April 12, 2007

Members of the Legislative Audit Committee:

In our audit report dated February 12, 2007, we concluded that the Permanent School Fund’s (Fund) basic financial statements for fiscal year 2006 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

**Auditors identified a reportable condition regarding controls over financial statement note disclosures.**

Auditors identified one weakness in controls over financial reporting that we classified as a “reportable condition.” However, this issue is not considered to be a material weakness. The General Land Office (Office) did not prepare two financial statement note disclosures for fiscal year 2006 in a manner that was consistent with procedures it used for the fiscal year 2005 financial statements. As a result, the unaudited note disclosures contained significant errors. The routine internal processes the Office uses to review the financial statements did not identify and correct these inconsistencies. Note disclosures are an integral part of the financial statements.

The inconsistencies resulted from (1) improper application of an accounting pronouncement requiring disclosure of future income from certain leases of surface real estate and (2) the inadvertent departure from the Office’s documented method to estimate the fair value of its mineral properties. Auditors recommended, and the Office accepted, audit adjustments to correct the two note disclosures. This issue and management’s response, which indicates management agreed with our recommendation, are presented in detail in Chapter 1 of the attachment to this letter and in our *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.*

**Auditors identified other opportunities to strengthen financial reporting or operational controls.**

The major internal controls that we reviewed for the purpose of forming our opinion on the financial statements were generally operating effectively. However, the attachment to this letter presents other issues related to financial reporting or operational controls at the Office, as well as management’s responses to those issues. The Office agreed with our recommendations. A summary of the issues follows:

- The Office has not selected appropriate revenue and expenditure object codes (or worked with the Office of the Comptroller of Public Accounts to establish such codes) for the financial statement presentation of its purchase and subsequent resale of natural gas. As a result, the Office’s unaudited financial statements presented two items incorrectly. Revenue from sales of purchased gas was presented as if it was royalty income earned from Fund mineral leases. Expenditures to purchase natural gas for resale were presented as “Communications and Utilities” expenditures, making it appear as if those costs arose from the Office’s consumption of energy. (See Chapter 2 of the attachment to this letter for details.)

SAO Report No. 07-029
The Office does not reconcile oil and gas production reports with the related collection of royalty payments on a timely basis. Reconciliations of production and payments for all mineral leases for fiscal years 2002 through 2005 had not yet been completed during audit fieldwork in fiscal year 2007. In addition, the Office does not routinely run automated reports that could promptly identify missing production reports or the associated royalty payments shortly after those payments are due. Not performing these activities impairs the Office’s ability to provide complete and accurate financial reporting of accounts receivable at any fiscal year-end and (2) could result in an increase in the amount of money that is owed to the Fund but is uncollectible (See Chapter 3 of the attachment to this letter for details.)

The Office does not have or has not implemented certain accounting and financial reporting policies for its new investments in external real estate funds. In addition, the Office’s State Energy Marketing Program (SEMP) has not always executed certain accounting control procedures on a timely basis. (See Chapter 4 of the attachment to this letter for details.)

The Office substantially resolved a reportable condition identified in the fiscal year 2005 audit, but it should improve processes to correctly allocate the year-end revenue accrual. The Office’s SEMP has significantly improved procedures to provide the Office’s Financial Reporting Division with accurate and timely information about the year-end balance of accounts receivable from mineral sales. The revised procedures have resulted in more timely billing and collection of revenues earned for the Fund from gas sales. Although SEMP’s year-end revenue and accounts receivable accrual of approximately $18 million was prepared on a timely basis for the fiscal year 2006 financial statements, the entire balance was incorrectly reported as being earned as a result of sales of purchased gas. Based on auditors’ review of this accrual, the Office later corrected the reported accrual by (1) reducing by $5 million the revenue and receivable related to sales of purchased gas; (2) increasing by $4.7 million the revenue and receivable related to sales of the Fund’s own gas (‘’take-in-kind” royalties), reported as Land Endowment Income; and (3) making minor adjustments to other accounts. (See Chapter 5 of the attachment to this letter for details.)

