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An Audit of the Texas Permanent School Fund's Financial Statements and the Fund's Material Accounts Reported by the Texas Education Agency

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Key Points of Report

An Audit of the Texas Permanent School Fund's Financial Statements and the Fund's Material Accounts Reported by the Texas Education Agency

June 1998

Overall Conclusion

The Texas Permanent School Fund's (Fund) financial statements and the Fund's material accounts reported by the Texas Education Agency (Agency) for fiscal year 1997 are accurately presented in all material respects, in accordance with generally accepted accounting principles. We noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants (AICPA).

Key Facts and Findings

The Agency and the Fund continue to have difficulty properly applying the Governmental Accounting Standards Board's (GASB) pronouncements related to financial reporting. The Agency and the Fund have relied on the Comptroller of Public Accounts and the State Auditor's Office to ensure the Agency's and the Fund's financial statements are in compliance with standards.

- The Fund initially prepared its unaudited financial statements using the AICPA *Guide for Investment Companies* (Guide). This Guide is not considered to be in conformance with generally accepted accounting principles for governmental entities.
- The Fund did not implement new GASB financial statement reporting and disclosure requirements for securities lending activities. In addition, it did not include all the information required by GASB for the deposit and investment note disclosure. For the third consecutive year, the Agency included information submitted by the Fund in the Agency's Annual Financial Report without ensuring that the financial statement presentation and the note disclosures were in compliance with GASB.
- The Fund's accounting and control processes are not sufficient to ensure complete and accurate financial reporting and proper recording of accruals. Two significant accounts receivable and the associated revenue and an investment purchases payable were not accurately recorded in the accounting records or accurately reported in the financial statements.

At August 31, 1997, the Fund's investments had a fair value of \$15.3 billion. Income of \$692.7 million was assigned to the Available School Fund for the fiscal year ended August 31, 1997.

Contact: Carol A. Smith, CPA, Audit Manager, (512) 479-4700



Office of the State Auditor

Lawrence F. Alwin, CPA

This audit was conducted in accordance with Government Code, Section 321.0133.

Executive Summary

The Texas Permanent School Fund's (Fund) financial statements and the Fund's material accounts reported by the Texas Education Agency (Agency) for fiscal year 1997 are accurately presented in all material respects, in accordance with generally accepted accounting principles. We noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants (AICPA).

Improve Research, Understanding, and Application of the Governmental Accounting Standards Board's Pronouncements

- The Agency and the Fund continue to have difficulty properly applying the Governmental Accounting Standards Board's (GASB) pronouncements related to financial reporting. The Agency and the Fund have relied on the Comptroller of Public Accounts and the State Auditor's Office to ensure the Agency's and the Fund's financial statements are in compliance with standards.
- The Fund initially prepared its unaudited financial statements using the AICPA *Guide for Investment Companies* (AICPA Guide). This AICPA Guide is not considered to be in conformance with generally accepted accounting principles (GAAP) for governmental entities. (GASB pronouncements are GAAP for governmental entities.)

Fund management considered the fair value financial statement format prescribed by the AICPA Guide more useful to the purchasers of school district bonds guaranteed by the Fund. Fund management subsequently adjusted the presentation of the financial statements to comply with GASB by early implementation of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This allowed the Fund's management to meet its objective of fair value reporting.

- For the third consecutive year, the Agency included information submitted by the Fund in the Agency's Annual Financial Report without ensuring that the financial statement presentation and the note disclosures were in compliance with GASB. The decentralized nature of compiling information for the Annual Financial Report results in no one division taking responsibility for the overall accuracy of the Agency's financial statements. The Fund's investments represent 91 percent of the \$11.5 billion in total assets reported on the Agency's balance sheet.
- Neither the Fund nor the Agency properly updated previous reporting and disclosures to present securities lending activities under the new GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, which became effective for fiscal year 1997 annual financial reports.

Executive Summary

In addition, neither the Fund nor the Agency include all the information required by GASB for the deposit and investment note disclosure.

