An Audit Report on

The Texas Education Agency's Administration of the Foundation School Program

April 2003

Report No. 03-033

State Auditor's Office

Lawrence F. Alwin, CPA
State Auditor

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Overall Conclusion

The Texas Education Agency (Agency) administers the Foundation School Program—the mechanism through which the State provides approximately $11 billion annually to school districts and charter schools—as statute requires. However, the Agency should address certain information technology issues to help ensure that it continues to properly administer this program.

Purposes of the Foundation School Program

To guarantee that each school district in the State has:

- Adequate resources to provide each eligible student a basic instructional program and facilities suitable to the student's educational needs
- Access to a substantially equalized program of financing in excess of basic costs for certain services, as provided by this chapter

Source: Texas Education Code, Section 42.002 (a)

As statute requires, the Agency makes Foundation School Program payments to school districts based on estimates of property values and student attendance. However, in fiscal year 2001 this process resulted in school districts making a $683.8 million net refund to the Foundation School Program. The State does not receive the interest on these funds; instead, the school districts retain the interest they earn on these funds.

It is also important to note that fluctuations in economic conditions could require the State to begin funding a larger share of the Foundation School Program. In fiscal year 2003, local revenue provided 59 percent of the total cost for the Foundation School Program, while the State contributed 41 percent. However, if economic conditions deteriorate, property values could decline, which could leave the State responsible for funding a larger share of the Foundation School Program.

Statutory wealth equalization requirements extend the reliance on property values to fund the Foundation School Program. If property values decline, the number of property-wealthy school districts could decrease. This would lead to a decrease in the amount of funds school districts return to the State through wealth equalization. In addition, if property values decline enough, some school districts would no longer be classified as property wealthy, which could require the State to start providing funding to those school districts. Through the statutory wealth equalization requirements, property-wealthy school districts contributed $2 billion directly or indirectly to the Foundation School Program during fiscal years 1999–2002.

In addition, one of the statutory wealth equalization options allowed school districts to receive a net gain of $200 million in excess of the amount allocated through the Foundation School Program in fiscal years 1999–2002. This represents a loss of revenue to the State because it reduces the total amount refunded to the State.

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This audit was conducted in accordance with Texas Government Code, Sections 321.0131 and 321.0133.

For more information regarding this report, please contact Carol Smith, CPA, Audit Manager, at (512) 936-9500.

Key Points

The Agency administers the Foundation School Program as statute requires, but it should address certain information technology issues.

Our test results indicate that the Agency administers the Foundation School Program as statute requires. However, it does not reconcile payments calculated by its Foundation School Program system with payments actually made through the Uniform Statewide Accounting System. The Agency has also not properly documented all applications and data used in the Foundation School Program allocation and payment processes. In addition, the Agency should further restrict access to its network server, strengthen separation of duties in the processing of key data inputs, and perform data edit checks of student count estimates. Six months after being advised that it should remove certain security-related information from its Web site, the contractor that maintains the Agency's mainframe removed from this Web site the information that posed the highest risk.

Although our testing did not identify any significant discrepancies that occurred because of the issues we identified, these areas should be strengthened to ensure that the Agency continues to properly administer the Foundation School Program.

The school district payment distribution process has led to school districts returning significant amounts to the State after the end of the school year.

As required by Texas Education Code, Chapter 42, the Agency makes Foundation School Program payments to school districts during the school year based on estimates of property values and attendance; it then adjusts those payments the following school year after it receives final or actual property value and attendance data. In fiscal year 2001, this process resulted in a $683.8 million net refund from school districts back to the Foundation School Program. The effect of this refund back to the Foundation School Program is that the State does not receive the interest on those funds; instead, the school districts retain that interest.

Fluctuations in economic conditions could require the State to begin funding a larger share of the Foundation School Program.

Local revenue has provided an increasingly larger share of the total funding for the Foundation School Program because property values have increased during the past decade in step with favorable economic conditions. However, if economic conditions deteriorate and property values decline, statutory funding formulas could require the State to provide a larger share of funding for the Foundation School Program.

Since fiscal year 1994, total state and local funding for public education has increased by 67 percent. However, while the State's share of that funding increased by 50 percent, the local share increased by 80 percent. In fiscal year 2003, the local share of Foundation School Program funding was 59 percent.

