



An Audit Report on

The General Land Office's Administration of Real Estate Transactions

March 2016

Report No. 16-018



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Overall Conclusion

The General Land Office (Office) has established processes and controls over its administration of real estate transactions; however, it could not provide documentation to show that it consistently complied with the Texas Natural Resources Code and its own internal procedures when it administered real estate transactions from September 2009 to May 2015.

Auditors tested two categories of real estate transactions during this audit, including:

- Land and commercial property dispositions, trades, coinvestments, and acquisitions that the Office made for the internal portfolio¹ of the Permanent School Fund.
- The Office's sales of state real property for state agencies.

The issues in this report are presented according to those two categories of transactions.²

Real Estate Transactions for the Permanent School Fund

Conflicts of Interest. The Office's code of ethics for Permanent School Fund portfolio management complied with requirements in the Texas Natural Resources Code and the Texas Government Code. However, the Office did not develop a process to identify potential conflicts of interest using the conflict of interest, financial disclosure, and ethics compliance forms its code of ethics requires School Land Board (board) members and key employees to complete.

Background Information

The mission of the General Land Office (Office) is to manage state lands and mineral-rights properties totaling 13 million acres.

The Office administers real estate transactions for assets that the Permanent School Fund owns and that state agencies own. That responsibility includes the evaluation, purchase, development, and sale of land.

The Permanent School Fund has an internal portfolio and an external portfolio. As of June 2015, the internal portfolio's real assets had a net market value of approximately \$254 million and the external portfolio's real assets had a net market value of approximately \$2 billion.

Sources: The Office and its *Quarterly Investment Report* for April 1, 2015, to June 30, 2015.

¹ Office employees manage the Permanent School Fund's internal portfolio. External fund managers manage the Permanent School Fund's external portfolio, and the Office's investment management division oversees those external fund managers.

² Chapters 1 and 2 discuss issues related to the Office's real estate transactions for the internal portfolio of the Permanent School Fund; Chapter 3 discusses issues related to the Office's sale of state real property for state agencies.

Auditors identified one instance in which the former chief clerk did not disclose a conflict of interest related to a fiscal year 2011 coinvestment; the Permanent School Fund invested \$6 million in that coinvestment and approved an additional \$27 million for that coinvestment. The Office also could not provide evidence that the former chief clerk complied with a requirement in the Texas Natural Resources Code to report conflicts of interest to the board in writing. While the Office's chief clerk can perform the duties of the Office's commissioner, the Office did not require the chief clerk to complete conflict of interest, financial disclosure, and ethics compliance forms.

Although not required to do so, the current chief clerk submitted a financial disclosure form to the Texas Ethics Commission when the commissioner appointed that individual to the position of chief clerk.

In addition, the Office did not consistently enforce certain requirements in its code of ethics for board members and key employees to complete conflict of interest, financial disclosure, and ethics compliance forms.

Written Procedures and Maintaining Documentation. The Office had procedures for administering real estate transactions for the Permanent School Fund, and it complied with statute and its own internal procedures when it made real estate acquisitions for the Permanent School Fund. However, it did not sufficiently document certain procedures related to other types of real estate transactions. In addition, the Office could not provide certain documentation related to Permanent School Fund real estate transactions; for example, it could not provide documentation showing that it complied with Texas Natural Resources Code requirements to communicate certain information regarding real estate transactions to the Legislature and the Legislative Budget Board.

The Office substantially complied with its procedures for performing due diligence for Permanent School Fund real estate transactions and obtaining board approval. However, it did not consistently maintain documentation of the required reviews of those transactions prior to making investment recommendations to the board. In addition, some of the appraisals the Office used to determine market value were not current³ at the time the board approved the real estate transactions, as required by the Office's procedures, and the Office did not document why it used appraisals that were not current.

Sales of State Real Property for State Agencies

Compliance with Statutory and Procedural Requirements. In accordance with its procedures, the Office reviewed all state real property sales contracts tested prior to the commissioner executing them. However, the Office did not comply with the Texas Natural Resources Code when it sold

³ According to the Office's procedures, an estimate of market value from an appraisal is considered current if the estimate is no more than 12 months old.

three state real properties for a total of \$19,000 less than appraised values. In addition, for three state real property sales tested, the Office did not comply with its procedures to use current appraisals to determine the market value of state real property.⁴

In addition, for nine state real property sales tested, the Office could not provide evidence that it complied with statutory requirements to communicate to the state senators and state representatives in whose districts the properties were located that the properties were for sale. For seven of those properties, the Office also could not provide evidence that it complied with Texas Natural Resources Code requirements to advertise the sale of the properties.

Auditors communicated other, less significant issues related to the Office's administration of real estate transactions to Office management separately in writing.

Summary of Management's Response

At the end of each subchapter in this report, auditors made recommendations to address the issues identified during this audit. The Office intends to implement those recommendations.

