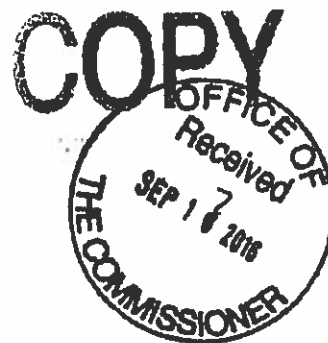




STATE AUDITOR'S OFFICE

SEP 28 2016

RECEIVED



September 13, 2016

Mr. Mike Morath, Commissioner of Education
Texas Education Agency
1701 North Congress Avenue
Austin, TX 78701-1494

Subject: Engagement Letter for an Audit of the Permanent School Fund's Financial Statements for Fiscal Year 2016

Dear Commissioner Morath:

This letter outlines the understanding of the State Auditor's Office with respect to the audit of the Permanent School Fund (Fund) for the fiscal year ended August 31, 2016.

The objectives of our audit are as follows:

- Express an opinion on whether the Fund's fiscal year 2016 financial statements are fairly presented, in all material respects, in conformity with U. S. generally accepted accounting principles.
- Report on any significant deficiencies and material weaknesses in internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements based on an audit of financial statements performed in accordance with the standards applicable to financial audits contained in Government Auditing Standards.
- Determine whether the total amount of school district and charter district bonds the Permanent School Fund Bond Guarantee Program guarantees is within the limits established by state statute.

The Management Discussion and Analysis is not part of the basic financial statements but is required by the Governmental Accounting Standards Board. Such information will be subjected to limited procedures in accordance with auditing standards generally accepted in the United States of America. We will not express an opinion or provide any assurance on that information.

The Introduction, Statistical Summary, Bond Guarantee Program, and Supplemental Schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. We will not audit that information or express an opinion on it.

Robert E. Johnson Building
1501 N. Congress Avenue
Austin, Texas 78701

P.O. Box 12067
Austin, Texas 78711-2067

Phone:
(512) 936-9500

Fax:
(512) 936-9400

MANAGEMENT'S RESPONSIBILITIES

Our audit will be conducted on the basis that Fund management acknowledges and understands that it is responsible for:

- The preparation and fair presentation of the Fund's financial statements in accordance with accounting principles generally accepted in the United States of America and the selection and application of the accounting policies.
- The design, implementation, and maintenance of internal control over compliance and internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
- Designing and implementing programs and controls to prevent and detect fraud.
- Identifying and ensuring that the Fund complies with laws, regulations, and the provisions of contracts and grants applicable to its activities.
- Providing (1) access to all records and information that are relevant to the preparation and fair presentation of the financial statements and to compliance with provisions of laws, regulations, contracts, and grant agreements; (2) access to additional information that the auditor may request for the purpose of the audit; and (3) unrestricted access to persons within the Fund from whom auditors determine it is necessary to obtain audit evidence.
- Adjusting the financial statements to correct material misstatements and for affirming to the auditor in the management representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in aggregate, to the financial statements taken as a whole.
- The audit does not relieve management or those charged with governance of their responsibilities.

In accordance with *Government Auditing Standards*, as part of our audit planning, we will evaluate whether management has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. To assist us, management agrees to identify previous audits, attestation engagements, or other studies that relate to the objectives of the audit, including whether related recommendations have been implemented, prior to first day of audit fieldwork.

At the conclusion of the engagement, management will provide the State Auditor's Office with a letter that confirms certain representations made during the audit. We will provide a draft representation letter for management to review at a later date. The representations in that letter should be completed and dated December 20, 2016. At the end of the audit, we will also request a legal representation letter that lists all outstanding lawsuits, and that letter should be dated December 20, 2016.

AUDITOR'S RESPONSIBILITIES AND SCOPE OF WORK

We are responsible for conducting the audit in accordance with generally accepted government auditing standards. These standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with generally accepted auditing standards. In addition, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

An audit includes obtaining an understanding of the Fund and its environment, including its internal control, sufficient to (1) assess the risks of material misstatement of the financial statements and (2) design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for ensuring that those charged with governance are aware of any deficiencies in internal control that come to our attention.