**Attorney General Opinion No. GA-0516 resolved a prior issue regarding the market value of the Fund.**

In response to questions raised during the audit of the Fund’s fiscal year 2004 financial statements, the Chair of the State Board of Education requested an Attorney General Opinion on February 9, 2006. The request involved clarification of how to measure the “market value” of the Fund when determining how much money the Fund will distribute annually to the Available School Fund. On February 13, 2007, the Attorney General issued Opinion No. GA-0516, which resolved this issue. That opinion stated that the State Board of Education must use accrual accounting, which will change the way the Fund’s market value is calculated because certain accruals had not previously been included in the calculation. The opinion also requires the exclusion from the market value calculation of the Fund’s cash held in the Office’s State Treasury account for purchasing additional real property, which is consistent with State Board of Education and Texas Education Agency practice. (See Chapter 6 of the attachment to this letter for details.)

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 Committee on School Finance/Permanent School Fund.
In fiscal year 2006, the fund balance of the Fund grew by 8.2 percent and the distribution to the Available School Fund decreased by 4.3 percent.

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

- The Fund’s fund balance as of August 31, 2006, grew to $23.91 billion, an increase of $1.81 billion, or 8.19 percent, over the balance at the end of fiscal year 2005. The Texas Education Agency reported a total return of 10.44 percent in fiscal year 2006 on the Fund assets it managed. In the prior fiscal year (2005), the fund balance grew by $2.2 billion, and the Texas Education Agency reported a total return of 14.18 percent on the assets it managed.

- The increase in the Fund’s fund balance was primarily due to a $1.56 billion net increase in the fair value of the investments the Texas Education Agency managed (the real estate investments managed by the Office are reported at historical cost on the balance sheet). The remaining $0.25 billion increase in the fund balance resulted from the combination of mineral income 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.

- In fiscal year 2006, the distribution to the Available School Fund was $842 million, which was a decrease of $38 million, or 4.3 percent, from its level in the prior two fiscal years. The distribution rate of 4.5 percent established by the State Board of Education was the same as the rate specified in the Texas Constitution for the first biennium in which distributions from the Fund were computed on a total return basis. However, the average market value of the Fund used to calculate the fiscal year 2006 distribution was lower than the Fund’s average market value in the prior measurement period.

We appreciate the assistance of the Texas Education Agency and the General Land Office during this 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: Members of the State Board of Education
    Ms. Geraldine Miller, Chair
    Mr. David Bradley, Vice Chair
    Mr. Rick Agosto, Secretary
    Mr. Lawrence Allen, Jr.
    Ms. Mary Helen Berlanga
    Ms. Barbara Cargill
    Mr. Bob Craig
    Ms. Cynthia Dunbar
    Ms. Pat Hardy
Ms. Mavis B. Knight
Ms. Terri Leo
Ms. Gail Lowe
Dr. Don McLeroy
Mr. Ken Mercer
Mr. Rene Nunez
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
The General Land Office (Office) did not prepare two financial statement note disclosures for fiscal year 2006 in a manner that was consistent with procedures it used for the fiscal year 2005 financial statements. As a result, the unaudited note disclosures contained significant errors. The routine internal processes the Office uses to review the financial statements did not identify and correct these inconsistencies. Note disclosures are an integral part of the financial statements.

The inconsistencies resulted from (1) improper application of an accounting pronouncement requiring disclosure of future income from certain leases of surface real estate and (2) the inadvertent departure from the Office’s documented method to estimate the fair value of its mineral properties. Auditors recommended, and the Office accepted, audit adjustments to correct the two note disclosures.

Lease note disclosure

The unaudited lease note disclosure understated by $63 million (21 percent) the $294 million corrected total of all future income from all noncancelable leases. The initial understatement occurred primarily because future income did not take into account predetermined rent increases included in various leases of Permanent School Fund (Fund) land and buildings. The Office did not have detailed written procedures to ensure that this note disclosure adhered to accounting principles, which require inclusion of known future rent increases.