Improve General Accounting and Control Processes

The Fund's accounting and control processes are not sufficient to ensure complete and accurate financial reporting and proper recording of accruals. Two significant accounts receivable and the associated revenue were not accurately recorded in the accounting records or accurately reported in the financial statements:

- **Outer Continental Shelf (OCS) Settlement Receivable** – Assets were understated by \$30.2 million, revenues were overstated by \$6.1 million, and beginning fund balance was understated by \$36.3 million.
- **Land Endowment Income Receivable** – Assets were understated by \$25.8 million, revenue was understated by \$780 thousand and beginning fund balance was understated by \$25.0 million.

The Fund should take a more active approach to financial reporting:

- The Fund was informed of the proper reporting for the OCS settlement in fiscal year 1996, when it hired a public accounting firm to audit its fiscal year 1995 financial statements. However, the Fund did not set up the receivable in its accounting records and did not adjust the fund balance to recognize the appropriate amount of accrued revenue.

- The public accounting firm also identified a Land Endowment income receivable from the General Land Office (GLO) and provided the Fund with the GLO reports it used to estimate the receivable. However, the Fund did not set up a Land Endowment income receivable in its accounting records, did not request subsequent GLO reports, and did not continue to estimate and report the receivable and revenue on an accrual basis.

An investment purchases payable of \$16.2 million was omitted on the Fund's initial unaudited Financial Statements and the financial statements of the Agency.

Monthly reconciliations for investment purchases and sales did not begin until May 1997; thus, all the reconciliations for the first three quarters of fiscal year 1997 were not prepared in a timely manner. Moreover, ten of the monthly international fixed-income disposition reconciliations for fiscal year 1997 had not been reviewed and approved at the time of our audit.

Access Controls Within the Permanent School Fund's Automated Investment System Need Further Improvement

Several staff members continue to have access to sections of the Fund's investment subsidiary ledger that are not needed to perform their daily functions.

Summary of Management's Responses

Management concurs with the findings and recommendations in this report. The response indicates that some corrective actions are already in progress. The full text of management's response is on page 15.

Executive Summary

Summary of Audit Objectives and Scope

The objectives of this audit were to (1) express an opinion on the Fund's financial statements and (2) test the Fund's material accounts and related note disclosures reported by the Agency for fiscal year 1997.

The scope of this audit included gaining an understanding of the overall internal control environment and testing controls for selected material accounts.

Account balances tested included investments, revenues, cash, accounts payable, accounts receivable, fund balance, investment purchases and sales, and net increase in fair value of investments. We also tested for compliance with GASB 3, GASB 28, and GASB 31.

This audit was performed in coordination with our examination of the State's *Comprehensive Annual Financial Report* for the year ended August 31, 1997. For further details see *A Report on the 1997 Financial and Compliance Audit Results*, SAO Report No. 98-041, June 1998.

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Section 1:

Improve Research, Understanding, and Application of the Governmental Accounting Standards Board's Pronouncements

The Texas Education Agency (Agency) and the Texas Permanent School Fund (Fund) continue to have difficulty properly applying the Governmental Accounting Standards Board's (GASB) pronouncements related to financial reporting. Management is responsible for the fair presentation in the financial statements of the financial position and results of operations in conformity with generally accepted accounting principles (GAAP). The Agency and the Fund have relied on the Comptroller of Public Accounts and the State Auditor's Office to ensure the Agency's and the Fund's financial statements are in compliance with standards. During the course of this audit, the audit team played an active role in researching generally accepted accounting principles, revising portions of the financial statements to comply with standards, ensuring the completeness of the financial statements, and defining accounting policy issues.

There appears to be a lack of adequate research, understanding, and application of GASB pronouncements by the Agency's and the Fund's accounting staffs, as demonstrated by the following two findings:

- The Fund initially followed the financial statement reporting standards in the *AICPA Guide for Investment Companies* (AICPA Guide) for the Fund's unaudited financial statements. The AICPA Guide is not considered to be in conformance with GAAP for governmental entities.
- The Fund did not implement new GASB financial statement reporting and disclosure requirements for securities lending activities. In addition, it did not include all of the information required by GASB for the deposit and investment disclosure. For the third consecutive year, the Agency included the information submitted by the Fund in the Agency's Annual Financial Report without ensuring that the financial statement presentation and the note disclosures were in compliance with GASB.

