February 6, 2006

Members of the Legislative Audit Committee:

In our audit report dated January 20, 2006, we concluded that the Permanent School Fund’s (Fund) basic financial statements for fiscal year 2005 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards, which is provided in the attachment to this letter. Our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations. Our procedures did not identify any material weaknesses in internal control over financial reporting or any noncompliance with laws or regulations that materially affected the financial statements; however, we identified a weakness in internal control over financial reporting that we determined to be a reportable condition. Specifically, the General Land Office (GLO) should ensure that better information about income earned from mineral sales is provided to its Financial Reporting Division in time to prepare more accurate financial statements. GLO management agreed with our recommendations. That issue and GLO management’s response are described in detail in the attachment to this letter.

With the exception of the issue referred to above, the major internal controls that we reviewed for the purpose of forming our opinion on the financial statements were generally operating effectively. As required by professional auditing standards, we will also communicate certain matters related to the conduct of a financial statement audit to the State Board of Education’s (SBOE) Committee on School Finance/Permanent School Fund.

In A Report on the Audit of the Permanent School Fund’s Fiscal Year 2004 Financial Statements (SAO Report No. 05-026, February 2005), the State Auditor’s Office made three recommendations. The implementation status of those recommendations is as follows:

- The Texas Education Agency (TEA) has fully implemented recommendations that it and the management of its Fund Investment Office ensure that Fund service providers and SBOE members submit certain annual ethics disclosures and that SBOE members fulfill annual ethics training requirements.
• TEA’s implementation of a recommendation to consider performing criminal background checks on employees (including those in the Fund Investment Office) who have access to assets that could be subject to abuse is ongoing. According to TEA’s human resources manager, an informal policy that includes performing a background check on a Fund position expected to be filled soon has been drafted. No formal policies have been approved for the Fund Investment Office, and no formal policies have been considered for TEA employees who work outside the Fund Investment Office.

• The 79th Legislature did not clarify in statute the meaning of the constitutional language regarding “the market value” of the Fund. The Fund’s average market value over a predefined, 16-fiscal-quarter period is one determinant of the dollar amount of annual distributions to the Available School Fund described in the Texas Constitution. The April 28, 2005, minutes of the SBOE’s Committee on School Finance/Permanent School Fund meeting indicate that the Committee members agreed that “asking the Attorney General’s Office to render an opinion concerning the interpretation of the Constitutional Amendment language would be appropriate before the Board meets again to set the spending rate.” To date, neither TEA nor the SBOE has requested an opinion from the Office of the Attorney General.

Conducting this audit also enabled us to obtain the following information:

• The Fund’s fund balance as of August 31, 2005, was $22.1 billion, an increase of $2.2 billion or 11 percent from the prior fiscal year’s ending balance. TEA reported a total return of 14.18 percent in fiscal year 2005 on the Fund assets it managed. In fiscal year 2004, the fund balance grew by $1.3 billion, and TEA reported a total return of 10.57 percent.

• The increase in the Fund’s fund balance was due almost entirely to the $2.1 billion net increase in the fair value of the investments TEA managed (the real estate investments managed by the GLO are reported at historical cost on the balance sheet). The remaining $0.1 billion increase in the fund balance resulted from the combination of mineral and other income from Fund land, dividends, interest, gains on land sales, and various other revenues in excess of operating expenditures and distributions to the Available School Fund on a total return basis.

• The cash basis distribution to the Available School Fund was $880 million, which is the same as it was in fiscal year 2004. Fiscal year 2004 was the first year in which distributions from the fund were computed on a total return basis. The Texas Constitution mandates that a single payout percentage be applied to a single amount of Fund average market value for both years of a biennium.
We appreciate the assistance of TEA and GLO during this audit. If you have any questions, please contact Carol Smith, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the State Board of Education
    Mrs. Geraldine Miller, Chair
    Dr. Don McLeroy, Vice Chair
    Mrs. Mavis B. Knight, Secretary
    Mr. Lawrence Allen, Jr.
    Mrs. Mary Helen Berlanga
    Dr. Joe J. Bernal
    Mr. David Bradley
    Mrs. Barbara Cargill
    Mr. Bob Craig
    Ms. Pat Hardy
    Mrs. Terri Leo
    Mrs. Gail Lowe
    Mr. Dan Montgomery
    Mr. Rene Nunez
    Mrs. Cynthia A. Thornton

Texas Education Agency
    Dr. Shirley Neeley, Commissioner of Education
    Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Texas Permanent School Fund

General Land Office and School Land Board
    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

Objective, Scope, and Methodology

The objective of the audit was to express an opinion on the Permanent School Fund’s (Fund) financial statements for the fiscal year ended August 31, 2005.

The scope of this audit included expressing an opinion on the Fund’s financial statements in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

The audit methodology included gaining an understanding of the Fund’s overall control environment and internal controls over financial reporting to the extent necessary to plan the audit. We tested internal controls and significant accounts as necessary to support our opinion. Tests of accounts primarily included tests of support for recorded transactions, confirmations of investments and related accounts, and analytical review. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts.