One lease was initially reported to have total future income over the remaining lease term (almost 29 years) of $177.5 million, although the correct total should have been $231.8 million. In fiscal year 2005, future income over the term to the end of the initial lease period (almost 30 years) was reported as $238.5 million. The Office’s financial statement review process did not detect that the note disclosure reported a $61 million decline in future rental income from this lease, despite the fact that the remaining lease term had been reduced by only one year.

Estimated fair value of the Fund’s mineral properties

Another unaudited note disclosure understated the estimated fair value of the Fund’s mineral properties by $159 million (6.4 percent of the revised total of $2.479 billion). This occurred because the estimate was based on quoted oil...
and gas prices on June 30 and July 1, respectively. However, the Office’s written procedures for this calculation require that the estimate be based on August 31 and September 1 oil and gas prices. The note disclosure correctly reported the use of the earlier dates; however, the Office’s routine financial statement review procedures did not identify this departure from written procedures. Accounting estimation methods generally should not be changed unless there is a valid reason to do so (for example, if a new method results in a more reliable estimate).

**Recommendations**

The Office should strengthen its procedures to prepare and review financial statement note disclosures. Specifically, it should:

- Ensure that employees who prepare note disclosures are knowledgeable and have a sufficient understanding of the underlying accounting principles and that they have detailed written procedures to follow to ensure consistent adherence to accounting principles.

- Ensure that supervisory review is performed of all financial statement note disclosures, as well as the underlying support for the note disclosures. Such review should ensure that procedures have been properly applied each year and that the reported results are reasonable in comparison with the prior year’s note disclosures.

**Management’s Response from the General Land Office**

The Office concurs with the recommendations for strengthening its reporting procedures and review processes to ensure that accounting principles and procedures have been properly applied to the financial statement note disclosures.

The Professional Services Program has created a database to track and calculate escalating future lease revenue. It also has documented procedures for calculating future lease revenue and developed a process for comparing current year reports with prior year reports. Energy Resources will ensure that the note disclosures are prepared in the spirit of FAS69 using the commodity price as of the balance sheet date.
Chapter 2

The General Land Office Miscategorized Revenue and Expenditure Account Codes in Its Accounting System

The Office has not selected appropriate revenue and expenditure object codes (or worked with the Office of the Comptroller of Public Accounts to establish such codes) for the financial statement presentation of its purchase and subsequent resale of natural gas. As a result, the Office’s unaudited financial statements presented two items incorrectly:

- Revenue from sales of purchased gas was presented as if it was royalty income earned from Fund mineral leases.
- Expenditures to purchase natural gas for resale were presented as “Communications and Utilities” expenditures, making it appear as if those costs arose from the Office’s consumption of energy.

Auditors noted these miscategorizations, and management corrected them in the stand-alone Fund financial statements published by the Texas Education Agency (Agency). However, the revenue and expenditure object codes the Office uses in accounting for transactions also affect how the Fund’s activities are captured in the Uniform Statewide Accounting System (USAS) maintained by the Office of the Comptroller of Public Accounts (Comptroller’s Office). USAS data, in turn, is used to compile information in various reports published by the Comptroller’s Office, including the Annual Cash Report and the State’s Comprehensive Annual Financial Report (CAFR).

As a result of audit adjustments to the Fund’s stand-alone financial statements:

- A total of $159 million (28 percent) of the $577 million in revenue that the Office initially reported as the Fund’s “Land Income” was reclassified as “Revenue from Sales of Purchased Gas.” Similarly, this revenue was reclassified in the State’s CAFR as “Cost of Goods Sold.” (However, the Annual Cash Report was published in early November and was based on data in USAS before auditors identified the need for this adjustment. Therefore, the Office’s miscoding of this revenue resulted in the Annual Cash Report containing a significant overstatement for the Fund’s reported total of “Gas Royalties from Land Owned by Educational Institutions.”)

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1 These stand-alone financial statements report the combined account balances of the Fund at both the Office and Agency because both state agencies have responsibility for portions of the Fund’s financial activities.