Section 1-A:

Ensure That Financial Statements Comply With Generally Accepted Accounting Principles for Governmental Entities

The initial presentation of the Fund's unaudited financial statements did not comply with GASB pronouncements, which are the generally accepted accounting principles for governmental entities. Fund management prepared the financial statements to comply with provisions of the AICPA Guide because management considers its operations to be similar to an investment company. Fund management did not perform sufficient research to ensure that the AICPA Guide conformed to generally accepted accounting principles for a governmental agency. The fair value financial statement format prescribed by the AICPA Guide was considered more useful to the purchasers of school district bonds guaranteed by the Fund.

AICPA Guide's Definition of an Investment Company

Generally, an entity that pools shareholders' funds to provide the shareholders with professional investment management. Typically, the investment company sells its capital shares to the public, invests the proceeds to achieve its investment objectives, and distributes to its shareholders the net income and net realized gains.

The Fund does not meet the AICPA Guide's definition of an investment company. The Fund was established by a series of constitutional appropriations and is managed by a division of a state agency. Unlike an investment company, the Fund does not pool shareholders' funds, does not issue capital shares, and does not distribute net income and net realized gains to

shareholders. As a result, the State Auditor's Office could not issue an unqualified opinion (a "clean opinion") on the unaudited financial statement presentation initially submitted. Fund management subsequently adjusted the presentation of the financial statements to comply with GASB by early implementation of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Early implementation of Statement No. 31 allowed the Fund's management to meet its objective of fair value reporting.

Recommendations:

We recommend Fund accounting staff obtain additional training in the areas of accounting principles and financial reporting standards for governmental entities. GASB generally issues new pronouncements every year. Periodic training updates will ensure that the Fund's accounting staff members are aware of new pronouncements and their impact on the Fund's financial reporting.

Section 1-B:

Improve Reporting and Disclosures for Securities Lending, Deposits, and Investments

The Fund did not implement new reporting and disclosure requirements for securities lending activities. In addition, it did not include all information required by GASB for the deposit and investment note disclosure. The Agency's accounting personnel also did not implement these new requirements or include deposit and investment note disclosure information. As a result, the Agency's Annual Financial Report was misstated, and additional research was needed to determine the proper reporting of securities lending activities and deposits and investments.

In April 1997, the State Auditor's Office reported that for the prior two years the Agency's process for preparing the Annual Financial Report was inadequate to detect significant errors in reporting. The financial information included in the Agency's Annual Financial Report pertaining to the Fund is submitted to Agency accounting personnel from Fund accounting personnel. The decentralized nature of compiling the report results in no one division taking responsibility for the overall accuracy of the Agency's financial statements.

The Agency is one of the largest agencies in the State. Errors in the Agency's financial statements have an impact on the accuracy of the State's *Comprehensive Annual Financial Report*. (For more details see *A Report on the 1997 Financial and Compliance Audit Results*, SAO Report No. 98-041, June 1998.) Although the Agency and the Fund both contracted with private accounting firms to address prior reporting errors, the Agency's financial statements had to be adjusted to properly reflect accounting standards for the third consecutive year.

The Fund managed investments with a reported cost basis of \$10.5 billion and a fair value of \$15.3 billion as of August 31, 1997. The Fund's investments represent 91 percent of the \$11.5 billion in total assets reported on the Agency's balance sheet.

Securities Lending

The transfer of securities to broker-dealers in exchange for collateral with a simultaneous agreement by the lender to return the collateral for the same securities in the future.

GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, became effective for fiscal year 1997 annual reports. However, neither the Fund nor the Agency properly updated previous reporting and disclosures to present securities lending activities under the new GASB standards.