As guarantor for the Foundation School Program, the State is vulnerable to shifting economic conditions and must contribute more or less to the Foundation School Program in response to these conditions. This means that the State ultimately bears the burden of funding for public education if economic conditions deteriorate.

Statutory wealth equalization requirements extend the reliance on property values to fund the Foundation School Program.

Texas Education Code, Chapter 41, requires school districts whose property values per student in weighted average daily attendance (WADA) exceed $305,000 to reduce their wealth through one of or a combination of five options outlined in statute. Through these options, the State receives any school district property tax revenue that exceeds the equalized wealth level. If property values decline, however, the number of property-wealthy school districts could decrease. This, in turn, would lead to a decrease in the amount of funds school districts return to the State through wealth equalization.

In addition, one of the wealth equalization options—option 4, education of nonresident students—resulted in a $200 million loss of revenue to the State in fiscal years 1999–2002. This loss occurred because, under option 4, property-wealthy school districts purchase WADA credits directly from other "partner" school districts whose wealth per student is less than $305,000. However, the net result of this arrangement is that the partner school districts receive a net gain in the form of additional funding in excess of the amount allocated through the Foundation School Program. Without this option, those funds would have been returned to the State.

A report on the Cost-of-Education Index has highlighted an additional challenge facing the Foundation School Program.

At the Legislature's request, the Charles A. Dana Center at The University of Texas at Austin conducted a study regarding the Cost-of-Education Index (CEI) currently used in the Foundation School Program funding process. This study found that the current CEI is based on a cost-differential analysis that is more than 10 years old. Using an updated CEI would require the State to devote an additional $296 million to $368 million to public education.

Summary of Management's Response

Management generally agrees with the recommendations. Management describes plans, provides time lines, and names parties responsible for ensuring the implementation of needed improvements.

Summary of Information Technology Review

Our review of the Agency's information technology was limited to reviewing the Foundation School Program system (a collection of Statistical Analytical Software programs used to calculate funding allocations) and other programs and interfaces related to the school district payment process. We performed an application controls review of the Foundation School Program system. We also reviewed logical security controls related to the Foundation School Program system and its data and to other programs and interfaces related to the school district payment process. In addition, the Agency performed a simulation using predefined criteria to determine the increases or decreases in the State's share of Foundation School Program funding that would result if district property values and student attendance fluctuated.

The Foundation School Program system is being replaced with modern technology that will serve as a more reliable platform. The new system is intended to correct most of the weaknesses noted above; however, certain programs and ad hoc procedures will not be replaced. Because the new system was not fully implemented at the time of our audit, we were not able to verify whether the new system would address the issues we identified in the current system.

We also performed a physical security review at the contractor that maintains the Agency's mainframe. Overall, we found that the contractor's physical security was adequate. Six months after being advised that it should remove certain security-related information from its Web site, the contractor removed from this Web site the information that posed the highest risk.

Summary of Objective, Scope, and Methodology

Our objective was to determine how the Agency's Foundation School Program's cash management processes affect funds available to support public education. To accomplish this overall objective, we determined whether the Agency:

- Has information technology systems adequate to support the administration of the Foundation School Program.
- Inputs accurate data into its Foundation School Program model.
- Incorporates all legislative mandates in its funding model (and whether that model functions properly).
- Distributes funds to school districts in a timely and accurate manner.
- Accurately adjusts school districts' funding through a post-funding adjustment process.

The scope of the audit included testing the funding allocation and settle-up processes for fiscal year 2001. We also tested a sample of payments made to school districts for fiscal year 2002.

The audit methodology consisted of collecting information, testing two random samples and performing other simulation procedures, analyzing and evaluating the results, and conducting interviews with Agency management and staff.