Audit Objective and Scope

The objective of this audit was to determine whether the Office administers real estate transactions, such as sales, purchases, or exchanges, in accordance with state law, administrative rules, Office policies and procedures, and other applicable requirements.

The scope of this audit covered September 1, 2009, through June 1, 2015, and included (1) real estate dispositions, trades, coinvestments, and acquisitions for the Permanent School Fund's internal portfolio and (2) sales of state real property. The audit scope did not include alternative investments that the Office's investment management division made for the benefit of the Permanent School Fund.

⁴ One of the properties without a current appraisal was also one of the properties sold for less than its appraised value.

Contents

Detailed Results

Chapter 1

The Office Should Comply with Statutory Requirements
and Strengthen Its Identification of Conflicts of Interest
Related to Permanent School Fund Real Estate
Transactions..... 1

Chapter 2

The Office Should Strengthen and Comply with
Requirements for Real Estate Transactions That It
Administers for the Permanent School Fund’s Internal
Portfolio6

Chapter 3

The Office Did Not Consistently Comply With Statute
and Internal Procedures When It Sold State Real
Property 15

Appendix

Objective, Scope, and Methodology 18

Detailed Results

Chapter 1

The Office Should Comply with Statutory Requirements and Strengthen Its Identification of Conflicts of Interest Related to Permanent School Fund Real Estate Transactions

Texas Natural Resources Code, Section 51.408(a), requires the School Land Board (board) to adopt and enforce an ethics policy that provides standards of conduct related to the management and investment of funds in the Permanent School Fund. In addition, Texas Government Code, Chapters 572 and 2263, specify standards of conduct required of state officers, state employees, and outside financial advisors. The General Land Office (Office) developed its code of ethics for Permanent School Fund real estate portfolio management in accordance with the requirements in the Texas Natural Resources Code and the Texas Government Code. However, the Office could not provide evidence that it consistently adhered to provisions related to conflicts of interest in the Texas Natural Resources Code and its code of ethics.

The Office should strengthen its process for identifying conflicts of interest related to Permanent School Fund real estate transactions.

The Office's code of ethics requires board members, key employees (see text box), and employees⁵ to submit to the Office's chief compliance officer:

- Conflict of interest forms identifying any existing or potential conflicts of interest.
- Ethics compliance forms certifying compliance with the Office's code of ethics.
- Financial disclosure forms disclosing financial relationships or investments that might reduce independence of judgment.

Key Employee

A key employee is an employee who has been designated by the board or the commissioner as one who exercises significant influence or decision-making authority regarding the management of real estate assets of the Permanent School Fund.

Source: The Office's code of ethics.

The Office has not established a process to use the information in the financial disclosure and conflict of interest forms that board members and key employees submit to identify potential conflicts of interest related to proposed real estate transactions. That increases the risk that the Office may not identify potential conflicts of interest. In addition, because the Office does not have an established process to evaluate potential conflicts of

⁵ Employees are required to submit conflict of interest forms and ethics compliance forms, but not financial disclosure forms.

interest at the individual transaction level, with one exception discussed below, auditors could not determine whether conflicts of interest existed related to the Permanent School Fund real estate transactions tested.

The Office did not require the chief clerk to submit forms specified in its code of ethics.

The Office did not require the chief clerk to submit the forms specified in its code of ethics; however, the current chief clerk submitted a personal financial statement to the Texas Ethics Commission when the commissioner appointed that individual to the position of chief clerk. The Office could not provide evidence that the former chief clerk submitted any of the forms that its code of ethics requires.

According to Texas Natural Resources Code, Section 31.015(b), the Office's chief clerk may perform any of the duties of the commissioner if the commissioner is ill, absent, dies, or resigns. Not requiring the chief clerk to submit those forms increases the risk that the Office may not be aware of any potential conflicts of interest that the chief clerk has related to Permanent School Fund real estate transactions.

In fiscal year 2011, the Office entered into a coinvestment for the Permanent School Fund with an entity with which the former chief clerk had an undisclosed conflict of interest. The former chief clerk signed the contract that established the coinvestment, and the Permanent School Fund invested \$6 million in that coinvestment and committed another \$27 million to that coinvestment. The Office could not provide evidence that the former chief clerk complied with the requirement in Texas Natural Resources Code, Section 51.409(a), to report conflicts of interest to the board in writing.

The Office could not provide evidence that board members and key employees consistently submitted the forms that its code of ethics requires.

Auditors tested conflict of interest, financial disclosure, and ethics compliance forms for two commissioners, two board members, and nine key employees for fiscal years 2011 through 2015.

Conflict of interest forms. The Office's code of ethics requires board members and key employees to revise their conflict of interest forms when their situations change. In 2015, all board members and key employees submitted conflict of interest forms; however, the Office could not provide evidence that board members and key employees consistently submitted conflict of interest forms prior to 2015. Specifically, the Office could not provide evidence that 6 (55 percent) of the 11 board members and key employees hired or appointed before 2015 submitted conflict of interest forms prior to 2015. Without previous conflicts of interest forms, the Office may not be aware of any potential conflicts of interest prior to 2015.