Specifically, the following issues were noted:

- Over \$2 billion in short-term investments made with cash collateral were not reported as assets on the balance sheet with a corresponding liability to pay back the collateral to brokers.
- Net securities lending income of \$4.7 million was reported rather than properly reporting gross proceeds of \$143.2 million as income and corresponding fees and rebates totaling \$138.5 million as expenditures in the Available School Fund.
- The securities lending disclosure did not contain information such as the category of custodial credit risk for invested cash collateral, legal authorization, type of collateral received, and loss indemnifications as required.

GASB Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements) and Reverse Repurchase Agreements*, and GASB Technical Bulletin No. 94-1 on disclosures for derivative investments provide specific disclosure requirements. Neither the Fund's nor the Agency's accounting staffs included the following required information when preparing the deposit and investment note:

- Proper segregation of deposit custodial risks from investment custodial risk ratings
- Disclosure of legal or contractual provisions for deposits and investments
- Disclosure of foreign currency forward contracts

Recommendations:

We recommend that the Fund, in conjunction with the Agency:

- Ensure accounting staff members gain knowledge of new GASB accounting and reporting standards.
- Closely follow the Comptroller of Public Accountant's Reporting Requirements in coordination with the Agency's own research of accounting and reporting standards for next year's Annual Financial Report.
- Update next year's Annual Financial Report process to ensure that the issues reported above do not recur.
- Review current reports provided by the securities lending agent to determine if they provide sufficient information to ensure that securities lending activities can be properly accounted for and reported in next year's Annual Financial Report.

Section 2:

Improve General Accounting and Control Processes

The Fund's general accounting and control processes are not sufficient to ensure complete and accurate financial reporting and proper recording of accruals. Two significant accounts receivable and associated revenue, as well as an investment purchases payable, were not properly recorded or reported.

Section 2-A:

Improve Accounting Policies and Internal Controls to Ensure Complete and Accurate Financial Reporting

The Fund's accounting policies and internal controls were not sufficient to ensure complete and accurate financial reporting. In two instances, significant accounts receivable and associated revenue were not properly recorded in the financial records and were not properly reported on the financial statements:

- **Outer Continental Shelf (OCS) Settlement Receivable** – Assets were understated by \$30.2 million, revenues were overstated by \$6.1 million, and beginning fund balance was understated by \$36.3 million.
- **Land Endowment Income Receivable** – Assets were understated by \$25.8 million, revenue was understated by \$780 thousand, and beginning fund balance was understated by \$25.0 million.

The Fund did not record a \$43.4 million account receivable for the OCS settlement or recognize the revenue associated with it in fiscal year 1986 when the settlement was awarded and the receivable was first known and measurable. Instead of using GAAP

accrual accounting, the Fund has been recognizing revenue in the amount of the yearly settlement payment (\$2.68 million from 1987 through 1991; \$6.25 million from 1992 through 1996) in the year it was received. As a result, assets have been understated and some revenue has been reported in the wrong fiscal year.

The Fund should take a more active approach to financial reporting:

- The Fund was informed of the proper reporting for the OCS settlement in fiscal year 1996, when it hired a public accounting firm to audit its fiscal year 1995 financial statements. The public accounting firm properly reported the OCS settlement and restated the beginning fund balance to recognize the associated revenue in the Fund's audited financial statements for fiscal year 1995. However, the Fund did not set up the receivable in its accounting records and did not adjust the fund balance to recognize the appropriate amount of accrued revenue.
- The public accounting firm also identified a Land Endowment income receivable from the General Land Office (GLO) and provided the Fund with the GLO reports it used to estimate the receivable. However, the Fund did not set up a Land Endowment income receivable in its accounting records, did not request subsequent GLO reports, and did not continue to estimate and report the receivable and revenue on an accrual basis in its financial statements.

Recommendations:

We recommend that the Fund improve accounting policies and internal controls to ensure completeness and accuracy of financial reporting. All revenue should be recorded and reported on the accrual basis of accounting. Internal controls over financial statement preparation should be designed to ensure that all assets and revenues are reported accurately.

