



John Keel, CPA
State Auditor

An Audit Report on

Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2013

April 17, 2014

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, for the fiscal year ended August 31, 2013, the amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within the limits applicable to the Program. As of August 31, 2013, the total principal of the 2,789 outstanding bond issues guaranteed by the Program was \$55.2 billion (see the attachment to this letter for a summary of the Program's activity during fiscal year 2013). In addition, as of that date, the bond guarantee capacity of the Program under the State Board of Education (Board) limit was \$76.8 billion, and the Board held in reserve \$3.8 billion of that capacity. The bond guarantee capacity under the Internal Revenue Service (IRS) limit was \$117.3 billion.

The Board's rules in the Texas Administrative Code set a limit on the Program's bond guarantee capacity of three times the cost value of the Fund, as permitted by Texas Education Code, Section 45.053(d). The Board's rules also allow the Board to hold guarantee capacity in reserve of no less than 5 percent of the Fund's capacity, as permitted by Texas Education Code, Section 45.0531(a). The Board may use the reserve to award guarantees to school districts with unforeseen catastrophes or emergencies that require renovation or replacement of school facilities as described in Title 19, Texas Administrative Code, Section 33.65(e)(2). IRS Notice 2010-5, issued on January 11, 2010, established another limit on the bond guarantee capacity of no more than 500 percent of the total cost of the assets held by the Fund as of December 16, 2009. That federal limit is intended to provide flexibility to state and local governments to obtain credit enhancement for tax-exempt bonds.

The guarantee saves school districts money by enhancing their bond ratings to the highest possible rating. Without the Program's guarantee, school districts would need to (1) purchase private bond insurance or (2) pay higher interest rates on the bonds they sell.

Objective, Scope, and Methodology

The objective of this audit was to determine whether the total amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within applicable statutory limits.

The scope of this audit covered the Fund's valuation and all bonds guaranteed by the Fund at the end of fiscal year 2013.

To determine the accuracy of the internally managed investment data, auditors selected a nonstatistical sample of 30 purchases primarily through random selection designed to be representative of the population. Auditors used professional judgment to select two additional purchases for testing. Auditors also performed procedures on access and application report controls over internally managed investments and reviewed externally managed investments service organizations' control reports. In addition, auditors performed procedures on the outstanding bond guarantee reconciliations performed by the Fund. Based on this work, auditors determined that the investment and bond data was sufficiently reliable for purposes of this audit.

Audit fieldwork was conducted from February 2014 through March 2014. We conducted this performance audit in accordance with generally accepted governmental auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The following staff of the State Auditor's Office performed the audit:

- William J. Morris, CPA (Project Manager)
- Jennifer Ranea Robinson, CPA, MBA (Assistant Project Manager)
- Charles P. Dunlap, Jr., CPA (Quality Control Reviewer)
- Hillary Eckford, CIA (Audit Manager)

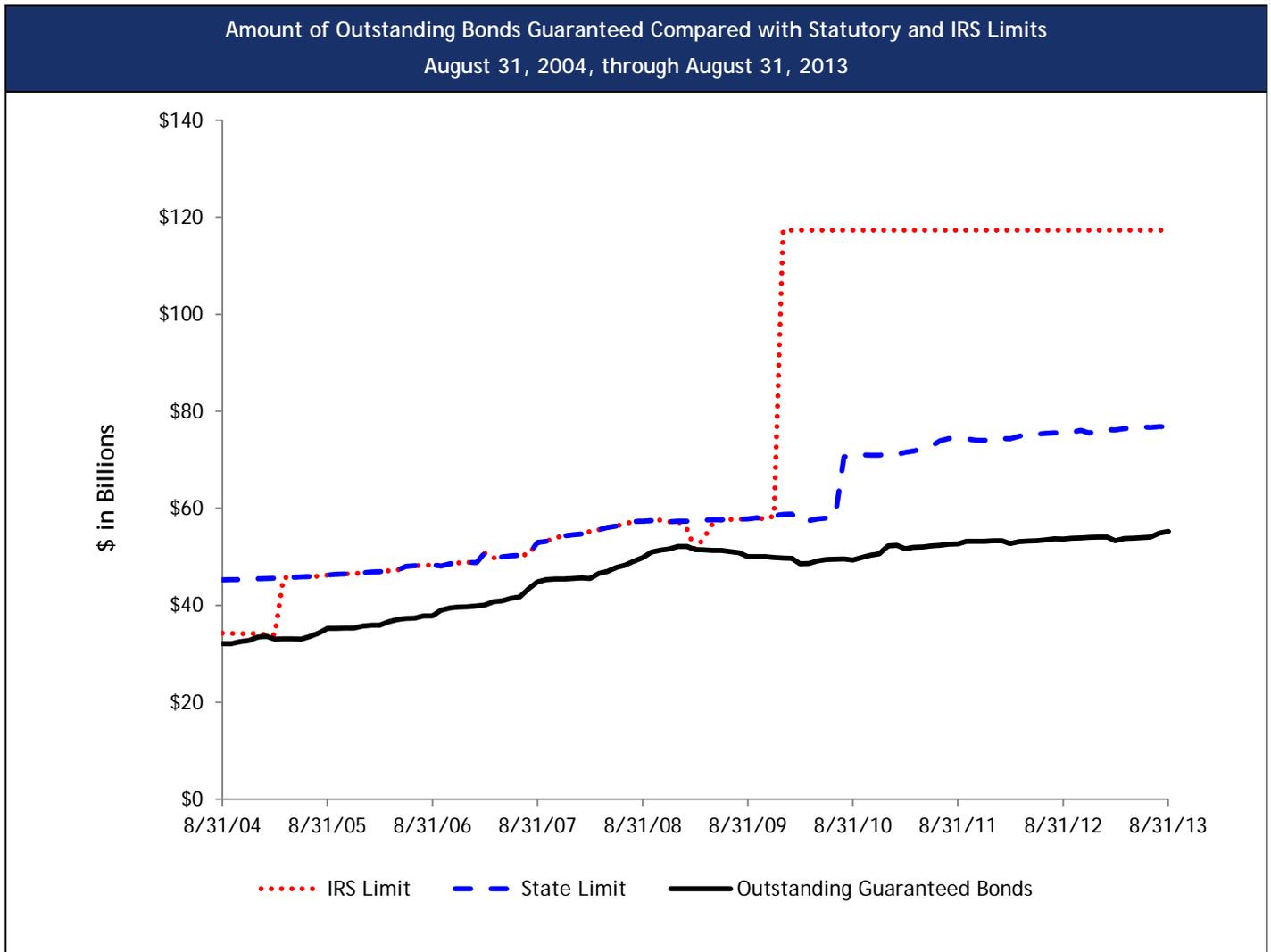
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The Program’s remaining statutory capacity, net of the Board’s \$3.8 billion reserve, was \$17.8 billion at the end of fiscal year 2013.