In the interest of facilitating the audit, the State Auditor's Office plans to use a desktop screen-sharing tool to obtain and observe audit documentation in limited circumstances. The desktop screen-sharing tool is a secure communication tool that is housed and operated by the State Auditor's Office, and it does not involve third-party or "cloud" services. While the use of that tool is not required, if the Fund chooses to use that tool, your staff will not need to install executable programs because the desktop screen-sharing tool is entirely accessible through a standard Internet browser.

To begin evaluating those areas, we request that current information be provided as soon as possible regarding any noncompliance, errors, fraudulent activity, or misappropriation of assets that are known or are presently under investigation.

Auditing standards require our auditors to exercise professional skepticism and increased awareness to detect potential violations, fraud, and abuse. As a result, interviews with employees at all levels as appropriate will include specific questions to help us assess fraud risk at the Fund.

In accordance with *Government Auditing Standards*, in certain circumstances we are also required to report fraud, noncompliance, or abuse directly to parties outside of the Fund.

STATE AUDITOR'S OFFICE CONTACTS

Michael Clayton is the audit manager overseeing the audit and can be reached at (512) 936-9500 or Michael.Clayton@sao.texas.gov. Greg Adams is the overall project manager and can be reached at 512-936-9673 or Greg.Adams@sao.texas.gov. The onsite team leader for the work will contact the Fund's internal auditor regarding the details of this engagement, including the timing of fieldwork.

Your contact manager, who serves as your resource for information and assistance throughout the year, is Jim Timberlake. He is kept informed of all audit projects related to the Fund. Please feel free to contact him regarding any questions, suggestions, concerns, or comments about this project or any other issue.

A copy of the most recent external quality control review report on the State Auditor's Office is available at <http://www.sao.texas.gov/About/PeerReviews/>. *Government Auditing Standards* include a requirement for audit organizations to have an external review every three years. The most recent review found that the State Auditor's Office conducts audits in accordance with auditing standards.

AUDIT FINDINGS AND RESULTS

Findings or exceptions noted will be provided to management for written responses. A written management response to the findings is expected within 10 working days of receipt. However, the response time may be fewer than 10 working days, based on the significance of any issues identified during the engagement. A draft of our findings and recommendations will be delivered to management prior to the exit conference.

Management's final responses, including corrective action plans for findings, should be typed on Fund letterhead and accompanied by your signature. In certain circumstances, auditor follow-up comments may be included in the findings.

The results of the Fund's 2016 financial statement audit will be issued in a written report (opinion). We cannot provide assurance that an unmodified opinion will be expressed. Circumstances may arise in which it is necessary for us to modify our opinion or withdraw from the engagement. The written report on the Fund's internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements will be issued on completion of the audit. We will also summarize the results of our audit in two reports to the

Mr. Mike Morath, Commissioner of Education
September 13, 2016
Page 5

Legislative Audit Committee and communicate certain matters required by auditing standards to those charged with governance.

ESTIMATED CHARGES

Reimbursement to the State Auditor's Office for audit work performed for the State of Texas for fiscal year 2016 to meet the requirements of the Single Audit Act of 1996 and Title 2, U.S. Code of Federal Regulations, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, is authorized by Article X of the State's General Appropriations Act and the Interagency Cooperation Act (Texas Government Code, Chapter 771). The State Auditor's Office will invoice the Fund for services provided. The Fund shall reimburse the State Auditor's Office within thirty (30) days after the receipt of invoices from the State Auditor's Office from appropriation items or accounts from which like expenditures normally would be paid for similar resources, based upon vouchers drawn by the Fund payable to the State Auditor's Office. The State Auditor's Office will credit Fund payments to current appropriation item(s) or account(s) from which the expenditures of that character originally were made. Payment shall be made in accordance with Texas Government Code, Section 771.008.

Based on our preliminary estimates of the work to be done and an hourly rate of \$90, we estimate the billing will be \$120,500.

That estimate may change as the audit progresses. Any significant changes in the estimated billing will be discussed with management at the time the changes are identified.