2 Although total revenue in this category was overstated (and, therefore, a more appropriate revenue code that the Office should have used to report sales of purchased gas was understated), the miscoding did not overstate total Fund revenue in the Annual Cash Report.
Nearly all of the expenditures ($158.5 million of the $158.8 million) that the Office initially reported as the Fund’s “Communication and Utilities” expenditures were reclassified as “Gas Supplies Purchased for Resale.” This reclassification was not applicable to the State’s CAFR. (However, the Office’s miscoding of these expenditures resulted in the Annual Cash Report, which was published before auditors identified the need for the adjustment, containing a significant overstatement of the Fund’s reported total of “Communications and Utilities” expenditures.3)

To avoid misinterpretation, transactions should be recorded in accounting records and presented in financial statements in a manner that results in an accurate description of the nature of those transactions.

Recommendations

The Office should (1) identify existing USAS revenue and expenditure object codes that accurately reflect the nature of its transactions involving the purchase and resale of natural gas or (2) work with the Comptroller’s Office to redefine existing USAS revenue and expenditure object codes, or create new object codes, that would apply to such transaction types.

Management’s Response from the General Land Office

The Office has already initiated discussion with the Comptroller’s Office concerning the appropriate object codes to use for reporting revenues from the sale of gas from PSF leases and from the purchase and resale of natural gas. The subsidiary and general ledgers used by the Office already differentiate between the revenues and expenses related to the purchase and resale of gas and those resulting from PSF leases. The Office will begin recording accruals according to the resolution agreed to by the Comptroller’s Office.

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3 Although expenditures in this category were overstated (and, therefore, a more appropriate expenditure code that the Office should have used to report gas purchased for resale was understated), the miscoding did not overstate total Fund expenditures in the Annual Cash Report.
Chapter 3

The General Land Office’s Procedures Do Not Ensure That Lessees of the Fund’s Minerals Submit Production Reports and Pay the Associated Royalties on a Timely Basis

The Office does not reconcile oil and gas production reports with the related collection of royalty payments on a timely basis. Reconciliations of production and payments for all mineral leases for fiscal years 2002 through 2005 had not yet been completed during audit fieldwork in fiscal year 2007. The lack of timely lease reconciliations for prior periods also was identified by the Office’s Internal Audit Division in a July 22, 2005, report.

In addition, the Office does not routinely run automated reports that could promptly identify missing production reports or the associated royalty payments shortly after those payments are due. The Office does not run monthly reports to identify mineral leases for which lessees should have, but did not, file all required production reports by the monthly due date. In addition, the Office could not demonstrate that it runs monthly reports to compare the amount owed for each mineral lease (as reported on the monthly production report) and the amount of royalties lessees actually remitted by the due date.

Not promptly performing reconciliations, not promptly identifying missing production or payment reports, and not promptly identifying underpayments (1) impairs the Office’s ability to provide complete and accurate financial reporting of accounts receivable at any fiscal year-end and (2) could result in an increase in the amount of money that is owed to the Fund but is uncollectible.

According to its rules in Title 31, Texas Administrative Code, Section 9.51(b)(3)(A)(i)(III), the Office can assess a penalty of $10 per report for each month a lessee is delinquent in filing a production report. However, those penalties can be assessed only after the Office has notified a lessee that past reports have been not been filed properly, and only future noncompliant reports can be penalized. Therefore, if the reconciliation process does not identify delinquent monthly lease reports until several years after their due dates, and that lessee has not previously received notification of delinquencies, no penalty could be assessed on any of these prior delinquent reports. The collectibility of underpayments, including allowable interest and underpayment penalties, could be impaired if they are identified long after the royalties were due but the lessee is in bankruptcy proceedings.
Recommendations

The Office should:

- Enhance its lease reconciliation processes and/or resources so that it performs comprehensive reconciliations on a more current basis. The report issued by the Office’s Internal Audit Division recommended that leases be reconciled within six months to a year after the production and payment reports were due.