We recommend Fund accounting staff set up receivables in its accounting system to accurately account for the OCS settlement and Land Endowment income receivables. If this is not practicable, we recommend that year-end financial statement procedures be established to ensure receivables are properly reported. The adjustments to the fund balance should also be recorded. Prior to financial statement preparation, the Fund should request the GLO report needed to estimate the accrual for Land Endowment income.

Section 2-B:

Improve Procedures for Reviewing Year-End Investment Transactions to Ensure Proper Reporting of Accruals

An investment purchases payable of \$16.2 million was omitted from the Fund's initial unaudited financial statements and the financial statements of the Agency that were included in the State's *Comprehensive Annual Financial Report (CAFR)* for fiscal year ended August 31, 1997.

Proper reporting processes require identification and evaluation of all the outstanding transactions and obligations at fiscal year end to ensure that appropriate payable and or receivable amount(s) are reported in the financial statements.

The Fund's financial statements have been corrected to properly report this investment purchases payable. However, due to the timing of this audit, the omission was not detected in time to keep the fiscal year 1997 CAFR from being misstated. The misstatement was not material to the CAFR.

Recommendations:

The Fund should improve its internal control procedures to ensure that all outstanding transactions and obligations at the fiscal year end are identified and that investment purchases payable and or receivable amount(s) are properly reported.

Section 2-C:

Improve the Monthly Investment Reconciliation Processes

Monthly reconciliations for investment purchases and sales did not begin until May 1997; thus, all the reconciliations for the first three-quarters of fiscal year 1997 were not prepared in a timely manner. Moreover, ten of the monthly international fixed-income disposition reconciliations for fiscal year 1997 had not been reviewed and approved at the time of our audit.

Proper internal controls require that reconciliations between the investment accounting system and the custodian's statements be prepared and approved on a monthly basis in a consistent and timely manner. Failure to exercise this internal control procedure could lead to untimely detection and adjustment of discrepancies, inconsistent reconciliation results, and errors in financial reporting.

Recommendations:

We recommend that the Fund prepare and approve, in a timely manner, monthly reconciliations between the investment accounting system and the custodian's monthly investment statements for investment purchases, sales, and holdings.

Section 3:

Access Controls Within the Permanent School Fund's Automated Investment System Need Further Improvement

The Fund has implemented most of the improvements to access controls within its automated accounting systems that were recommended in *A Review of Controls Over Investment Practices at Six Major State Investing Entities* (SAO Report No. 97-014, November 1996). However, one recommended access control for the Fund's investment subsidiary ledger (CAMRA) has not been fully implemented.

We found that several staff members continue to have access to sections of CAMRA that are not needed to perform their daily functions. According to Fund management, current access levels were put into effect to ensure appropriate backup for disaster recovery. While backups should be assigned, the current levels of access provide some staff members with more access than necessary. This causes a weakness in segregation of job duties. As a result, there is a risk that errors or irregularities may occur and not be detected in a timely manner.

The Fund has deleted the executive administrator's access to enter trades into CAMRA, and all accountants no longer have full access to CAMRA.

Recommendation:

We recommend that the Fund limit staff members' access to only those sections of CAMRA needed to perform their daily functions. If the situation arises where all assigned staff members and their appropriate backups are out or inaccessible, the system administrator or director of investment accounting should assign temporary access for a limited time to allow backup.

Objectives, Scope, and Methodology

Objectives

Our objectives were to accomplish the following:

- Perform a financial audit in order to express an opinion on the fiscal year 1997 financial statements in accordance with generally accepted auditing standards and Government Auditing Standards.
- Perform the financial audit work for the Statewide audit by testing the Fund's material accounts reported by the Texas Education Agency.
- Review and evaluate significant internal controls.
- Provide the Fund with a management letter.
- Design audit procedures to provide reasonable assurance of detecting material errors or irregularities and be alert for areas of waste, fraud, and abuse.
- Verify compliance with laws and regulations that may have a material effect on the Fund's financial statements.
- Evaluate the status of prior year findings that have a significant impact upon other audit objectives.

