



A Report on

The Audit of **the Permanent School Fund's** Fiscal Year 2017 Financial Statements

December 29, 2017

Members of the Legislative Audit Committee:

In our audit report dated December 20, 2017, we concluded that the Permanent School Fund's (The Fund) basic financial statements for fiscal year 2017 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. The Fund published our audit report as part of its basic financial statements, which it intends to post on its Web site at www.tea.texas.gov.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards (that report, including responses from management, is presented in the attachment to this letter). In that report, auditors identified a significant deficiency in the General Land Office's disclosure of the existence of certain related investment entities.

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. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting or on compliance with laws and regulations.

Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the Fund's management.

As required by auditing standards, we will also communicate to the State Board of Education and School Land Board certain matters related to the conduct of a financial statement audit.

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

Sincerely,

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

Attachment

SAO Report No. 18-013

cc: The Honorable Greg Abbott, Governor
Members of the State Board of Education

Ms. Donna Bahorich, Chair

Mr. Marty Rowley, Vice Chair

Mr. Lawrence A. Allen, Jr.

Ms. Erika Beltran

Mr. David Bradley

Ms. Barbara Cargill

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Mr. Ken Mercer

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Ms. Georgina C. Pérez

Ms. Marisa B. Perez-Diaz

Texas Education Agency

Mr. Mike Morath, Commissioner of Education

Mr. Holland Timmins, Executive Administrator and Chief Investment Officer, Permanent School Fund

General Land Office and School Land Board

The Honorable George P. Bush, Land Commissioner and Chairman of the School Land Board

Mr. Gilbert Burciaga, School Land Board Member

Mr. Scott Rohrman, School Land Board Member

Mr. Mark Havens, Chief Clerk



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Attachment

Section 1

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters as Required by Auditing Standards



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

Independent Auditor's Report

Members of the State Board of Education
Members of the School Land Board

We have audited, in accordance with the 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, the financial statements of the Permanent School Fund (Fund) as of and for the year ended August 31, 2017, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements and have issued our report thereon dated December 20, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we

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consider to be material weaknesses. We did identify a certain deficiency in internal control described in the accompanying schedule of findings and responses that we consider to be a significant deficiency.

Summary of Findings and Responses
Finding Number
2017-1

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, 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*.

Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the Fund's management.

Fund's Response to Findings

The Fund's response to the finding identified in our audit is described in the accompanying schedule of findings and responses. The Fund's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control over financial reporting and compliance. Accordingly, this communication is not suitable for any other purpose.

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

December 20, 2017

Schedule of Findings and Responses

Section 1

The Office Did Not Disclose the Existence of Certain Related Investment Entities

Reference No. 2017-1

Type of finding: Significant Deficiency

The General Land Office (Office) did not disclose in the notes to the Permanent School Fund's (Fund) financial statements the existence of certain related investment entities as required by accounting and reporting standards. Those related investment entities were limited liability companies created for and on behalf of the State of Texas for the use and benefit of the Fund to make, hold, and dispose of certain investments. The related investment entities shared management with the Fund. In addition, the nature of the relationship of those related investment entities was not communicated to the Office's financial management group to promote disclosure. The Office also did not have policies and procedures designed to govern why the related investment entities would be established and how they would be used, managed, and dissolved when no longer needed.

As of November 2017, auditors had identified 20 related investment entities that should be disclosed as related entities in the notes to the Fund's financial statements. The balances of the Fund investments held by related investment entities totaled \$470.5 million at August 31, 2017. Although there are no regulations to prohibit the Fund from using related investment entities in this manner, without adequate internal guidance and monitoring, and required disclosure of those relationships, there are significant risks, including fraud or misstatement.

Recommendations

The Office should:

- Develop policies and implement procedures to govern the creation, use, and dissolution of limited liability companies created by the Office and establish monitoring procedures to ensure that those investment entities are used for the purpose intended and within the guidance established.
- Strengthen its policies and procedures to ensure that all related investment entities are identified and disclosed as required.

Schedule of Findings and Responses
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- Improve communication regarding the disclosure of related investment entities and the risks associated with those investment entities.

Management's Response

Management concurs with the recommendation. Financial Management will strengthen its ability to ensure all limited liability companies are identified, monitored, and disclosed as required. To do this, a Full-Time Employee will be transferred to the Financial Reporting and Accounting Team effective February 1, 2018. This position will primarily focus on performing various investment analytics including developing necessary policies and procedures related to investment accounting and reporting. Additionally, the CFO or designee will begin to attend the School Land Board (SLB) and Investment Advisory Committee (IAC) meetings and will establish a process of communicating relevant information within the Financial Management Division to ensure accurate reporting and analysis.

Contact Person - Director, Financial Reporting & Accounting; Financial Management

Implementation date - March 1, 2018