State Auditor's Office

John Keel, CPA
State Auditor

A Supplemental Report on

The Audit of the Permanent School Fund's Fiscal Year 2006 Financial Statements

May 10, 2007

Members of the Legislative Audit Committee:

In April 2007, we issued *A Report on the Audit of the Permanent School Fund's Fiscal Year 2006 Financial Statements* (State Auditor's Office Report No. 07-029), which summarized the results of that audit.

During that audit, auditors also determined that the General Land Office (Office) does not produce reliable and timely investment performance reports regarding all of the discretionary real estate investments it oversees on behalf of the School Land Board (Board). As a result, the Board, the Office, the Legislature, and other interested parties cannot adequately evaluate the performance of all Permanent School Fund (Fund) investments overseen by the Board. Such information is routinely available for other major state investment funds. Accurate performance measurement and reporting, and the evaluation of that performance against stated expectations, is an important method that fiduciaries use to demonstrate their accountability for assets entrusted to them.

We previously reported a similar issue in *An Audit Report on Controls over Permanent School Fund Real Estate and Collection of Oil and Gas Revenue at the General Land Office* (State Auditor's Office Report No. 04-040, June 2004). The issue identified during the most recent audit and the Office's response are presented in detail below.

Performance Measurement for Internally Managed Assets Has Not Conformed to Industry Standards and Has Contained Errors

The Office's investment performance calculation methods for internally managed assets do not conform to the standards by which institutional funds typically measure their real estate investment returns. The Office does not have formal policies and procedures to ensure that the underlying data or its calculation methods conform to such standards. Auditors also identified several errors that caused the resulting performance to be unreliable.

Conforming to industry standards for valuation and calculation methods is important because it would permit the Board's real estate performance to be meaningfully compared to the performance reported by other institutional investors that adhere to industry standards. For example, *The General Land Office 2006 Annual Report* on the Office's Web site reports that "overall earnings plus appreciation reached $104 million for a gross return of 14.4 percent." According to Office documentation, this number represents the return using historical cost-based valuations. However, the same documentation reports a return of 11.3 percent based on market values, the valuation method required by industry standards. Although we did not audit all of the Office's underlying data used in the performance calculations based on market values, auditors also noted several errors, discussed in more detail below, that indicate that the 11.3 percent figure is not correct.

The Importance of Following Standard Investment Performance Calculations

According to Real Estate Information Standards:

- Data consistency is the foundation of full, fair, and comparable investment performance presentations.
- Achieving comparability of returns requires uniformity in calculation methodologies.

Source: Real Estate Information Standards; last revised on November 15, 2006; the Pension Real Estate Association, the National Association of Real Estate Investment Managers, and the National Council of Real Estate Investment Fiduciaries.

Robert E. Johnson Building
1501 North Congress Avenue
Austin, Texas 78701

P.O. Box 12067
Austin, Texas 78711-2067

Phone: (512) 936-9500
Fax: (512) 936-9400
Internet: www.sao.state.tx.us

Standards for real estate performance measurement specify the minimum frequency at which the estimated market value of investment properties should be updated, for example at least every three years by independent external appraisers with more frequent internal valuation updates. However, the Office does not have formal policies to ensure that its properties are revalued at the specified minimum intervals. To the extent that market values of the properties in the internal portfolio have generally risen since acquisition, if the Office uses out-of-date valuations that are relatively lower, it will tend to understate its actual investment performance.

As discussed above, auditors noted several errors in the Office's calculation and reporting methodology. The following errors caused both overstatements and understatements in the calculated market value-based performance:[1]

- The Office overstated the $18 million in gains (price appreciation) that it calculated for properties it sold during fiscal year 2006 because it based its calculations on the difference between the sales price and the properties' historical cost. Rather than using historical cost, it should have used the market value at the beginning of the fiscal year as recorded in its inventory system. In general, historical cost would be significantly lower than beginning market value. This error caused an <u>overstatement</u> of calculated return.

- Although gains on the sale of investments represent a form of price appreciation, the Office included the gains it calculated on properties sold during fiscal year 2006 as a component of the Fund's "income return," rather than as a component of the Fund's "appreciation return." Although this error had no net effect on "total return" (the combination of income and appreciation return), it caused income return to be <u>overstated</u> and appreciation return to be <u>understated</u>.

- The Office understated its interest income from the investable cash held in the State Treasury because it used $15.83 million, a "cash-basis" measure, rather than using the $16.76 million "accrual-basis" measure that is required by industry standards. Because the accrual-basis interest income was higher, this error caused an <u>understatement</u> of calculated return.

- The Office understated the Fund's weighted average cash balance that it used in the calculation of the performance of the overall portfolio (including real estate and cash). The understatement occurred because the Office excluded from its weighted average cash balance the cash in the portfolio that had already been committed but not yet expended for specific future investments. The committed cash remains part of the total available investable assets and should have been included in the calculation. If the Office had included <u>all</u> cash, its fiscal year 2006 calculations would have used an average cash balance of $319 million instead of $264 million. Understating this number caused an <u>overstatement</u> of calculated return. If the Office corrected only this error, its calculated return for the total portfolio on a market value basis would have declined from 11.3 percent to 10.6 percent.

