

Secretary of State Audit Report

Kate Brown, Secretary of State

Gary Blackmer, Director, Audits Division



Department of State Lands: Improve Accounting of Common School Fund

Summary

The Common School Fund (Fund) was established at statehood and is intended to generate earnings to distribute to public schools. The State Land Board is the trustee and the Department of State Lands (Department) is the administrative agency of the Fund. The distributable portion of the Fund is mainly generated from investment earnings. Based on the Fund balance, the State Land Board (Board) determines the amounts to distribute to public schools. The Board has sought to maintain a stable level of distributions to schools by retaining excess earnings to help smooth distributions during years when earnings are less.

The purpose of this audit was to gain an understanding of how the Department administers the Common School Fund, which includes unclaimed property principal, other principal and the distributable income account. To provide better information to the State Land Board for managing the Fund, we found the Department could improve its accounting of the Fund and these three components. We found that \$75.7 million in Fund principal was inappropriately distributed to schools from 2001-2007. In addition, although the Department correctly reported the Fund was increasing, it did not disclose that a large portion of the increase was due to an increasing unclaimed property balance, which the State does not own but serves as custodian. We found that the portion of the Fund owned by the State, the other principal and distributable income account, has declined by about \$109.3 million (16%) over the last 10 years due to distributions exceeding net earnings, including investment losses.

We recommend the Department separately account and regularly report to the Board on the components of the Fund and set up a payment schedule to repay \$75.7 million to the Fund principal.

Agency Response

The agency response is at the end of this report.

Background

The Common School Fund (Fund) was established at statehood when the federal government granted about 6% of Oregon's land for the support of K-12 public education. Article VIII of the Oregon Constitution governs the management of the Fund and specifies the standards for the distribution of monies from the Fund to public schools.

The Constitution also created the State Land Board (Board), which consists of the Governor, the Secretary of State, and the State Treasurer. The Board is the trustee of the Fund with its main goal being to obtain the greatest benefit for public schools while conserving the Fund principal. The Board is responsible for the management of assets in the Fund, including state lands and resources, submerged and submersible lands, and escheated and forfeited property. The Oregon Investment Council manages the Fund's investments. In managing the Fund, the Board makes determinations regarding the distribution of monies from the Fund for public education. The Department of State Lands (Department) is the administrative agency of the Board and under the Board's jurisdiction the Department administers the Fund and manages state lands. The Legislature designated the Department to also be the trust agent for unclaimed property and directed the income derived from unclaimed property be deposited in the Fund's distributable income account.

Common School Fund Components

Other Principal

The Fund's other principal primarily includes revenues from sales of mineral and timber resources, leases of rangelands and waterways, and sales of state lands.

The Oregon constitution only allows Fund principal to be spent on the management of dedicated lands and operations of the Board. Acting as trustee of the Fund, the Board must administer the Fund in accordance with strict trust principles. Attorney general opinions have consistently stated that neither the legislature nor the Board have the authority to distribute the principal derived from constitutional sources.

Initially, the principal of the Fund only included constitutionally-dedicated sources. Over time the Legislature has directed other revenue sources to the Fund principal. Because these additional revenues are derived from statutorily-dedicated sources, the Legislature retains the authority and may direct these resources to be distributed.

Unclaimed Property Principal

Under current law, unclaimed property is to be deposited in the Fund. Unclaimed property is any financial asset (e.g. bank accounts, dividend

proceeds, unpaid wages) that has been inactive for an extended period and is being held on behalf of a person or entity.

The State obtains custody but not title to unclaimed property and is required to hold the property until claimed by the rightful owner. Only the earnings derived from unclaimed property assets belong to the State. Unclaimed property consisted of about \$400 million in assets as of June 30, 2011.

Distributable Income Account

ORS 273.105 established the distributable income account within the Fund. The monies in this account are available for distribution to public schools. Investment earnings are the primary contributing source to this account. Over the years the laws governing this account have been amended to provide flexibility to the Board in managing the distributions to schools.