CONCLUDING REMARKS

We are currently gathering information to assist with the planning phase of the audit. To avoid duplicating audit efforts, we will coordinate our work with your internal auditor. We have also prepared an engagement expectations memo to document what the Fund can expect from the State Auditor's Office and what the State Auditor's Office can expect from the Fund (see attachment).

We anticipate completing our onsite audit work by December 20, 2016.

Our office looks forward to working with the Fund's personnel over the next few months.

If the terms of this engagement as outlined above are acceptable, please indicate by signing below. Please return this letter to the State Auditor's Office. THE UNDERSIGNED PARTIES do hereby certify that (1) the services specified above are necessary and essential for activities that are properly within the statutory functions and programs of the affected agencies of State Government; (2) the proposed arrangement serves the interest of the economical administration of the State Government, and (3) the services, supplies, or material that are the subject of this

Mr. Mike Morath, Commissioner of Education
September 13, 2016
Page 6

agreement are not required by Section 21 of Article 16 of the Constitution of Texas to be supplied under contract given to the lowest responsible bidder. The Fund further certifies that it has the authority to contract for the above services.

The undersigned parties bind themselves to the faithful performance of this agreement.

Sincerely,



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

Enclosure/Attachment

cc: **Members of the State Board of Education**

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

Ms. Kara Belew, Chief Deputy, Texas Education Agency
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer,
Permanent School Fund
Ms. Catherine Civileto, CPA, Deputy Executive Administrator, Permanent School Fund
Mr. William Wilson, CPA, CIA, Director of Internal Audit, Texas Education Agency

Mr. Mike Morath, Commissioner of Education
September 13, 2016
Page 7

Acknowledged and agreed to on behalf of Permanent School Fund by:



B.1. PRG

Name

Commissioner

Title

9/23/16

Date

ENGAGEMENT EXPECTATIONS BETWEEN THE STATE AUDITOR'S OFFICE (SAO) AND THE PERMANENT SCHOOL FUND (TEXAS EDUCATION AGENCY)

Introduction

The SAO and the Permanent School Fund (Fund) shall develop an engagement expectations memo to establish what the Fund can expect from the SAO and what the SAO can expect from the Fund.

If the Fund has an internal audit function, the SAO will work with internal audit to coordinate the audit work unless Fund management specifically asks the SAO to do otherwise.

The SAO's Commitment to the Fund

To achieve its mission to actively provide government leaders with useful information that improves accountability, the SAO is committed to the highest level of professional standards. The SAO will be professional, objective, fact-based, nonpartisan, nonideological, fair, and balanced in its approach.

The SAO performs its audits in accordance with generally accepted government auditing standards (GAGAS or the "Yellow Book" standards, which can be found at <http://www.gao.gov/assets/590/587281.pdf>).

The Fund's Rights

The Fund has the right to:

- Share its concerns about the audited area(s) so that the auditors may consider expanding the scope of work.
- Be briefed on the status of the audit.
- Receive notice of audit findings and recommendations prior to issuance of the audit report.
- Have management's views concerning findings, conclusions, and recommendations included in the audit report.

Types of Audits

The work that the SAO performs is described in Texas Government Code, Chapter 321, and includes:

- Financial audits.
- Compliance audits.
- Economy and efficiency audits.
- Effectiveness audits.
- Special audits, investigations, and other projects approved by the Legislative Audit Committee.

Access to the Fund's Information

The SAO must have unrestricted access to all personnel, records, files, internal audit working papers, and other confidential and nonconfidential information needed to conduct the audit. The SAO has the legal right to this access, as established in Texas Government Code, Sections 321.013(e) and 2262.154, and other law. Some of these records may include confidential and/or proprietary information.

With regard to these records:

- If records must be locked up while the SAO is on site, the Fund will provide a suitable, secure storage space for the records.
- The Fund will provide or facilitate access to the records the SAO requests in a timely manner. This may include notifying all Fund staff of the expectation that they be candid with auditors and offer full disclosure when responding to SAO information requests.

Communication Between the SAO and the Fund

The SAO is committed to maintaining constructive and continuing communication with audited entities. The Fund agrees to place no restrictions on the communication between its staff and SAO auditors. To ensure there are no limitations on the scope of the engagement, the Fund agrees that its staff will not be required to provide detailed write-ups or accounts of their communications with SAO auditors to Fund management – as this could unintentionally result in restrictions on the communication. Routine communication between Fund management and staff regarding the audit is expected.