Financial disclosure and ethics compliance forms. The Office's code of ethics requires board members and key employees to submit financial disclosure and ethics compliance forms annually. Auditors tested the Office's compliance with those requirements for board members (including the commissioner, who is also the chair of the board) and key employees. All board members and key employees tested submitted required financial disclosure and ethics compliance forms for 2014 and 2015; however, the Office could not provide evidence that it consistently ensured that those individuals submitted those forms prior to 2014. Specifically:

- The Office could not provide evidence that any board members or key employees submitted financial disclosure and ethics compliance forms for 2011 and 2012.
- The Office could not provide evidence that 1 key employee (11 percent) of 9 board members and key employees tested submitted financial disclosure and ethics compliance forms for 2013.

When the Office does not ensure that board members and key employees consistently submit the forms that its code of ethics requires, it may not be aware of potential conflicts of interest related to Permanent School Fund real estate transactions.

Board members and key employees did not consistently submit forms the Office's code of ethics requires in a timely manner.

New board members and new key employees. The Office's code of ethics requires new board members and new key employees to submit conflict of interest, financial disclosure, and ethics compliance forms within 30 days of being appointed or hired. Texas Natural Resources Code, Section 51.409(d), also requires decision makers or those with fiduciary authority to submit a financial disclosure statement within 30 days of being employed. During fiscal year 2015, the Office did not enforce those requirements for the newly elected commissioner and a newly hired key employee, who submitted those forms approximately 5 months and 2.5 months after the required 30 days, respectively.

Current board members and current key employees. The Office's code of ethics requires current board members and current key employees to submit financial disclosure and ethics compliance forms annually by January 31. In 2013, the eight board members and key employees who submitted financial disclosure and ethics compliance forms did so by the required due date. However, in 2014 and 2015, the nine board members and key employees

who submitted financial disclosure and ethics compliance forms generally submitted them more than four months after the due date.⁶

When the Office does not ensure that board members and key employees consistently submit the forms that its code of ethics requires in a timely manner, it may not be aware of potential conflicts of interest related to Permanent School Fund real estate transactions.

Recommendations

The Office should:

- Develop and implement a process to evaluate each potential real estate transaction for potential conflicts of interest, and require board members and key employees to disclose any potential conflicts of interest associated with each recommendation for a real estate transaction that the Office presents to the board.
- Review board members' and key employees' financial disclosure and conflict of interest forms to identify and resolve potential conflicts of interest related to real estate transactions.
- Classify the chief clerk as a key employee, and require the chief clerk to complete all forms that the Office's code of ethics specifies.
- Enforce its requirement that all board members and key employees complete all forms that statute and the Office's code of ethics require by the required due date, and maintain those forms.

Management's Response

In order to ensure that potential conflicts of interest and similar matters are properly addressed, the incoming administration of the GLO established the Office of Compliance and Ethics ("OCE") in 2015. The OCE ensures that all key employees and board members sign financial disclosure and conflict of interest forms on an annual basis. As noted in the audit report, in 2015 all board members and key employees submitted conflict of interest forms and required financial disclosure and ethics compliance forms. The OCE is also implementing a process to review board members' disclosure forms before each meeting of the board, which will be used to determine whether the board would be considering any item that would present a conflict of interest for any individual member. In order for this process to work, however, the

⁶ The nine board members and key employees who submitted financial disclosure and ethics compliance forms in 2014 and 2015 were not all the same individuals.

GLO will be relying on the individual board members to fully disclose any potential conflicts of interest through these forms. OCE is also developing a process to screen potential real estate projects for conflicts of interest with regards to key employees as part of the new conflict check process. In addition, although the former Chief Clerk did not submit the forms specified in its code of ethics, the current Chief Clerk will sign all forms specified by the code of ethics and will be designated as a key employee.

The OCE is also in the process of developing ethics training sessions tailored specifically to each of the various program areas of the GLO.

Responsible Party: Director of the Office of Compliance and Ethics

Implementation Date: August 2016

The Office Should Strengthen and Comply with Requirements for Real Estate Transactions That It Administers for the Permanent School Fund's Internal Portfolio

Board Authority

"The board may acquire, sell, lease, trade, improve, maintain, protect or otherwise manage, control, or use land, mineral and royalty interests, real estate investments, or other interests, including revenue received from those sources, that are part of the Permanent School Fund in any manner, at such prices, and under such terms and conditions as the board finds to be in the best interest of the fund."

Source: Texas Natural Resources Code, Section 51.011(a-1).