Table of Results and Recommendations (denotes entry is related to information technology)
The Agency administers the Foundation School Program as statute requires. (Page 1)
(No recommendations)
The Agency should address certain information technology issues to help ensure that it continues to properly administer the Foundation School Program. (Page 2)
The Agency should: ▪ Perform a monthly reconciliation between the payments the Foundation School Program system calculates and actual payments made to school districts through the Uniform Statewide Accounting System (USAS). ▪ Ensure that sufficient documentation exists to support student count projections. ▪ Improve the detail of the documentation for applications not replaced by the new system. ▪ Ensure that the new Foundation School Program system includes adequate baseline application documentation. ▪ Restrict access to data files and applications on the network server to only those users whose job responsibilities require them to have this access. ▪ Ensure that adequate separation of duties exists among the individual(s) responsible for collecting, processing, and reporting data used in determining funding allocations. ▪ Perform data edit checks of student count estimates.
The school district payment distribution process has led to school districts returning significant amounts to the State after the end of the school year. (Page 6)
(No recommendations)
As property values increase, local revenue contributes a larger share of Foundation School Program funding. (Page 7)
(No recommendations)
Statutory wealth equalization requirements extend the reliance on property values to fund the Foundation School Program. (Page 10)
(No recommendations)
Two other reports have highlighted challenges facing the Foundation School Program. (Page 14)
(No recommendations)

Recent SAO Work

Number	Product Name	Release Date
02-064	A Joint Audit Report on the Status of State Student Assessment Systems and the Quality of Title I School Accountability Data	August 2002
02-044	An Audit Report on the Quality of the State's Public Education Accountability Information	May 2002
02-030	An Audit Report on the Texas Education Agency's Monitoring of School Districts	March 2002

Other SAO Products

Number	Product Name	Release Date
03-327	A Legislative Summary Document Regarding Texas Education Agency	February 2003

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Detailed Results

Chapter 1

The Texas Education Agency Administers the Foundation School Program as Statute Requires, but It Needs to Address Certain Information Technology Issues

The Texas Education Agency (Agency) administers the Foundation School Program—the mechanism through which the State provides approximately $11 billion annually to 1,044 school districts and 166 charter schools—as statute requires. However, we identified certain information technology issues in areas such as system reconciliation, documentation, and access controls that the Agency should address to help ensure that it continues to properly administer the Foundation School Program.

Background Information

The State's Foundation School Program is funded through appropriations from the following:

- General Revenue
- Available School Fund (interest and dividends earned by the State's Permanent School Fund and 25 percent of the motor fuel taxes)
- Lottery proceeds
- Appropriated Receipts – Attendance Credits (local funds that school districts provide directly or indirectly to the Foundation School Program in accordance with statutory wealth equalization requirements)

As Chapter 42 of the Texas Education Code requires, the Agency makes Foundation School Program payments to school districts during the school year based on estimates of property values and student attendance. It is important to note, however, that in fiscal year 2001 this process resulted in school districts making a $683.8 million net refund to the Foundation School Program (in fiscal year 2000, the net refund was $275.1 million). The effect of this refund is that the State does not receive the interest on these funds; instead, the school districts retain the interest they earn on these funds.

Chapter 1-A

The Agency Administers the Foundation School Program as Statute Requires

The Agency's Foundation School Program system calculates funding allocations to school districts accurately and in compliance with legislative mandates. We recalculated the Tier I and Tier II funding allocations for one school district. We also randomly selected and tested 67 school districts and 30 charter schools to review the key inputs into the funding model for fiscal year 2001 (see text box). We did not identify any significant discrepancies. We also tested a sample of 12 payments made to school districts for timeliness and accuracy for fiscal year 2002 and identified no discrepancies. In addition, we confirmed that distributions from the Foundation School Program did not exceed the sum-certain amount of $11,567,272,693 in fiscal year 2001 as required by Rider 2, page III-9, the General Appropriations Act (76th Legislature).

Significant Inputs to the Agency's Foundation School Program System

- Student attendance
- District property values
- Budgeted/audited tax collections

Management of the Agency's School Finance/Fiscal Analysis and State Funding Divisions appear knowledgeable, experienced, and committed to complying with legislative mandates in administrating the Foundation School Program. According to the Agency, key staff in these divisions have an average of 15 years of work experience with the Agency, a majority of which is in the school funding process. Their tenure provides consistency and expertise to the operation of the Foundation School Program.

Chapter 1-B

The Agency Should Address Certain Information Technology Issues to Help Ensure that It Continues to Properly Administer the Foundation School Program

Although the Agency administers the Foundation School Program as statute requires, we identified certain information technology (IT) issues the Agency should address. While our testing did not identify any discrepancies that occurred because of these issues, the Agency should strengthen these areas to help ensure that it continues to properly administer the Foundation School Program.