Investment Performance of the Internally Managed Portfolio and the Fund's Overall Real Estate Portfolio Is Not Measured by an Independent Expert

The Board does not use an independent expert to calculate and evaluate the investment performance of internally managed real estate investments that the Office has assisted the Board in making. Although the Board's investment policy requires its external consultant to provide performance reporting for its externally managed real estate investments, the consultant is not required to measure the performance of the internal

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[1] The general formula for calculating investment return includes income items (such as rent, interest, and price appreciation) in the numerator and the weighted average market value of cash and investments owned during the year in the denominator.

portfolio of real estate and cash or to combine the results of the external and internal portfolios to provide performance reporting on the overall Fund portfolio that the Board oversees. Instead, internal staff in the Office's real estate investment department calculate and report on the performance of the investments that department manages. Using an external firm to calculate investment performance enhances the perceived independence of the reported performance because an outside firm would not be measuring the results of its own investment decisions.

Statutes require several other large state investing entities to use outside experts to report on the performance of the investment portfolios overseen by the boards of each of those entities (see the attachment to this letter for additional details).

Investment Performance Reporting by the Office Has Not Been Timely, Has Not Been Sufficiently Frequent, and Was Not Limited to the Board's Discretionary Investments

As of the end of February 2007, the Office had not yet reported to the Board the Fund's investment performance for fiscal year 2006. Comprehensive performance reporting for other major state funds is typically available within a few months after the end of a measurement period. (The Board's external consultant will be required to report on the performance of the external portfolios within 90 days of the end of a quarter.) The Office also has historically measured performance on an annual basis, although quarterly reporting is common for institutional investors.

In addition, the Office does not separate the performance of the discretionary investments made by the Board from the performance of the historical land endowment properties. Because the Board has had the authority to purchase real estate for the Fund only since fiscal year 1986, many of the Fund's current real estate properties consist of the remaining unsold portion of the land endowment the Legislature gave to the Fund when the Fund was established (see text box for additional details). Separate measurement and presentation of the investment performance of only those investment properties acquired by the Board would permit users of the performance reports to assess the success of the Board's and Office's investment decision-making.

Summary of Properties in the Office's Property Inventory

Of the 1,790 properties listed on the Office's property inventory as of August 31, 2005:

- 1,727 properties had acquisition costs that were equal to zero. This means that no funds had been invested to obtain these properties and that they were original land endowment tracts or obtained through bequest.
- 63 properties had nonzero acquisition costs. This means they were purchased by the Board.

Recommendations

The Board and Office should (1) take steps to ensure that accurate performance reports are produced that conform to industry standard calculation methods or (2) obtain independently prepared performance calculations, evaluations, and reports for the entire discretionary investment portfolio. The Office also should ensure that its property valuation and calculation methods are consistent with industry standards and free from error.

The resulting performance reports should:

- Adhere to relevant industry standards, including standards for the frequency of internal and external market valuations; calculation methods; and information presentation, such as the inclusion of multi-year performance results in addition to the current quarter's and current year's results.
- Report the performance of the entire discretionary real estate portfolio, including external real estate funds, internally managed investments made by the Board with the Office's assistance, and cash held for future investment.
- Be presented to the Board within a reasonable time after the end of each measurement period.

- Exclude, or separately present, the performance of the real estate that was part of the original land endowment given to the Fund from the performance of the investments that the Board chose to make.

Management's Response from the General Land Office

> *During fiscal year 2007, the Office awarded a contract to a nationally recognized firm to perform the real estate investment custodial, accounting, and performance measurement and reporting services related to our discretionary real estate investment portfolio. The discretionary portfolio consists of externally-managed real estate funds, internally-managed direct real estate investments, and cash. The firm will perform quarterly and year-end performance reporting in a timely manner on an on-going basis and will produce the fiscal year 2007 performance reports for the discretionary portfolio. The performance measurement methodologies used by the firm will conform to industry standards for real estate investment, and the reports produced will be comparable to those used by similar real estate institutional investors.*

We appreciate the Office's cooperation during the 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: School Land Board and General Land Office
  The Honorable Jerry Patterson, Land Commissioner and Chairman of the School Land Board
  Mr. Todd F. Barth, School Land Board Member
  Mr. David S. Herrmann, School Land Board Member
  Mr. Larry L. Laine, Deputy Land Commissioner and Chief Clerk

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Attachment

Excerpts from Statutory Requirements for Large Investing Entities to Use Independent Experts for Investment Performance Reporting

The following are excerpts from statutes that require the State Board of Education, the Teacher Retirement System, and the Employees Retirement System to use independent performance measurement services.

State Board of Education (Permanent School Fund)

The board shall employ a well-recognized performance measurement service to evaluate and analyze the investment results of the permanent school fund. The service shall compare investment results with the written investment objectives developed by the board, and shall also compare the investment of the permanent school fund with the investment of other public and private funds. (Texas Education Code, Section 43.004(b))

Teacher Retirement System

The board of trustees shall employ one or more performance measurement services to evaluate and analyze the investment results of those assets of the retirement system for which reliable and appropriate measurement methodology and procedures exist. Each service shall compare investment results with the written investment objectives developed by the board, and shall also compare the investment of the assets being evaluated and analyzed with the investment of other public funds. (Texas Government Code, Section 825.301(c))

Employees Retirement System

The board of trustees shall employ one or more well-recognized performance measurement services to evaluate and analyze the investment results of those assets of the retirement system. Each service shall compare investment results with the written investment objectives developed by the board, and shall also compare the investment of the assets of the retirement system with the investment of other public and private funds. (Texas Government Code, Section 815.301(d))