The Office should strengthen certain aspects of the board-approved real estate transactions that it administers for the Permanent School Fund's internal portfolio (that portfolio includes the Permanent School Fund properties that Office employees manage). Those transactions include land and commercial property dispositions, trades, coinvestments, and acquisitions. The Office enters into coinvestments through limited partnership agreements with external real estate fund managers, and it contributes funds or property to those coinvestments.

Chapter 2-A

The Office Should Strengthen and Consistently Comply with Statute and Procedures for Its Real Estate Dispositions for the Permanent School Fund and Maintain Documentation Related to Those Dispositions

The Office has procedures for the disposition of Permanent School Fund properties that include determining a price based on an appraisal of the properties, identifying properties to be listed for sale on the Office's Web site, obtaining approval from the board, and obtaining a legal review of sales contracts. However, it should consistently comply with statutory requirements related to its dispositions and strengthen its procedures to include certain documentation and reporting requirements discussed below. Auditors tested 34 properties that the Office disposed of between September 1, 2009, and June 1, 2015.⁷

Posting of purchase instructions. According to the Office, it generally sells property directly to an entity that expresses interest in purchasing the property. Of the 31 property sales that auditors tested, the Office sold 30 of those properties directly to a purchaser, and it sold 1 through auction. However, the Office did not comply with Texas Natural Resources Code, Section 51.052(i-1), which requires it to post instructions for purchasing commercial real estate on its Web site. Posting those instructions on its Web site would provide direction to individuals who are interested in purchasing property.

⁷ Auditors tested 31 property sales, 2 property contributions to coinvestments, and 1 property donated to a higher education institution.

Notification of adjacent land owners. Texas Natural Resources Code, Section 51.052(e), specifies that adjacent land owners must be given preference in purchasing land the board approves for sale if the board finds the use of the preference to be in the best interest of the State. For all applicable property sales tested, there was no evidence that the Office granted a preference to adjacent land owners or documented why it was in the best interest of the State not to grant a preference. The Office's procedures did not address granting adjacent land owners a preference to purchase land the board approved for sale.

Use of current appraisals. For each property disposition tested that the Office sold or contributed to a coinvestment, the Office had an appraisal that received a quality control review and approval from its chief appraiser. However, for 3 (9 percent) of 33 property dispositions tested, the appraisal was not current, as required by the Office's procedures. According to the Office's procedures, an estimate of market value from an appraisal is considered current if the appraisal is no more than 12 months old. Those three appraisals exceeded 12 months by 7 months, 8 months, and 24 months. In addition, the Office did not document a reason for not having a current appraisal. Without a current appraisal, the Office could sell property for less than it is worth.

Reporting certain sales to the Legislative Budget Board. Texas Natural Resources Code, Section 51.011(a-2), requires the Office to annually report to the Legislative Budget Board the sale of any land for less than appraised value. The Office sold two of the properties tested for less than appraised value⁸, and it could not provide evidence that it reported those sales to the Legislative Budget Board. In addition, the Office did not have procedures for reporting that information. Not reporting those sales limits the information that the Legislative Budget Board receives related to real estate dispositions.

Determination of best interest. For all 34 property dispositions tested, the Office complied with the requirement in Texas Natural Resources Code, Section 51.402(b), to determine that the dispositions were in the best interest of the Permanent School Fund. In addition, the Office provided evidence that the board approved 33 (97 percent) of those 34 property dispositions. The remaining property disposition tested was related to an agreement from 1998, and that agreement allowed the other party to purchase land from the Office across a 20-year period. The Office was unable to provide evidence that it presented key information related to that agreement, including sales price, to the board or that the board approved the original agreement.

⁸ The Office sold one property for approximately \$2.7 million below the appraised value. It sold the other property for approximately \$62,000 below the appraised value.

The Office complied with its procedures by ensuring that (1) its legal department reviewed and approved all property sales contracts tested and (2) the commissioner or chief clerk signed those contracts.

Recommendations

The Office should:

- Post instructions for purchasing property on its Web site.
- Strengthen property disposition procedures related to preferential rights for adjacent land owners to include (1) evaluating whether the Office should grant preferential rights and (2) documenting the reason for granting or not granting preferential rights.
- Comply with its procedure requiring a current appraisal to determine the market value for property dispositions, and strengthen those procedures to include a requirement to document any reason for not using a current appraisal.
- Strengthen and implement property disposition procedures to ensure compliance with statutory requirements to report to the Legislative Budget Board any properties sold for less than the appraised value.
- Maintain documentation related to property sales, including key information that the Office presents to the board and evidence of board approval.

Management's Response

Instructions for purchasing property were placed on the GLO web site in 2015. In the newly redesigned website, a link to purchasing instructions is conveniently and prominently placed on the right side of each listing, and general purchasing instructions are also on the Overview page of the LAND tab on the main navigation panel of <http://www.glo.texas.gov/>.