According to Agency staff, the automated system the Agency uses to administer the Foundation School Program was created in the mid-1970s, and the Agency has been patching this system to keep it intact and to comply with new legislative mandates. Agency staff also informed us that the original database technology the system uses is no longer supported by its vendor. Because of that, the Agency uses Statistical Analytical Software (SAS) applications to compute funding allocations.

The Agency is developing a new Foundation School Program automated system and has already implemented several of the new system's modules. The new system is intended to serve as a more reliable platform and is expected to be fully operational for the 2003–2004 school year. Because the new system was not fully implemented at the time of our audit, we were not able to verify whether all of the IT issues we identified in the current system would be corrected after the new system is fully implemented. As it continues implementing its new system, the Agency should ensure that it does not duplicate the issues we identified in the current system.

The Agency Does Not Reconcile Payments Calculated by Its Foundation School Program System with Payments Actually Made Through the Uniform Statewide Accounting System

The Agency reconciles the total dollar amount of payment vouchers in the Uniform Statewide Accounting System (USAS) with the total dollar amount of payment vouchers in its internal accounting system. However, it does not reconcile payments made through USAS back to the Foundation School Program system, which is the original system that calculates school district payments.

We selected a sample of school district payments made through USAS and traced them back to the Foundation School Program system to assess their accuracy and timeliness. We did not identify any discrepancies. Nevertheless, without a formal reconciliation between USAS and the Foundation School Program system, there is a potential for errors to occur and go undetected.

The Agency Has Not Properly Documented All Applications and Data Used in the Foundation School Program Allocation and Payment Processes

The Agency did not have adequate documentation for the student count projections it used in the Foundation School Program allocation and payment processes for fiscal year 2001. The data was available, but the Agency did not maintain the complete set of applications it used to generate that data. Maintaining adequate documentation is important in thoroughly documenting the entire funding allocation process.

In addition, the Agency's documentation for the applications it uses in the allocation and payment processes does not adequately describe the applications. Furthermore, Agency staff responsible for the payment applications lack an adequate understanding of what these applications do. Although many of the applications in the current Foundation School Program system will be eliminated with the implementation of the new system, not all applications will be replaced.

As discussed in Chapter 1-A, key staff in the Agency's School Finance/Fiscal Analysis and State Funding Divisions have many years of experience in the allocation process; however, business continuity could be interrupted through staff turnover or other unforeseen circumstances if applications used in the funding process are not properly documented.

The Agency Should Further Restrict Access to Data Stored on Its Network Server

Although they do not need it to perform their jobs, certain users have the authority to read, change, copy, modify, and delete student count estimates, audited tax collections data, and district property value data. This increases the risk that unauthorized changes could be made to this data without detection. Given the amount of funds that flow through the Foundation School Program, the risks of unauthorized changes to the data are significant.

In addition, systems development staff have direct access to internal accounting system data and can perform voucher change and approval activities. Again, this increases that risk that unauthorized changes could be made without detection.

Separation of Duties in the Processing of Key Data Inputs Should Be Strengthened

It is possible for a single individual to receive, process, and submit data used in funding allocations. This increases the risk that accidental or unauthorized changes to funding allocations could be made. The fact that school districts have independent data to compare with the results of the allocation process acts as a compensating control. However, this compensating control would detect errors only after the fact.

Adjustments Made to School District Student Counts Increase the Risk of Error

A lack of data edit checks and sufficient verification in the Agency's process for allowing school districts to update student count estimates increases the risk that data errors could go undetected.

The Contractor that Maintains the Agency's Mainframe Is Disclosing Sensitive Information

Overall, we found that the contractor's physical security was adequate; however, the contractor's Web site publicly displays sensitive information and could compromise the security of the Agency's mainframe. During a prior State Auditor's Office audit, the contractor was advised in October 2002 that displaying this information was not appropriate. After we repeated this concern to the contractor six months later (during this current audit) the contractor removed from its Web site the information that posed the highest risk.