- Routinely run and review reports to identify leases for which complete production reports were not filed by the due date.

- Routinely run and review reports to identify leases for which the appropriate royalty payments, based on the amounts owed to the Fund as reported by lessees, have not been paid on a timely basis.

- Take prompt follow-up action for each lease for which a reporting or payment delinquency appears to exist, including providing the required notification to enable the Office to promptly impose allowable penalties on delinquent reports and penalties and interest on late payments.

Management’s Response from the General Land Office

Management concurs with the recommendations for improving the timeliness of reconciliations for mineral leases. The Royalty Management Division is currently in discussion with the Information Systems and Mineral Leasing Divisions to develop a system that will allow companies to report on a well level basis. This change should speed up the lease volume reconciliation process by identifying incorrect well information.

A Royalty Management Accounts Examiner will be assigned to routinely run a report scan that will identify monthly production reports that have not been filed by the due date. The division will assign Accounts Examiners to begin reviewing royalties due according to the monthly production reports versus royalties paid. The reviews will be performed on a current monthly basis beginning with fiscal year 2007.

Starting approximately May 1, 2007, Accounts Examiners will begin reviewing royalty due versus royalty paid for September 2006 thru January 2007. This will allow time for required changes to be made to the current reconciliation system and for the new system to be tested. An additional Accounts Examiner will begin reviewing the production month of February 2007 (oil production reports and royalties due by April 5, 2007, and gas production reports and royalties due by April 15, 2007) and will continue on a current month-to-month basis.
By May 1, 2007, procedures and related documentation will be created to specify the follow-up actions required for missing production reports that are identified and for the differences in royalty due versus royalty paid resulting from the report scans and reviews mentioned above.
Chapter 4

The General Land Office Does Not Have or Has Not Implemented on a Timely Basis Certain Accounting and Financial Reporting Policies and Procedures

The Office does not have or has not implemented certain accounting and financial reporting policies for its new investments in external real estate funds. In addition, the Office’s State Energy Marketing Program (SEMP) has not always executed certain accounting control procedures on a timely basis.

Specifically, auditors noted that:

- Formal, written policies have not been developed related to the accounting for subsequent cash inflows from the Office’s external real estate investments.

- The unaudited financial statement note disclosures did not address how the cost basis (reported on the balance sheet) and the estimated fair value (reported in the note disclosures) were determined until after auditors recommended the addition of these disclosures.

- Certain reconciliations between SEMP financial records and the related general ledger balances for fiscal year 2006 were completed long after the end of the fiscal year or had not yet been completed by January 2007.

It is important for management to document, through written policies and procedures, (1) its methods to account for and report financial transactions, (2) staff members’ responsibilities related to performing program activities, and (3) the performance of control procedures to monitor the accuracy of financial records. In addition, policies and procedures are beneficial for new employees and backup personnel.

The Office’s real estate investments in external funds represent new activities that include some accounting and reporting issues not encountered in relation to the types of real estate investments the Office has historically overseen. SEMP key management and staff have been in place for a relatively short time and have made progress in organizing and improving operations. However, SEMP’s activities are highly complex and, therefore, performing accounting control procedures on a timely basis is important.

Recommendations

The Office should ensure that:

- It develops written procedures explaining how it will account for all types of cash flows related to investments in external real estate funds or any other new types of investments.
Future financial statement note disclosures adequately explain how (1) the cost basis of investments in external real estate funds is measured on the balance sheet, both at inception of the investment and after the Office begins receiving cash back from the investments, and (2) how fair value is determined for reporting in the notes to the financial statements.

SEMP ensures that accounts are reconciled on a timely basis.

Management’s Response from the General Land Office

Management concurs with the recommendations for improving its documentation of accounting and financial reporting policies. During fiscal year 2007, the Office received its first cash flows related to investments in real estate funds and has been developing written procedures on accounting for the cash flows it receives from all types of investments. It will ensure that financial statement note disclosures adequately explain the cost basis of investments and the method used to determine the fair value.