Texas Natural Resources Code §§ 51.052 (e) and (f) do specify that the owners of land that surround or have a common boundary with a tract of land approved for sale by the board shall have a preferential purchase right, provided the owner pays not less than market value for the tract and the board finds use of the preference right is in the best interest of the state. As such, the GLO may notify adjacent land owners on a case-by-case basis for business purposes prior to seeking board approval for a sale of a particular tract (although not statutorily required to do so). For each subject property,

the GLO will document its determination of whether or not the preference is in the best interest of the State along with any resulting correspondence.

In addition, procedures will be adopted and updated to ensure compliance with statutory requirements to report to the LBB any properties sold for less than appraised value. The GLO will also maintain all documentation related to property sales and will ensure all appraisals are current when determining market value for property dispositions.

Responsible Party: Deputy Director of Asset Management

Implementation Date: August 2016

Chapter 2-B

The Office Should Use Current Appraisals to Determine the Value of the Land It Trades on Behalf of the Permanent School Fund and Report Those Trades to the Legislature

Texas Natural Resources Code, Section 51.011(a-1), gives the Office the authority to trade property from the Permanent School Fund if the board determines it is in the best interest of the State to do so. Although the Office has procedures for trades, it should strengthen its procedures related to appraisals and reporting requirements. Auditors tested all four Permanent School Fund real estate trades that the Office made between September 2009 and May 2015.

Determination of best interest and use of current appraisals. The Office's procedures specify that a trade is in the best interest of the State if the land being traded to the Permanent School Fund has a value that is equal to or more than the value of the land being traded from the Permanent School Fund. For all trades tested, the Office complied with those procedures and determined that the trades were in the best interest of the State because the acquired property had a value that exceeded the value of the property the Office provided in the trade. However, the Office did not consistently make those determinations based on a current appraisal. For each of the four trades tested, the Office did not have a current appraisal for the acquired property, the property it provided in the trade, or both. Specifically:

- For two trades tested, the Office had a current appraisal for the acquired property, but not for the property it provided in the trade. For one of those trades, the Office informally assessed the value of the property it provided in the trade and determined that the assessed value was

equivalent to that property's historical cost. However, the Office had no evidence that it communicated that information or the appraised value of the acquired property to the board. The other trade had an appraisal that exceeded the Office's 12-month requirement for a current appraisal by 7 months.

- For one trade tested, the Office did not have an appraisal for the property it acquired through the trade. The Office conducted that trade to obtain legal access to another property that the Permanent School Fund owned.
- For one trade tested, the Office did not have a current appraisal for either the property acquired or the property it provided in the trade. Both appraisals exceeded the Office's 12-month requirement for a current appraisal by approximately 2.5 years. However, the Office documented that neither the property acquired nor the property it provided in the trade had changed significantly in value and, therefore, it did not perform new appraisals required by its procedures.

Without current appraisals for both properties involved in a trade, the Office may not be able to determine whether it is acquiring a property with a value at least equal to the value of the property it is providing.

Reporting to the Legislature. For all four trades tested, the Office followed its procedure to review trade information prior to submitting it to the board, and the board approved each of those trades. However, the Office could not provide evidence that it reported those trades to the Legislature, as required by Texas Natural Resources Code, Section 32.258(a), and Title 31, Texas Administrative Code, Section 13.2. In addition, the Office did not have procedures to report those trades. Not reporting those trades limits the information that the Legislature receives related to trades the Office makes for the Permanent School Fund.

Deed signatures. The Office complied with requirements in Texas Natural Resources Code, Section 32.255, and Title 31, Texas Administrative Code, Section 13.2, to ensure that the commissioner and the governor jointly signed the deeds for the traded properties, when required.

Recommendations

The Office should:

- Comply with procedures that require a current appraisal to determine market value of traded properties, and strengthen those procedures to

include a requirement to document any reason for not using a current appraisal.

- Communicate information related to the appraised value of traded properties to the board.
- Develop, document, and implement procedures for reporting all trades to the Legislature.

Management's Response

With the establishment of the new administration at the GLO, updated procedures concerning communicating property trade information to the board and Legislature will be implemented, and current appraisals are being utilized when determining the market value of trade properties.

Responsible Party: Deputy Director of Asset Management

Implementation Date: August 2016

Chapter 2-C

The Office Should Develop and Implement Coinvestment Procedures for the Permanent School Fund and Review and Approve Coinvestments Prior to Recommending Them to the Board

The Office had no documented procedures for entering into coinvestments for the Permanent School Fund. Instead, the Office used its acquisition procedures to generally guide the coinvestment process. Therefore, auditors

Coinvestments

Coinvestments of funds occur when the Office enters into limited partnership agreements with external fund managers. As a limited partner in those coinvestments, the Office has limited voting or decision-making power related to the day-to-day operations of the coinvestments.