The attachment to this letter provides additional information on the Program’s fiscal year 2013 activity. As of August 31, 2013, the Program could guarantee an additional \$17.8 billion in bonds before reaching the limit imposed by the Board, net of its \$3.8 billion reserve.

Figure 1 shows the amounts of outstanding bonds guaranteed and the statutory and IRS guarantee limits from August 31, 2004, through August 31, 2013. The Board’s additional reserve is not presented in the graph.

Figure 1



Source: Permanent School Fund’s Bond Guarantee Program Capacity Calculations.

Recent changes have been made to Program statutes and rules.

The 82nd Legislature passed Senate Bill 1, which contained a provision that called for the inclusion of charter schools in the Program. That provision went into effect on September 28, 2011. In October 2011, the State of Texas requested an IRS ruling on whether the inclusion of charter schools in the Program might cause the Program to violate current arbitrage laws, which could result in the loss of the Program's tax-free status. The U.S. Treasury and IRS published proposed rules in the *Federal Register* for September 16, 2013¹, that would extend the guarantee of tax-exempt bonds to include charter schools. Final IRS rules had not been published as of March 2014. The Fund plans to award the first bond guarantees to charter schools during fiscal year 2014, as allowed by the proposed IRS rules.

We appreciate the Texas Education Agency's cooperation during this audit, particularly the cooperation of staff of the Permanent School Fund. If you have any questions, please contact Hillary Eckford, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the State Board of Education

Ms. Barbara Cargill, Chair
Mr. Thomas Ratliff, Vice Chair
Ms. Mavis B. Knight, Secretary
Mr. Lawrence A. Allen, Jr.
Ms. Donna Bahorich
Mr. David Bradley
Mr. Ruben Cortez, Jr.
Dr. Martha M. Dominguez
Ms. Patricia Hardy
Mr. Tom Maynard
Ms. Sue Melton-Malone
Mr. Ken Mercer
Ms. Geraldine "Tincy" Miller
Ms. Marisa B. Perez
Mr. Marty Rowley

Texas Education Agency

Mr. Michael Williams, Commissioner of Education
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer,
Permanent School Fund

¹ See *Federal Register* 78 (September 16, 2013), page 56847.



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Attachment

Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2013 activity for the Permanent School Fund's Bond Guarantee Program (Program). Tables 1 and 2 show the changes in the number and dollar amount of outstanding bonds guaranteed by the Program.

Table 1

Number of Guaranteed Bonds Outstanding	
Category	Number of Issues
Balance on August 31, 2012	2,634
Issued during fiscal year 2013	345
Issues that matured during fiscal year 2013	(134)
Issues that refunded during fiscal year 2013	<u>(56)</u>
Balance on August 31, 2013	2,789

Source: Supplementary information in the Permanent School Fund's *Annual Financial Report for the Fiscal Year Ending August 31, 2013*.

Table 2

Dollar Amount of Guaranteed Bonds Outstanding	
Category	Dollar Amount of Issues
Balance on August 31, 2012	\$ 53,634,455,141
Issued during fiscal year 2013	8,565,825,610
Issues that matured during fiscal year 2013	(1,917,815,299)
Issues that refunded during fiscal year 2013	(5,105,754,130)
Other adjustments	<u>42,177,834</u>
Balance on August 31, 2013	\$55,218,889,156

Source: Supplementary information in the Permanent School Fund's *Annual Financial Report for the Fiscal Year Ending August 31, 2013*.