Scope

The scope included consideration of the following:

- Internal control structures over cash receipts, cash disbursements, and investments
- Compliance with laws and regulations that could have a material effect on the financial statements
- Financial statement reporting
- Accuracy in the reporting of selected accounts, including investments with a fair value of \$15.3 billion and revenues of \$2.5 billion (Other tests of selected account balances included cash, accounts payable, accounts receivable, fund balance, investment purchases and sales, and net appreciation in fair value of investments.)

We were engaged to audit the Fund's fiscal year 1997 *Annual Financial Report*. The financial statements presented in the *Annual Financial Report* were presented to conform to the AICPA's *Guide for Investment Companies*. The AICPA Guide is not

considered to be in conformance with generally accepted accounting principles for governmental entities. The Fund's management subsequently adjusted the presentation of the financial statements to conform to GASB pronouncements. The scope of our audit changed to an audit of the Fund's adjusted fiscal year 1997 financial statements, not the *Annual Financial Report*.

Additionally, the audit team audited three material accounts and related note disclosures for the Texas Education Agency's financial statements. The audit of these accounts was conducted in conjunction with the SAO's statewide audit of the *Comprehensive Annual Financial Report* of the State of Texas. (See SAO Report No. 98-041, *A Report on the Financial and Compliance Audit Results*, for more details)

Methodology

We gained an understanding of the overall internal control environment and tested controls for selected material accounts. We performed tests of details on investments, revenues, cash, accounts payable, accounts receivable, fund balance, investment purchases and sales, and net increase in fair value of investments. We also tested for compliance with GASB 3, GASB 28, and GASB 31.

We collected and analyzed necessary financial information, performed fluctuation analyses, and reviewed prior management letter comments.

Other Information

Fieldwork was conducted from January 1998 through February 1998. The audit was conducted in accordance with applicable professional standards, including:

- Generally accepted government auditing standards
- Generally accepted auditing standards

The audit work was performed by the following members of the State Auditor's Office staff:

- Robin R. Smith, CPA (Project Manager)
- Lena Lui, CPA
- Hugh Ohn, CIA
- James T. Stolp, CPA
- Bill Wood, CPA
- Larry Vinyard, CPA (First Level Reviewer)
- Worth Ferguson, CPA (Quality Control – Statewide)
- Roger A. Ferris, CPA (Quality Control – Fund)
- Dennis D. O'Neal, CPA (Quality Control – Fund)
- Carol A. Smith, CPA (Audit Manager)
- Craig D. Kinton, CPA (Director)

Fund Profile

The sole purpose of the Texas Permanent School Fund (Fund) is to assist in the funding of public education for present and future generations. The Fund was created with a \$2 million appropriation by the Constitution of 1854 expressly for the benefit of the public schools of Texas. The Constitution of 1876 stipulated that certain lands and all proceeds from the sale of these lands should also constitute the fund. Additional acts later gave more public domain land and rights to the Fund. Under these acts, 46.5 million acres of land, including mineral interests of 7.1 million acres, have been granted to the Fund. In 1954, the U.S. Congress recognized Texas' clear title to its submerged coastal lands to a distance of 10.35 miles. All lands lying within that limit are Fund lands. All of the proceeds from the sale or the mineral-related rental of these lands, including bonuses, delay rentals, and royalty payments, become the corpus of the Fund.

Article 7 of the Texas Constitution assigns control of the Fund's assets to the State Board of Education. Administrative duties related to the Fund reside with the Commissioner of Education, who is the head of the Texas Education Agency (Agency). The operations of the Fund are included in the Agency's financial reporting for the purposes of the *Comprehensive Annual Financial Report* of the State of Texas.

The Texas Constitution describes the Fund as "permanent" and "perpetual." All interest and dividends produced by Fund investments are transferred to the Available School Fund, a State of Texas expendable trust fund, from which distributions are made to local school districts.