Source: The Office.

assessed coinvestment transactions using the acquisition procedures. However, those procedures do not specifically address how the Office selects the external fund manager, the amount the Office will invest, the property type, or the desired rate of return on the investment. Auditors tested all six Permanent School Fund real estate coinvestments that the Office entered into between September 2009 and May 2015. The Office contributed approximately \$81 million in cash and land to those six coinvestments while they were in the internal portfolio.⁹

⁹ The Office transferred three of the six coinvestments that auditors tested to the external portfolio on October 1, 2013.

According to the Office, participating in a coinvestment allows it to benefit from an external fund manager's¹⁰ real estate expertise and take advantage of property development capabilities that the Office does not have. The Office uses an investment consultant to provide research on prospective external fund managers and potential coinvestment acquisition target properties.

Due diligence and presentation of information to the board. For all six coinvestments tested, the Office performed due diligence on the external fund manager and the acquisition target property. However, for one of those coinvestments, the Office did not communicate information related to the acquisition target property to the board. Although the external fund manager had identified the property that it intended to acquire through that coinvestment, the Office did not present that information to the board. The Office's acquisition procedures require board approval of the acquisition target property. The Office presented that information to the board for the five other coinvestments tested.

Identification of benefits and determination of best interest. The Office identified the benefits of each coinvestment tested and how each coinvestment fit into the Permanent School Fund portfolio, as required by its procedures. In addition, for the coinvestments tested, the Office complied with Texas Natural Resources Code, Section 51.011(a-1), which requires it to document its determination that a real estate investment is in the best interest of the Permanent School Fund. The coinvestments that auditors tested were all real estate investments.

Obtaining board approval and performing related reviews. Consistent with Texas Natural Resources Code, Section 51.402(b), the board approved all six coinvestments tested before the Office entered into those coinvestments. However, it did not consistently comply with its procedures to review and approve those coinvestments before recommending them to the board. According to the Office's acquisition procedures, the Office's prospect review team and the investment advisory committee must approve certain commercial property investments prior to submitting a recommendation to the board.¹¹ For four of the six coinvestments tested, the Office could not provide evidence that the prospect review team reviewed and approved the coinvestments. For one of those four coinvestments, the Office also could not provide evidence of investment advisory committee review. Without prospect review team and investment advisory committee review and

¹⁰ The external fund managers serve as general partners in the limited partnerships with the Office.

¹¹ If a commercial property is valued at less than \$5 million, the Office's acquisition procedures do not require investment advisory committee approval.

approval, the Office may not properly evaluate a coinvestment before recommending it to the board.

Levels of review. For all six coinvestments tested, the Office complied with its procedures to ensure that the associated partnership agreements received multiple reviews, including a legal review, before the commissioner or the chief clerk executed the partnership agreement. In addition, the Office approved the contribution amounts and remitted the payments after the commissioner or chief clerk executed the partnership agreements. As discussed in Chapter 1, however, for one of the six coinvestments tested, the Office's former chief clerk executed a partnership agreement without disclosing a conflict of interest.

Recommendations

The Office should:

- Develop, document, and implement procedures for the coinvestment process.
- Communicate information related to the coinvestment acquisition target property to the board.
- Ensure that coinvestments receive prospect review team and investment advisory committee review and approval before recommending coinvestments to the board.

Management's Response

In 2015, internal procedures were expanded to include strengthened approval processes for real estate acquisitions and dispositions transactions over \$5,000,000 as well as potential co-investment opportunities. Prior to seeking board approval, the transactions must now clear two additional internal hurdles, which are the Property Review Team and the Investment Advisory Committee. GLO staff will ensure that all pertinent details are communicated to board members prior to a transaction being approved.

Responsible Party: Deputy Director of Asset Management

Implementation Date: August 2016

Chapter 2-D

The Office Complied with Statute and Its Procedures When It Made Real Estate Acquisitions for the Permanent School Fund

In addition to entering into coinvestments, the Office directly acquires land and commercial property for the Permanent School Fund. Auditors tested all four Permanent School Fund real estate acquisitions that the Office made between September 2009 and May 2015.¹² Those acquisitions totaled approximately \$12.5 million. The Office complied with its procedures for the four acquisitions tested by performing due diligence on those properties, identifying the benefits of each acquisition for the portfolio, and determining whether those acquisitions were in the best interest of the Permanent School Fund. All four acquisitions tested had a current appraisal that received a quality control review in accordance with the Office's procedures. In addition, the Office's chief appraiser approved the appraisals for all four acquisitions tested. The Office also acquired those properties at the appraised value or below the appraised value.

Consistent with Texas Natural Resources Code, Section 51.402(b), and its procedures, the board approved all four acquisitions tested. The Office complied with its procedures by performing multiple reviews of the acquisition contracts tested, including a legal review. In addition, the commissioner executed those contracts.