To ensure adequate monies are in the account to distribute to schools, legislation was passed in 2005 that removed the requirement for investment losses to be deducted from the distributable income account. Investment losses could now be applied against the principal. Beginning in 2009, due to a change in Board policy, amounts not distributed are retained in the account instead of reinvested in the Fund principal. Board action is required to move undistributed amounts from the account to the Fund principal.

Investments

The State Treasurer and the Oregon Investment Council invest the Fund in accordance with policies adopted by the Oregon Investment Council, taking Board policies and concerns into consideration.

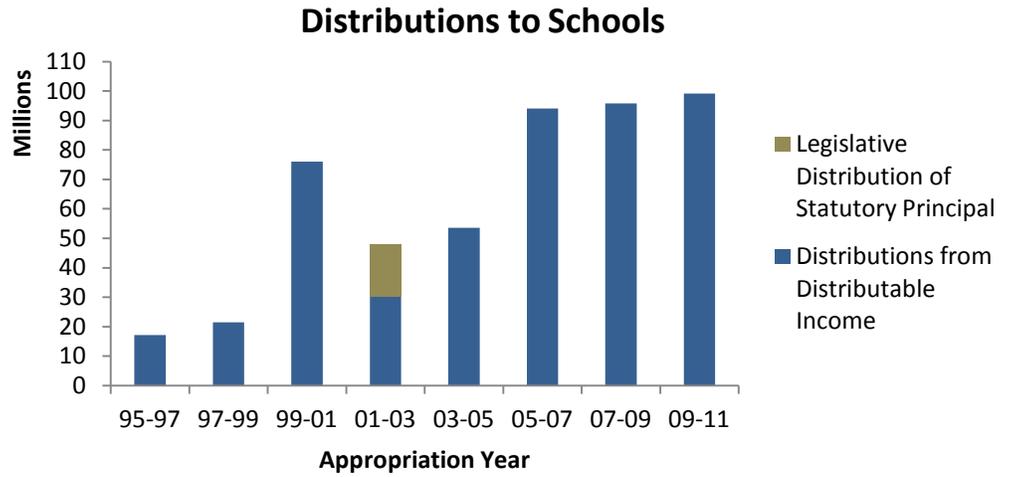
A main goal of the Board has been to grow the principal of the Fund as rapidly and as prudently possible. Over time, changes to Oregon law and investment policies were made to address the goal of Fund growth and increase investment earnings. In the last 10 years, the investment balance of the Fund has ranged from approximately \$700 million to over \$1 billion, depending on market conditions.

Distributions to Oregon Schools

The Oregon Constitution and legislation provide for the distribution of Fund monies to Oregon school districts. The Board makes semiannual distributions from the distributable income account to public schools. The distributions are based on a three-year rolling average of the fair value of the Fund's investments as of December 31 each year. In 2001-2003, the Legislature directed the Department to distribute to schools \$17.7 million of accumulated statutory revenue in Fund principal.

The Board has sought to maintain a stable level of school distributions for more predictable school budgeting decisions. Nonetheless, during the

past several years, distributions have fluctuated along with the fluctuations in the investment values of the Fund. To help compensate for these fluctuations, in 2009 the Board decided to retain some excess earnings in the distributable income account to help smooth distributions to schools when earnings are less.



Audit Results

To provide better information to the State Land Board for managing the Fund, we found the Department could improve its accounting of the Fund, which includes unclaimed property principal, other principal and the distributable income account. We found that \$75.7 million in Fund principal was inappropriately distributed to schools from 2001-2007. In addition, although the Department correctly reported the Fund was increasing, it did not disclose that a large portion of the increase was due to an increasing unclaimed property balance, which the State does not own but serves as the custodian. We found that the portion of the Fund owned by the State, the other principal and distributable income account, has declined by about \$109.3 million (16%) over the last 10 years due to distributions exceeding net earnings, including investment losses.