Management's Responses

Thank you for completing our initiative in auditing the fiscal 1997 Financial Statements of the Permanent School Fund. Management of the Permanent School Fund believes that the Fund's financial statements should be audited every year in order to draw upon the expertise of a professional accounting organization possessing specialized expertise and depth of resources to contribute to the accurate presentation of financial statements of the Fund.

Since the last financial statement audit was conducted by Coopers and Lybrand, the number of portfolios accounted for has increased from three to seventeen, the number of security classes has increased from two to six, the number of transactions per year has increased from approximately 2,000 to 17,000, the number of external entities requiring reconciliations has increased from two to five and the number of different currencies accounted for has increased from one to eighteen. There has been much change and many challenges continue to face the operation of the Permanent School Fund.

Management concurs with the Auditor's recommendations and appreciates the time and effort expended by the State Auditor's Office in researching and learning the accounting issues confronting the Permanent School Fund in accurately accounting for and in presenting the Fund's financial statements.

With regard to specific recommendations, we agree with the need for accounting staff to continue to update their knowledge of financial reporting standards. The Fund's accounting staff will also follow closely the Comptroller's reporting requirements in coordination with the Agency's reporting standards for next year's annual report. In regard to Section 1, the Fund will review current reports provided by the securities lending agent to determine that sufficient information is provided. For Recommendation 2A, receivables will be established subsequent to fiscal year end to account for the OCS settlement in land endowment income receivables. Adjustments to Fund balances will be recorded.

With respect to Recommendation 2B, review procedures are in place to address identification and evaluation of outstanding transactions at fiscal year end. With respect to Recommendation 2C, the Fund currently prepares and approves monthly reconciliations on a monthly basis. For Section 3, management will review access levels of all CAMRA users and reduce access levels where appropriate to performing necessary accounting functions.

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Appendix 4:

Auditor's Report on Internal Controls

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OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
STATE AUDITOR

Auditor's Report on Internal Controls

February 27, 1998

State Board of Education
Texas Permanent School Fund

Members of the Board:

We have audited the financial statements of the Texas Permanent School Fund (Fund), a nonexpendable trust fund of the State of Texas, as of and for the year ended August 31, 1997, and have issued our report thereon dated February 27, 1998.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

The management of the Fund is responsible for establishing and maintaining internal controls. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that (1) assets are safeguarded against loss from unauthorized use or disposition and that (2) transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal controls, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the Fund for the year ended August 31, 1997, we obtained an understanding of the internal controls. With respect to the internal controls, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal controls. Accordingly, we do not express such an opinion.

We noted certain matters involving internal controls and their operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that, in our judgment, could adversely affect the Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The detailed findings relating to these reportable conditions are included in Sections 1 through 3 of this report.

State Board of Education
Texas Permanent School Fund
February 27, 1998
Page 2

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal controls would not necessarily disclose all matters in the internal controls that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

This report is intended for the information of the members of the State Board of Education, management, and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in cursive script, appearing to read "Lawrence F. Alwin".

Lawrence F. Alwin, CPA
State Auditor

rmn

Appendix 5:

**Auditor's Report on Compliance With Laws and Regulations Material
to the Financial Statements**

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OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
STATE AUDITOR

**Auditor's Report on Compliance With Laws and Regulations
Material to the Financial Statements**

February 27, 1998

State Board of Education
Texas Permanent School Fund

Members of the Board:

We have audited the financial statements of the Texas Permanent School Fund (Fund), a nonexpendable trust fund of the State of Texas, as of and for the year ended August 31, 1997, and have issued our report thereon dated February 27, 1998.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

Compliance with laws and regulations is the responsibility of management. As part of obtaining reasonable assurance about whether the financial statements are free from material misstatement, we performed tests of the Fund's compliance with certain provisions of laws and regulations. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the members of the State Board of Education, management, and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in cursive script, appearing to read "Lawrence F. Alwin".

Lawrence F. Alwin, CPA
State Auditor

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