachment

khm

SAO Report No. 00-017

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Issue for Further Study

A spending rule based on total return would allow the Fund to distribute to the Available School Fund (ASF) a prudent portion of its principal rather than only its interest and dividend income. (Total return is an investment's annual price appreciation plus interest and dividend income.) Under the current constitutional requirement, the Fund will have difficulty meeting the conflicting objectives of maintaining the purchasing power of its distributions to the Available School Fund and increasing the market value of its principal. (Figure 1 shows how the market value of the Fund's investments has substantially outperformed inflation since fiscal year 1995. Figure 2 shows how the distributions to the ASF have not kept pace with inflation.)

Figure 1

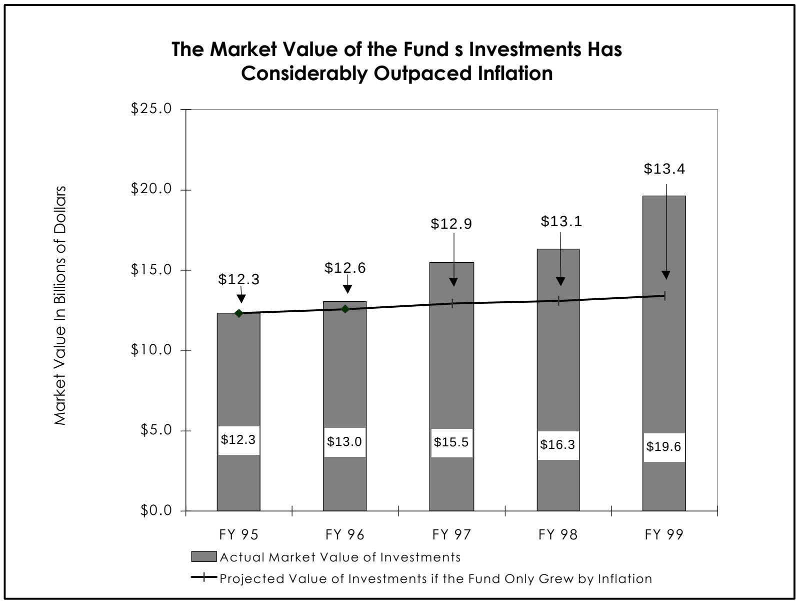
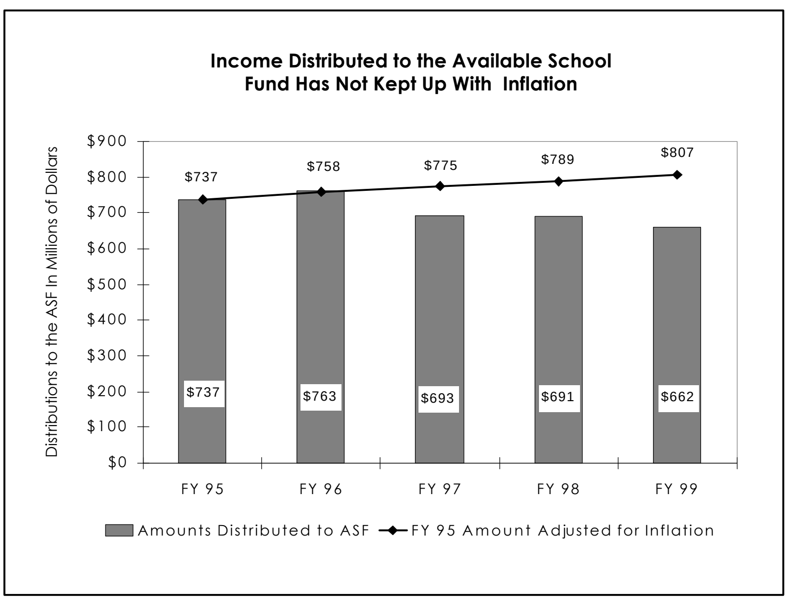


Figure 2



Source for Figures 1 and 2: *Permanent School Fund Annual Report for the Year Ended August 31, 1999*

These objectives conflict because investments that generate high interest and dividend income usually do not increase very much in value over time. For example, bonds generate comparatively higher income, but do not tend to increase in value. Conversely, stocks which tend to increase in value over time, have not recently generated high levels of income.

To preserve the long-term value of the Fund's principal, the State Board of Education reallocated more of the Fund's assets to stocks and fewer assets to bonds. While this strategy contributed to the Fund's $3.3 billion increase in value in fiscal year 1999, it also contributed to the decrease in the Fund's distribution to the ASF. (The amount deposited in the ASF peaked at $763 million in fiscal year 1996.)

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, 1999.

The scope of this audit included examining, on a test basis, evidence supporting the amounts and disclosures in the Fund's financial statements. Our audit did not cover the financial statements of the Texas Education Agency. We conducted our audit in accordance with generally accepted auditing standards and the 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 control to the extent necessary to plan the audit. We tested internal control and significant accounts as deemed necessary to support our opinion.

Tests of accounts primarily included test of details supporting entries, confirmations, and analytical review. In addition, we tested compliance with laws and regulations primarily related to investments. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts.

Distribution Information

Copies of this report were distributed to the following:

- Chair and Members of the State Board of Education

- Texas Education Agency
  - Mr. Jim Nelson, Commissioner of Education
  - Mr. Paul B. Ballard, Executive Administrator, Texas Permanent School Fund