If the SAO auditors become aware that Fund staff are being required to provide detailed write-ups or reports back to management, we will evaluate whether this activity creates a scope limitation and, if so, the audit report will be modified to include that determination.

Communication may include the following (not necessarily in this order):

- Before beginning any new audit, the SAO seeks to obtain information and data from the Fund. To obtain this information, the SAO will contact Fund management's designee regarding the audit's subject and objectives.
- The SAO will work with the Fund's management or its designee to make arrangements for work space, telephones, computer access, security badges, and parking (if necessary) prior to SAO auditors' moving on site.
- The SAO may conduct preliminary interviews and obtain documentation to gain an understanding of the Fund's processes before the entrance conference. In addition, the SAO will conduct interviews with various personnel at the Fund throughout the audit.
- Fund Management's designee will notify staff at the Fund about the potential for the SAO to contact them.
- If gaining access to systems at the Fund requires that SAO auditors follow special processes, Fund management's designee will notify the SAO within two weeks of the date that the Fund is notified concerning the audit.
- The SAO will provide the Fund with an engagement letter informing the entity of the planned audit, its scope and objectives, how the audit will be conducted, and the report(s) to be produced. The SAO will address the engagement letter to the Commissioner of Education and provide copies to board members and the Director of Internal Audit. This memorandum will be attached to the engagement letter.
- The SAO will hold an entrance conference with officials of the Fund at the start of an engagement to discuss (1) the reasons for the audit work; (2) information needs, including any special precautions necessary to protect data; (3) an estimate of how long the work will take, to the extent possible; and (4) the cost of the audit, if applicable.

- To ensure that auditing standards are met and that the audit scope is not limited, only invited employees of the Fund will attend interviews or walk-throughs that the SAO conducts unless the SAO project team agrees to another arrangement prior to the interview or walk-through.
- Audit issues are normally handled by discussing potential issues with the relevant staff and supervisors of the Fund. Issues that are not resolved are discussed at status update meetings.
- The SAO will provide the Fund with periodic updates on the status of the audit and potential issues according to a schedule that is jointly determined by the SAO and the Fund.
 - SAO representatives attending these update meetings will include the audit manager, project manager, and team members as needed.
 - The Fund's representative(s) attending these update meetings should include the head of the Fund (or his designee), the internal auditor, and the head of the audited area. Other individuals may be designated as needed.
- The SAO will offer to hold an exit conference with management to discuss the final audit results.
- Six weeks after the report is released, the SAO will provide you with an automated survey to obtain feedback about the audit. Completing this survey is voluntary.

Significant Changes

The SAO's plan for conducting the audit may change because of information reviewed during the course of the audit, staff turnover, or other resource issues. The SAO will inform the Fund as soon as possible to communicate significant changes in:

- Project manager or other key team members.
- Audit scope or objectives.
- Project completion date.

Draft Reports and Fund Comments

The SAO will discuss the preliminary findings and recommendations with the Fund during the audit. At the conclusion of fieldwork, the SAO will send the Fund the report draft for management's responses to findings and recommendations.

The Fund will have the opportunity to provide responses within the required time frames. The typical allotted response time is two weeks. However, the response time may be less than two weeks, based on the significance of the issues identified.

The SAO will ask management of the Fund to sign a representation letter for all audit engagements. This letter clarifies the roles of auditors and management and confirms that management has provided SAO auditors with all relevant and complete data.

Report Distribution

Draft reports are considered audit working papers under the Public Information Act. As such, they are not intended for public distribution.

Contacts

Primary contacts for each entity are listed below.

SAO:

Name	Title
Michael Clayton	Audit Manager
Greg Adams	Project Manager

General Land Office

Name	Title
Mr. Holland Timmins	Executive Administrator and Chief Investment Officer
Ms. Catherine Civiletto	Deputy Executive Administrator
Ms. Deborah Saunders	Director of Investment Operations
Mr. William Wilson	Director of Internal Audit
Ms. Kara Belew	Chief Deputy