Chapter 2-E

The Office Accurately Entered Permanent School Fund Real Estate Transactions into Its Internal Accounting System

The Office used its internal accounting system to record real estate transactions it administered for the Permanent School Fund. The Office accurately recorded key information for all Permanent School Fund real estate transactions tested in its internal accounting system and the Uniform Statewide Accounting System.

¹² Two acquisitions tested were commercial transactions, and two acquisitions tested were for undeveloped land.

The Office Did Not Consistently Comply With Statute and Internal Procedures When It Sold State Real Property

In addition to administering real estate transactions for the Permanent School Fund, the Office sells state real property on behalf of state agencies (see text box). In accordance with Texas Natural Resources Code, Sections 31.1571(g) and 31.158(a), the governor authorized or the Legislature directed all nine state real property sales that auditors tested. However:

- For all nine state real property sales tested, the Office could not provide evidence that it complied with Texas Natural Resources Code, Section 31.158(c)11. That statute requires that, before it sells state real property, the Office must communicate information regarding the sale to the state senators and state representatives who represent the districts where the Office is selling the property. When those individuals do not receive notification, they may not be informed about issues of interest to their district.
- For three state real property sales tested, the Office did not comply with Texas Natural Resources Code, Section 31.158(c), which requires it to sell state real property for at least the appraised value. The Office sold those three properties for a total of \$19,000 below appraised value.
- For three state real property sales tested, the Office did not have an appraisal that was no more than 12 months old, as required by its procedures.¹³ While the Office did not have current appraisals for those properties, it ensured that the appraisals it had for all nine property sales tested received a quality control review, in accordance with its procedures. In addition, the Office's chief appraiser approved the appraisals for all nine property sales tested.
- For seven of the nine properties tested, the Office could not provide evidence that it (1) complied with the requirement in Texas Natural Resources Code, Section 31.158(c)2, to advertise certain state real properties for auction or (2) documented a reason for not complying with that requirement. For the remaining two properties tested:

The Office's Sale of State Real Property

The Office works with state agencies to identify, evaluate, and recommend to the governor the sale of state real property. The Legislature may also direct the Office to sell state real property. The Office acts as a broker in those sales.

Source: The Office.

¹³ One of those properties was one of the properties the Office sold for less than the appraised value.

- The Office sold one property directly to a political subdivision in accordance with Texas Natural Resources Code, Section 31.0672(a).
- The Office sold one property to an adjacent land owner. Although the Office had evidence that there was no public access to that property, it did not document that the lack of public access was the reason for not conducting an auction or sealed bid for the sale of that property.

By not advertising a property sale, the Office may not receive the best price for the property.

Recommendations

The Office should:

- Develop and implement procedures to provide information on state real property sales to the state senators and state representatives who represent the districts where the Office intends to sell state real property, and maintain documentation of that communication.
- Sell state real property for at least the appraised value, as required by Texas Natural Resources Code, Section 31.158(c).
- Use appraisals that are no more than 12 months old to determine the market value for sales of state real property.
- Develop and implement procedures to advertise the sale of state real property and maintain documentation that shows when and in what publications it advertised auctions for the sale of state real property, or document its reason for not advertising.

Management's Response

Updated procedures are being implemented to ensure state senators and state representatives are notified prior to the sale or lease of state real property in their district pursuant to Texas Natural Resources Code § 31.158(c). With the establishment of the new administration at the GLO, all state real property will be sold for no less than the appraised value, and current appraisals will be used to determine market value.

The procedures have been updated to ensure state real property being offered for sale or lease pursuant to Texas Natural Resources Code § 31.1573 and § 31.158 is advertised in the manner required by Section 31.158(c) and that such advertisement is properly documented.

Responsible Party: Deputy Director of Asset Management

Implementation Date: August 2016

Appendix

Objective, Scope, and Methodology

Objective

The objective of this audit was to determine whether the General Land Office (Office) administers real estate transactions, such as sales, purchases, or exchanges, in accordance with state law, administrative rules, Office policies and procedures, and other applicable requirements.

Scope

The scope of this audit covered September 1, 2009, through June 1, 2015, and included (1) real estate dispositions, trades, coinvestments, and acquisitions for the Permanent School Fund's internal portfolio and (2) sales of state real property. The audit scope did not include alternative investments that the Office's investment management division made for the benefit of the Permanent School Fund.

Methodology

The audit methodology included gaining an understanding of and evaluating controls over real estate transactions at the Office, including controls related to obtaining approvals, conducting and reviewing appraisals, performing due diligence, and complying with statutory reporting requirements. Auditors interviewed Office personnel, analyzed data, performed testing, and evaluated the results. Auditors also reviewed the Office's policies and procedures, the Texas Administrative Code, the Texas Natural Resources Code, and the Texas Government Code.

Sampling Methodology

Auditors used professional judgment to select sample items for testing dispositions for the Permanent School Fund and quarterly reconciliations between the Office's accounting system and land asset management system. Auditors used a nonstatistical random sample for testing sales of state real property.

