January 18, 2019

Members of the Legislative Audit Committee:

In our audit report dated December 20, 2018, we concluded that the Permanent School Fund’s (the Fund) basic financial statements for fiscal year 2018 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 will be posted 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 that the General Land Office’s oil and gas mineral reserve valuation did not accurately reflect the value of the underlying mineral reserve holdings.

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 Michael Clayton, Audit Manager, or me at (512) 936-9500.

Sincerely,

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

Attachment
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. Barbara Cargill
   Mr. Ruben Cortez, Jr.
   Ms. Aicha Davis
   Dr. Keven Ellis
   Ms. Patricia Hardy
   Ms. Pam Little
   Mr. Tom Maynard
   Ms. Sue Melton-Malone
   Mr. Ken Mercer
   Ms. Georgina C. Pérez
   Ms. Marisa B. Perez-Diaz
   Dr. Matt Robinson
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
Attachment

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

State Auditor's Office

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, 2018, 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, 2018.

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

SAO Report No. 19-305
Summary of Findings and Responses

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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.

The 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, 2018
Schedule of Findings and Responses

Section 1
The Office’s Oil and Gas Mineral Reserve Valuation Did Not Accurately Reflect the Value of the Underlying Mineral Reserve Holdings

Reference No. 2018-1
Type of finding: Significant Deficiency

Mineral Holdings and Valuation
The General Land Office (Office) has oil and natural gas mineral interest in approximately 13.1 million acres of land and water bodies within Texas. Land owners (either the Office or others) lease this land to entities that drill and construct wells to extract the oil and gas from the land. When the lease holders extract the oil and gas, the Office receives a portion of the income (known as royalties) from the lease holders. Additionally, the Office is responsible for estimating the value of the remaining oil and gas reserves of stored but not yet extracted oil and gas and reporting that amount in its financial statements.
Source: General Land Office.

The General Land Office’s (Office) oil and gas mineral reserve valuation did not include all Permanent School Fund (Fund) mineral holdings, resulting in the Fund inaccurately reporting the value of the underlying mineral holdings (see text box for more information about the Office’s mineral holdings). The Office reported that the value of the Fund’s oil and gas mineral holdings at August 31, 2018, was $2 billion. Revenues recognized on those holdings totaled $804 million for the year.

Government Accounting Standards Board Statement No. 72, Fair Value Measurement and Application, requires that governmental entities report oil and gas royalty holdings at fair value. To comply with that requirement, the Office used a third-party valuation specialist to calculate the estimated value of those holdings. The Office provided the specialist a list of oil and gas wells in which the Fund owns a mineral royalty interest. The list provided to the specialist did not include 716 mineral holdings on which the Fund earned royalties of approximately $237 million in fiscal year 2018.

Those 716 mineral holdings were not included because the Office’s process did not include verification of the completeness and accuracy of the information prior to submitting it to the valuation specialist. The Office asserted that the minerals holdings had been incorrectly excluded due to errors in the mineral holding source data.

Not verifying the accuracy and completeness of the information it sends to the valuation specialist resulted in the Office reporting inaccurate mineral reserve valuations on its financial statements. This resulted in assets being understated by $437.8 million for the year ended August 31, 2018.
Recommendation

The Office should implement a process to ensure that it obtains and sends accurate mineral holding data to the specialist for use in calculating the mineral reserve valuation.

Management's Response

The Agency concurs with the recommendation.

A verification process to confirm the accuracy and completeness of the inventory of PSF oil and gas wells submitted to the third-party mineral valuation specialist will be implemented beginning with the FY2019 mineral valuation. All PSF mineral holdings extracted from the Agency’s well inventory source data for use by the specialist will be matched by the mineral lease number to the monthly oil and gas production reports received by the Agency for PSF mineral holdings during the same period. Any differences will be investigated and included, if appropriate, prior to submitting the mineral holding data to the specialist.

Contact Person - Deputy Director of Energy Resources

Implementation Date: June 1, 2019