Fund's Other Principal is Declining

Based on our analysis, over the last 10 fiscal years the Fund has increased in total by about \$173.6 million. This increase is due to an increase in unclaimed property of \$282.9 million and a net decrease in the other Fund components of \$109.3 million.

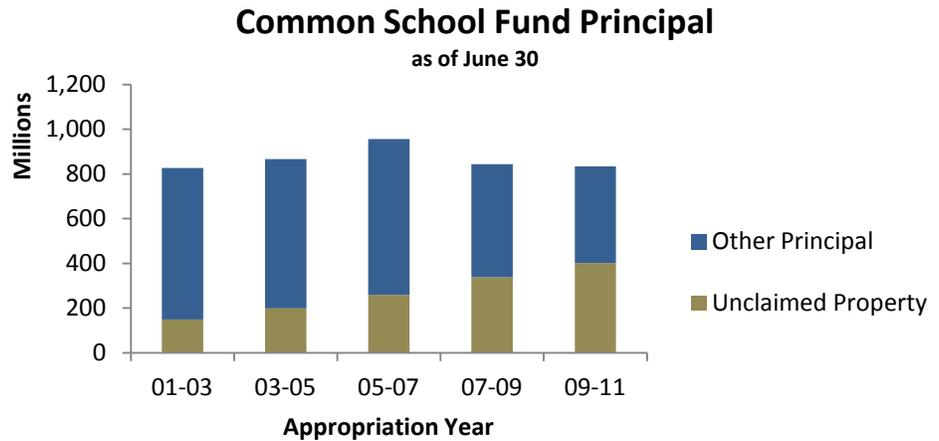
Results of Common School Fund Analysis

		Change in Balance
PRINCIPAL		
Unclaimed Property		
July 1, 2001 Balance	118,000,000	
Change in Unclaimed Property Assets	282,900,000	
June 30, 2011 Balance	\$ 400,900,000	\$ 282,900,000
Other Principal		
July 1, 2001 Balance (estimate)	685,000,000	
Net Principal Earnings	133,600,000	
Investment Losses (July 1, 2005 - June 30, 2011)	(310,200,000)	
School Distributions Paid by Principal	(75,700,000)	
June 30, 2011 Balance	\$ 432,700,000	\$ (252,300,000)
Common School Fund Principal Balance - June 30, 2011	\$ 833,600,000	
DISTRIBUTABLE INCOME ACCOUNT		
July 1, 2001 Balance (estimate)	0	
Net Distributable Income Earnings	440,200,000	
Plus Principal to Pay School Distributions	75,700,000	
Distributions to Schools	(372,900,000)	
June 30, 2011 Balance	\$ 143,000,000	\$ 143,000,000
COMMON SCHOOL FUND BALANCE- June 30, 2011	\$ 976,600,000	\$ 173,600,000

The other Fund principal has declined by \$252.3 million, primarily due to applying investment losses to the principal. Legislation was passed in 2005 allowing for investment losses to be applied against the principal instead of against the distributable income account. As a result, according to the Department, from 2006 through 2011 all investment losses were applied against the Fund’s principal. For our analysis, we did not apply any investment losses to unclaimed property principal because unclaimed property is not owned by the State and it is not impacted by changes to Fund principal.

In addition, from 2002 through 2007 distributions to schools exceeded the amounts available in the distributable income account, drawing down the Fund principal by \$75.7 million. The largest portion of this decline occurred in 2003-2005 when distributions to schools were \$53.5 million and the net earnings available to distribute were only \$3.2 million.

Over the 10 fiscal years reviewed, the Fund principal attributable to unclaimed property has consistently increased. The Fund’s other principal started to decline in 2007-2009 when significant investment losses were applied to the other principal.



No tracking of Distributable Income Account Balance

Although the Department was able to provide summary level Fund information, the Department was not able to provide separate balances for the Fund principal or the distributable income account. The Department was separately tracking the unclaimed property balance. During the course of our audit, the Department started tracking the distributable income account and was able to determine the account balance back to 2005-2007.