The following staff of the State Auditor’s Office performed the audit:

- Roger A. Ferris, CPA (Project Manager)
- Ron Zinsitz, CPA, CIDA (Assistant Project Manager)
- Kristin Alexander
- Michael Clayton, CPA, CFE
- Hugh Ohn, CPA, CFA, CIA
- Jim Timberlake, CIA
- Alan Walton, MBA, CIA
- Michael Yokie, CISA
- Charles P. Dunlap, Jr., CPA (Quality Control Reviewer)
- Worth S. Ferguson, CPA (Quality Control Reviewer)
- Carol Smith, CPA, CIA (Assistant State Auditor)
Attachment

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards

Members of the State Board of Education
and
Dr. Shirley J. Neely, Commissioner of Education
Texas Education Agency

We have audited the financial statements of the Permanent School Fund (Fund), as of and for the year ended August 31, 2005, and have issued our report thereon dated January 20, 2006. Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

We have chosen not to comply with a reporting standard that specifies the wording that should be used in discussing restrictions on the use of this report. We believe that such restrictions are not in alignment with our role as a legislative audit function.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Fund’s internal control over financial reporting 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 control over financial reporting. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Fund’s ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable condition is described in the accompanying schedule of findings and responses.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud 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 control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that the reportable condition described above is not a material weakness.
Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund’s financial statements are free of material misstatement, we performed tests of the Fund’s compliance with certain provisions of laws and regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

This report is intended for the information and use of the State Board of Education, management of the Texas Education Agency, and the Legislature. However, this report is a matter of public record, and its distribution is not limited.

John Keel, CPA
State Auditor

January 20, 2006
Schedule of Findings and Responses

The General Land Office Should Improve the Timeliness, Accuracy, and Completeness of Year-End Accrual Information Its State Energy Marketing Program Provides to Its Financial Reporting Division

The General Land Office's (Office) State Energy Marketing Program (SEMP) did not provide the Office's Financial Reporting Division (Financial Reporting) with timely, accurate, and complete year-end information about earned but uncollected income from SEMP's mineral sales. Because of this, Financial Reporting could not determine reliable year-end balances for certain SEMP accounts when it prepared the PSF's fiscal year 2005 financial statements. As a result, those statements required correction during the audit process.

Financial Reporting's initial financial statements understated accounts receivable by a total of $21.8 million as of August 31, 2005. The $21.8 million amount is the sum of understatements in gas royalty income (understated by $15.6 million), oil royalty income (understated by $2.7 million), and deferred revenues (understated by $3.5 million).

A significant portion of the correction made to accounts receivable was related to SEMP's sales of gas acquired from third parties and its "take-in-kind" program through which SEMP receives the PSF's royalty share from oil or gas leases in the form of the actual commodities and then resells those commodities. Because SEMP sells these commodities, its personnel have access to the most accurate information about (1) the market value of oil and gas sold through the last day of the fiscal year, (2) the dollar amount of collections during the first 60 days after year-end that Financial Reporting should report as revenue, and (3) the amount of any remaining uncollected balances, which should be reported as deferred revenues.

In addition, SEMP personnel informed us that SEMP often does not bill its customers until six to eight weeks after the end of the month in which the minerals were delivered. This billing delay might make it more difficult for SEMP to provide Financial Reporting with accurate accrual information in time to issue reliable financial statements within established deadlines. In addition, billing delays that result in collection delays diminish the PSF's potential earnings from reinvestment of collected cash.
Recommendations

To assist Financial Reporting in preparing complete and accurate financial statement information related to SEMP accounts receivable for mineral sales, the Office should ensure that:

- SEMP provides Financial Reporting with a reconciled analysis of total mineral sales that occurred through August 31 for which payments had not been received at fiscal year-end.

- The information SEMP provides to Financial Reporting properly distinguishes between amounts expected to be collected by October 30 (60 days after fiscal year-end) and amounts expected to be collected after that date.

To enhance the reliability of the expected timing of future collections and to increase the PSF’s potential reinvestment earnings, the Office also should ensure that SEMP bills customers as soon as it has complete information about the quantities of minerals sold in the prior month, subject to any contractual restrictions on the earliest allowable billing date.

Management’s Response from the General Land Office

SEMP concurs with the recommendations. The program has hired a new Director who is a CPA with industry experience and is taking action to fill the SEMP Financial Manager position. These two positions, and possibly other positions, will enhance the resources of the program.

- Procedures will be developed for performing reconciliations. The SEMP Financial Manager will have direct responsibility for accounting, including reconciliations.

- SEMP is working with the application software provider to bill on contractually scheduled volumes before the 10th of the subsequent month with an adjustment to actual volumes on the following month’s invoice. This change will facilitate accurate accruals and enable post balance sheet review of collections after the close of the fiscal year.