April 18, 2005

Members of the Legislative Audit Committee:

We certify that as of August 31, 2004, the amount of bonds guaranteed by the Permanent School Fund’s (PSF) Bond Guarantee Program (Program) was within the two limits applicable to the Program. One limit, prescribed by Section 45.053(a) of the Texas Education Code, protects the PSF by minimizing the risk of loss to the fund. The other, established by an Internal Revenue Service (IRS) letter ruling, 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 tax-exempt bonds).

In October 2004, the Texas Education Agency (Agency) stopped awarding guarantees for new bond issues because the Program lacked available capacity under the limit set by the IRS in 1991. However, on March 31, 2005, the IRS increased its limit in response to a November 2004 request from the Agency and the Katy Independent School District. The new IRS limit essentially matches the limit set in the Texas Education Code. This action, which was effective immediately, increased the Program’s capacity to guarantee bonds by at least $8 billion.

In December 2004, the Agency and the State Board of Education formalized the method for prioritizing bond guarantee requests (see Texas Administrative Code, Title 19, Section 33.65). Guarantees are awarded each month, beginning with the school districts with the lowest property wealth per average daily attendance, until the Program reaches 98 percent of its capacity to guarantee bonds.

Based on the amended rules and the lack of fund capacity under the 1991 IRS letter ruling limit, the Agency denied about $1.4 billion in bond guarantee requests from 28 independent school districts during January and February 2005. As a result, it is probable that the independent school districts experienced construction delays, higher interest costs due to lower unenhanced bond ratings, or added fees of an estimated $71,000 to $125,000 if they purchased private-company bond guarantees.

No. 04-030), we recommended that the Agency, in conjunction with the Legislature, begin discussions regarding the 1991 IRS letter ruling limit and whether the limit could be re-evaluated. The Agency obtained legal counsel and began discussions with the IRS. In November 2004, the Agency formally requested a private letter ruling and received a favorable response on March 31, 2005.

Because the 1991 IRS letter ruling limit was more restrictive than the Texas Education Code limit, the positive 2005 response from the IRS permits the Agency to resume approving requests for guarantees. As Figure 1 shows, the Program’s available capacity under the Texas Education Code limit was $13.1 billion as of August 31, 2004; under the 1991 IRS letter ruling limit, the capacity was only $2.1 billion.

![Figure 1](change_in_bond Guarantee Program Capacity as of August 31)

The State Auditor’s Office previously identified a related issue that the Agency is addressing to ensure that it continues to comply with these limits, make additional disclosure, and manage Program risk. Details and management’s current-year response are provided in the attachment. We also previously provided the Agency with specific recommendations in a separate.
management letter regarding school districts’ accounting for accretion on capital appreciation bonds. The Agency implemented those recommendations.

We appreciate the Agency’s cooperation during this audit. If you have any questions, please contact Carol Smith, CPA, CIA, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the State Board of Education
    Dr. Shirley J. Neeley, Commissioner of Education, Texas Education Agency
    Mr. Joe Wisnoski, Assistant Commissioner for School Finance and Fiscal Analysis, Texas Education Agency
    Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Texas Permanent School Fund
    Ms. Catherine A. Civiletto, CPA, Deputy Executive Administrator, Texas Permanent School Fund
Follow-Up on Prior Recommendations

The Texas Education Agency’s (Agency) Investment Office is still addressing an issue previously identified by the State Auditor’s Office in An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program (SAO Report No. 02-038, April 2002), An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program (SAO Report No. 03-032, April 2003) and An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program (SAO Report No. 04-030, April 2004). The following table summarizes the issue and its current status.

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Status</th>
<th>Comments</th>
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<tbody>
<tr>
<td>PSF should complete its planning and set a target date for systematic accounting for CAB accretion. After PSF quantifies outstanding accretion, it should disclose the amount in the notes to its financial statements.</td>
<td>Partially Implemented</td>
<td>The Agency’s Investment Office used its investment accounting system to calculate bond accretion, but we found that the results understated total accretion to date and did not agree with accretion amounts reported by school districts. This is because the Permanent School Fund (PSF) system excluded initial accretion known as capital appreciation bond (CAB) premium and applicable accretion on CAB premium. The Investment Office advised us that significant additional time would be needed to perform side spreadsheet calculations to supplement its automated system so that it could calculate total accretion to date at any point in time. The Investment Office suggested that, alternatively, it could disclose the difference between the principal amount counted as bonds guaranteed and the ultimate maturity value of the CABs. The alternative disclosure of total accretion to maturity would allow for the monitoring and management of Bond Guarantee Program (Program) risk to provide assurance that the PSF’s guarantee of CABs does not add excessive leverage to the fund. We believe such a disclosure, included with the Agency’s report of bonds guaranteed, will resolve this issue.</td>
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Summary of Information Technology Review

Overall, the Agency’s information systems that support the Bond Guarantee Program (Program) appear to be working properly, and they enabled the Investment Office to report Program amounts and limitations accurately. Tests of reconciliations and financial transactions processed by the information systems indicated that amounts reported were accurate. As part of obtaining an understanding of internal control relevant to our audit, we performed limited general and application control review procedures for the PSF’s major investment information systems.

Management’s Response

The Texas Education Agency (Agency) continues to work through database calculation issues in regards to accretion on capital appreciation and premium capital appreciation bonds, resulting in the inability to presently generate a reliable calculation. We recognize the importance of proper disclosure in the Permanent School Fund (“PSF”) financial statements and we are committed to developing the most appropriate disclosure statement in regards to loss contingencies as related to the Bond Guarantee Program.

We believe the guidelines of FASB Statement of Financial Accounting Standards No. 5 and Financial Accounting Standards Board Interpretation No. 45 are open to interpretation and before we commit to disclosing accretion on the financial statements, the PSF would like to obtain additional guidance from bond counsel and our legal counsel. We also may consult the FASB directly and obtain their advice in regards to this matter. Before we commit to this expanded disclosure, the PSF would like to have assurances from bond and legal counsel and possibly the FASB that increased disclosure is required under the terms of the guarantee.

Additional Comments

The State Auditor’s Office requests the opportunity to review the Financial Accounting Standards Board’s response to the Agency’s request for guidance. We discussed this matter with a representative from the Governmental Accounting Standards Board (GASB), who did some brief research and discussed this issue with another GASB representative. The GASB representative’s thoughts on this matter are consistent with our recommendation for disclosure of CAB accretion pursuant to the requirement of Financial Accounting Standards Board Interpretation No. 45 to disclose the maximum potential amount of future payments under the guarantee. These boards set the accounting standards that the Agency must follow, and legal or bond counsel’s opinion to the contrary would be inappropriate.
Summary of Objectives, Scope, and Methodology

Our objectives were to determine whether the total amount of school district bonds guaranteed by the Program exceeded the limits established by state statute and the IRS and to follow up on related issues from the previous year. We limited the scope to the amount of outstanding guaranteed bonds as of August 31, 2004.

To analyze bond information, we:

- Gained an understanding of governing statutes and business processes.
- Interviewed Program personnel.
- Compared bond information with external sources, including the Municipal Advisory Council and independent audit reports of certain school districts.

The certification is required by Section 45.053(b) of the Texas Education Code. This audit was conducted in accordance with generally accepted government auditing standards.

Fieldwork was conducted from January 2005 to March 2005. The following members of the State Auditor’s staff performed this audit:

- Ron Zinsitz, CPA, CIDA (Project Manager)
- Terry Nickel, CFE
- Worth Ferguson, CPA (Quality Control Reviewer)
- Carol A. Smith, CPA, CIA (Audit Manager)