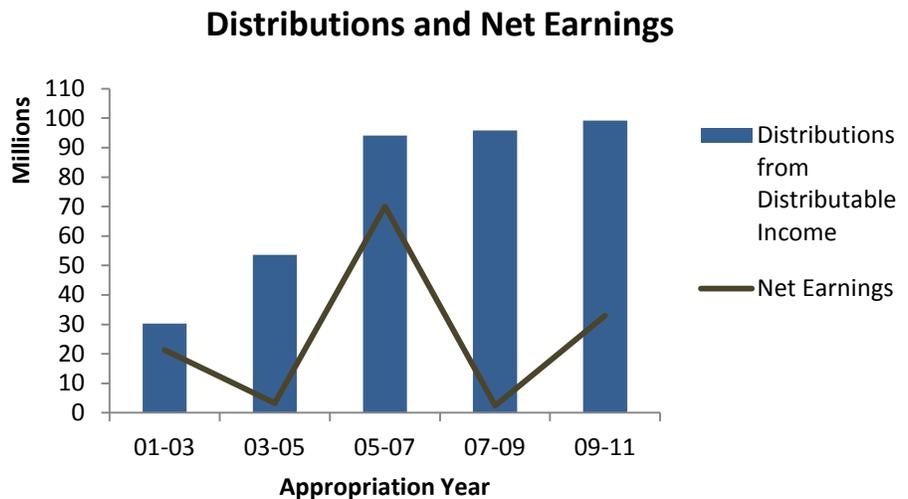
Numerous attorney general opinions discuss the distinct legal requirements that apply to the Fund principal, including unclaimed property, and distributable income, further supporting the need to separately track and account for these amounts.

The Board has a fiduciary responsibility to protect the principal of the Fund. The Board, through policy and other documentation, has clearly indicated there must be sufficient funds available for distribution without distributing the principal. The Board relies on the Department to provide sufficient management information regarding the Fund balance. Separately accounting for and safeguarding the principal balance becomes more important during economic downturns when resources and investment earnings tend to decline, and State General Funds are less able to meet budget needs.

Sustainability of Common School Fund at Risk

Starting in 2005, instead of netting investment losses and gains in the distributable income account, all losses from the sale of Fund investments were applied against the principal and all gains deposited in the distributable income account. During periods of sustained investment losses, this practice results in the decline of Fund principal. Declining principal will reduce potential earnings, and future distributions to schools must decline.

If all losses had been applied to the distributable income account, the distributions to schools would have exceeded net earnings available to distribute for the last 10 years.



Recommendations

We recommend Department management:

- Separately account for the types of Fund principal and distributable income.
- Provide sufficient management information to the State Land Board for decision-making, including Fund principal and distributable income account balances, actual investment earnings and losses, and the impacts to these balances for recorded losses.
- Repay the principal \$75.7 million for the years the distributions exceeded the amount in the distributable income account.
- Develop a policy for Board consideration that minimizes the long-term impact of investment losses on Fund principal.

Objectives, Scope and Methodology

The purpose of this audit was to gain an understanding of how the Department administers the Common School Fund. We interviewed Department personnel, reviewed background information, State Land Board minutes and policies, and other documentation provided by the Department. We also reviewed applicable Oregon Statutes and the Oregon Constitution, along with various changes made over time. We also reviewed attorney general opinions and advice providing clarification related to the Fund and unclaimed property.

Because the Department was only able to provide summary level Fund information and not separate balances for the Fund principal or the distributable income account, we prepared an analysis to identify changes to these components for appropriation years 2003 through 2011 (July 1, 2001 to June 30, 2011). We prepared our analysis using the following:

- Revenue, expense and school distribution amounts prepared by the Department for use in those appropriation years, excluding investment related amounts. We compared these balances to the Fund financial information included in the State of Oregon's financial statements and concluded the balances were reliable for the purpose of our analysis.
- Investments, investment income and expenses, and realized investment gains and losses obtained from the Fund's external investment custodian reports.
- Unclaimed property liability balances as reported in the State's financial system.