Those sample items generally were not representative of the population and, therefore, it would not be appropriate to extrapolate those results to the population.

Auditors tested the entire population of real estate transactions for trades, coinvestments, and acquisitions for the Permanent School Fund.

Auditors assessed the reliability of data used in the audit by performing work to assess the accuracy and completeness of data within the Office's accounting system. In addition, auditors traced the data to supporting documentation. Auditors determined that the data in the Office's accounting system was sufficiently reliable for the purposes of this audit.

Information collected and reviewed included the following:

- The Office's policies and procedures.
- Data from the Office's accounting system and land asset management system.
- Quarterly reconciliations between the Office's accounting system and land asset management system.
- Data from the Uniform Statewide Accounting System.
- Office records for real estate transactions for the Permanent School Fund, including transaction ledgers, approval documents, transaction memorandums, purchase contracts, sales contracts, partnership agreements, property appraisals, land surveys, land deeds, and other supporting documentation.
- Financial disclosure, conflict of interest, and ethics compliance forms for members of the School Land Board (board) and key employees.
- Board meeting minutes and executive session recordings.
- Reports to the governor with recommended transactions for state real property.
- State real property database.
- Office records for state real property transactions, including approval documents, sales contracts, property appraisals, and other supporting documentation.

Procedures and tests conducted included the following:

- Interviewed Office management and staff.
- Tested Permanent School Fund real estate coinvestments and acquisitions for evidence of the following:
 - Prospect review team, investment advisory committee, and board review and approval.

- A current appraisal that received a quality control review and chief appraiser approval.
 - Reasonable due diligence and communication of that information to the board.
 - The Office's determination that the coinvestment or acquisition was in the best interest of the Permanent School Fund.
 - Appropriate review of and approval of purchase contracts received.
- Tested Permanent School Fund real estate dispositions for evidence of the following:
 - The Office's determination regarding whether it was in the best interest of the State to offer preferential rights to adjacent land owners to purchase the property.
 - The Office's determination that the disposition was in the best interest of the Permanent School Fund.
 - A current appraisal that received a quality control review and chief appraiser approval.
 - Reporting property sales for less than appraised value to the Legislative Budget Board.
 - Communicating relevant information to the board.
 - Appropriate review, due diligence, and approval of disposition documents.
 - Tested Permanent School Fund real estate trades for evidence of the following:
 - The Office's determination that the trade was in the best interest of the Permanent School Fund and that the property traded to the Permanent School Fund had a value that was equal to or more than the value of the property traded from the Permanent School Fund.
 - Current appraisals for the property traded to the Permanent School Fund and the property traded from the Permanent School Fund that received a quality control review and chief appraiser approval.
 - Reporting trades to the Legislature.
 - Appropriate review, due diligence, and approval of trade documents.

- Tested state real property sales for evidence of the following:
 - Sales were authorized by the governor or directed by the Legislature.
 - A current appraisal that received a quality control review and chief appraiser approval.
 - Legal review of and appropriate signatures on sales contracts received.
 - Property was sold for at least appraised value.
 - Communicating information related to properties the Office intends to sell to state senators and state representatives in whose districts the properties were located.
 - Offering properties for sale at auction and appropriately advertising those properties for sale.
- Compared hard-copy documentation to data in the Office’s information systems.
- Reviewed quarterly reconciliations between the Office’s accounting system and land asset management system.

Criteria used included the following:

- The Office’s policies and procedures.
- The Office’s code of ethics.
- Texas Natural Resources Code, Chapters 31, 32, 33, and 51.
- Title 31, Texas Administrative Code, Chapter 13.
- Texas Government Code, Chapter 572.
- Texas Government Code, Chapter 2263.

Project Information

Audit fieldwork was conducted from September 2015 through January 2016. 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.

The following members of the State Auditor's staff performed the audit:

- Michael F. Boehme, CIA, PHR (Project Manager)
- Cheryl Durkop, CFE (Assistant Project Manager)
- Jennifer Fries, MS
- Richard E. Kukucka III
- Adam Ryan, MACT
- Cameron A. Scanlon
- Joseph Smith, MBA
- Richard Wyrick, MBA
- George D. Eure, CPA (Quality Control Reviewer)
- Audrey O'Neill, CIA, CFE, CGAP (Audit Manager)

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Dan Patrick, Lieutenant Governor, Joint Chair

The Honorable Joe Straus III, Speaker of the House, Joint Chair

The Honorable Jane Nelson, Senate Finance Committee

The Honorable Robert Nichols, Member, Texas Senate

The Honorable John Otto, House Appropriations Committee

The Honorable Dennis Bonnen, House Ways and Means Committee

Office of the Governor

The Honorable Greg Abbott, Governor

General Land Office

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

Members of the School Land Board

Mr. Gilbert Burciaga

Mr. David S. Herrmann



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