SEMP has completed the reconciliations between its financial records and the related general ledger balances for fiscal year 2007 and for most of fiscal year 2006. Upon completing fiscal year 2006, it will perform the reconciliations for prior periods.
The Office’s SEMP has significantly improved procedures to provide the Office’s Financial Reporting Division with accurate and timely information about the year-end balance of accounts receivable from mineral sales. The revised procedures have resulted in more timely billing and collection of revenues earned for the Fund from gas sales. SEMP now bills its gas customers based on each month’s contractually scheduled gas volumes, and then it adjusts subsequent months’ billings for any differences between billed volumes and actual volumes taken. (In the past, SEMP typically waited to bill customers for a month until after all of that month’s actual gas consumption was known.)

Although SEMP’s year-end revenue and accounts receivable accrual of approximately $18 million was prepared on a timely basis for the fiscal year 2006 financial statements, the entire balance was incorrectly reported as being earned as a result of sales of purchased gas. Based on auditors’ review of this accrual, the Office later corrected the reported accrual by (1) reducing by $5 million the revenue and receivable related to sales of purchased gas; (2) increasing by $4.7 million the revenue and receivable related to sales of the Fund’s own gas (“take-in-kind” royalties), reported as Land Endowment Income; and (3) making minor adjustments to other accounts.

Transactions should be recorded in accounting records and presented in financial statements in a manner that results in an accurate description of the nature of those transactions. Accurately segregating revenue earned on the sales of purchased gas from other sources of revenue is necessary so that Office management can reliably determine whether SEMP’s purchase and sale of natural gas has generated the expected profits for the Fund.

Recommendation

The Office should ensure that its accounting records and financial statements properly distinguish between revenue earned by selling gas from the Fund’s leases and revenue earned by selling gas purchased by SEMP.

Management’s Response from the General Land Office

As mentioned in the management response to Chapter 2, the Office is working with the Comptroller’s Office to determine the appropriate codes to use for reporting revenues earned from selling gas from the Fund’s leases and those from the sale of purchased gas.
Chapter 6
The Attorney General Has Issued an Opinion That Resolved an Issue Identified in Prior Audit Reports

In response to questions raised during the fiscal year 2004 audit of the Fund’s financial statements, the Chair of the State Board of Education requested an Attorney General Opinion on February 9, 2006. The request involved clarification of how to measure the “market value” of the Fund when determining how much money the Fund will distribute annually to the Available School Fund, including whether the money held by the Office for potential investment in real estate should be included in the Fund’s market value.

On February 13, 2007, the Attorney General issued Opinion No. GA-0516, which resolved this issue. That opinion stated that the State Board of Education must use accrual accounting, and it may not administratively adopt another method, to determine the Fund’s market value for the distribution calculation. This will change the way the Fund’s market value is calculated because accruals, such as investment income earned but not yet received, previously had not been included in the calculation. The opinion also requires the exclusion from the market value calculation of the Fund's cash held in the Office’s State Treasury account for purchasing additional real property, which is consistent with State Board of Education and Texas Education Agency practice.
Appendix

Objective, Scope, and Methodology

Objective

The objective of this audit was to express an opinion on the Permanent School Fund’s (Fund) financial statements for the fiscal year ended August 31, 2006.

Scope

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.

Methodology

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. Auditors 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. Auditors also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts.

Project Information

Audit fieldwork was conducted from November 2006 through February 2007. This audit was conducted in accordance with generally accepted government auditing standards.

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

- Roger A. Ferris, CPA (Project Manager)
- Ron Zinsitz, CPA, CIDA (Assistant Project Manager)
- Kristin Alexander, CIA
- Annette Banks, MPA, CGAP
- Michael Clayton, CPA, CFE
- Gary Leach, MBA, CISA, CQA
- Hugh Ohn, CPA, CFA, CIA
- Cherisse Robison, MPAff
- Michael Yokie, CISA
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Verma Elliott, MBA, CIA, CGAP (Audit Manager)