In addition, because the Department was not able to provide a balance for the Fund principal, we developed an estimate of the balance as of June 30, 2001. From the June 2001 Fund's investment report, we obtained the Fund's total net assets value at cost for securities held by the custodian. The distributable income account balance was zero at June 30, 2001 as any balance was reinvested in the Fund principal.

Based on our understanding of the Fund, we analyzed changes to the distributable income account and Fund principal as a result of revenues, expenses, investment income, realized gains and losses, school distributions and changes in unclaimed property.

We conducted this performance audit in accordance with generally accepted government 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. Those auditing standards require auditors to be independent of the audited organization to avoid an actual or perceived relationship that could impair the audit work performed or findings reported. The Secretary of State is the constitutional Auditor of Public Accounts and the Constitution also requires that she serve as a member of the State Land Board, the trustee of the Fund. Because the Secretary did not play a role in determining the objectives or scope of our audit, or the information presented in this report we do not believe her membership on the State Land Board constitutes an organizational impairment.



Oregon

John A. Kitzhaber, MD, Governor

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State Land Board

February 2, 2012

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Secretary of State

Ted Wheeler

State Treasurer

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Oregon Audits Division
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RE: Department of State Lands: Improve Accounting of Common School Fund
Performance Audit

Dear Mr. Blackmer:

The Department of State Lands offers the following response to the recommendations in the above-referenced audit.

- We concur with the auditor's recommendation that the Department separately account for the types of fund principal and distributable income. The Department will continue to track the unclaimed property portion of the fund principal separately as a deposit liability held in trust for the rightful owners, as well. The Department has researched the factors that define the distributable income account and have determined the correct balance for this account. Accounting procedures are being developed to track distributable income separately from the fund principal and unclaimed property.
- We concur with the auditor's recommendation that Department management provide additional information to the State Land Board for decision-making, including Fund principal and distributable income account balances, actual investment gains and losses and the impacts to these balances for recorded losses. Department management, working with State Street Bank consultants, have developed reports with additional detail to allow for the tracking necessary to determine the impact of investment gains and losses on the fund principal and on the distributable income account. Reporting procedures and report formats are being developed to ensure that the State Land Board receives the information recommended on a regular basis.

- We concur with the recommendation that the Department pay the principal \$75.7 million for the years the distributions exceeded the amount in the distributable income account (2001-2007). Department management will work with the State Land Board to implement a repayment schedule that will return \$75.7 million to the Fund principal, and will continue to both maintain the balance of unclaimed property held in trust for the rightful owners and recognize the continued need to maintain a stable level of distributions to schools. The Department will be recommending action on this item to the Land Board at their February 14, 2012 meeting.
- We concur with the recommendation that the Department develop a policy for Board consideration that minimizes the long-term impact of investment losses on Fund principal. We will begin discussion of the issue with the Board at the February 14, 2012 Board meeting with the goal of making a policy recommendation at their April meeting.

I want to thank the staff in the Audits Division who worked with Department staff on this audit. They were professional, thoughtful and helpful throughout the process.

Sincerely,



Louise Solliday
Director

About the Secretary of State Audits Division

The Oregon Constitution provides that the Secretary of State shall be, by virtue of her office, Auditor of Public Accounts. The Audits Division exists to carry out this duty. The division reports to the elected Secretary of State and is independent of the Executive, Legislative, and Judicial branches of Oregon government. The division audits all state officers, agencies, Boards, and commissions and oversees audits and financial reporting for local governments.

Audit Team

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Principal Auditor: Michelle Rock, CPA

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The courtesies and cooperation extended by officials and employees of the Department of State Lands during the course of this audit were commendable and sincerely appreciated.