Recommendations

The Agency should:

- Perform a monthly reconciliation between the payments the Foundation School Program system calculates and actual payments made to school districts through USAS.
- Ensure that sufficient documentation exists to support student count projections.
- Improve the detail of the documentation for applications not replaced by the new system.
- Ensure that the new Foundation School Program system includes adequate baseline application documentation.
- Restrict access to data files and applications on the network server to only those users whose job responsibilities require them to have this access.
- Ensure that adequate separation of duties exists among the individual(s) responsible for collecting, processing, and reporting data used in determining funding allocations.
- Perform data edit checks of student count estimates.

Management's Response

The Texas Education Agency Fund Accounting Division will perform monthly reconciliations between the State Funding system for Foundation School Program payments and the actual ISAS payments at the school district level beginning in June 2003 for the May payments. ISAS payments are already reconciled monthly to USAS at the fund, appropriation, and object of expense levels; no additional USAS reconciliation will be done. If staffing limitations allow, the reconciliation will then be done each month on a year-to-date basis for a school year at the school district level. It is the agency's understanding that no discrepancies have been identified to date, and that school district reviews of payment amounts and data substantiating the calculations is a partial compensating factor.

The agency does not completely agree with the basis of the recommendation to retain the original programs used to generate the student count programs because, once information is provided to the legislature and adopted for appropriation purposes, the original programs used to make projections have not been referenced by any other outside agency until this review. However, adequate documentation of all student count projection programs is a desirable goal, and one which does not require substantial additional effort. The agency will maintain documented programs as recommended starting with the projections for the 2004-2005 biennium.

The state funding division staff will also attempt to improve baseline application documentation and will add data entry validation edits to the pupil projections process for the next biennial cycle. Additional scrutiny was given to data entered in the current cycle of review.

The new FSP system has been developed to meet all documentation standards applicable to any agency software development project. The system is expected to be fully operational beginning with the 2003-04 School Year.

The agency agrees with the recommendation to restrict access and will review access to the current system in May 2003. The new system will have a more restrictive security scheme. The agency also agrees that adequate segregation of duties is necessary, but has only limited staff resources to address the problem in the current work environment. Under the new system, there will be cleaner separation of duties that will allow for more control.

Person Responsible: Joe Wisnoski, Assistant Commissioner School Finance/Fiscal Analysis

State Auditor's Follow-up Comment

Although the Agency specifies that no other outside agency has referenced the student count projection programs until this audit, it should still maintain documentation supporting major decisions in the appropriations process for at least two biennia. Maintaining this documentation for two biennia would help to ensure that the Agency has documentation to support (1) Foundation School Program payments that are affected in the Agency's settle-up process and (2) current appropriations for the distribution of Foundation School Program funds.

Chapter 1-C

The School District Payment Distribution Process Has Led to School Districts Returning Significant Amounts to the State After the End of the School Year

Texas Education Code, Section 42.254
Estimates Required

(a) Not later than October 1 of each even-numbered year:

(1) the agency shall submit to the legislature an estimate of the tax rate and student enrollment of each school district for the following biennium; and

(2) the comptroller shall submit to the legislature an estimate of the total taxable value of all property in the state as determined under Subchapter M, Chapter 403, Government Code, for the following biennium.

(b) The agency and the comptroller shall update the information provided to the legislature under Subsection (a) not later than March 1 of each odd-numbered year.

Texas Education Code, Section 42.253
Distribution of Foundation School Fund

(a) For each school year the commissioner shall determine:

(1) the amount of money to which a school district is entitled under Subchapters B and C;

(2) the amount of money to which a school district is entitled under Subchapter F;

(3) the amount of money allocated to the district from the available school fund;

(4) the amount of each district's tier one local share under Section 42.252; and

(5) the amount of each district's tier two local share under Section 42.302.

(b) Except as provided by this subsection, the commissioner shall base the determinations under Subsection (a) on the estimates provided to the legislature under Section 42.254, or, if the General Appropriations Act provides estimates for that purpose, on the estimates provided under that Act, for each school district for each school year. The commissioner shall reduce the entitlement of each district that has a final taxable value of property for the second year of a state fiscal biennium that is higher than the estimate under Section 42.254 or the General Appropriations Act, as applicable.

As Chapter 42 of the Texas Education Code requires, the Agency makes Foundation School Program payments to school districts during the school year based on estimates of property values and attendance (see text box). The Agency then adjusts those payments the following school year after it receives final or actual property value and attendance data. Indirectly, the school districts refund to the Foundation School Program any overpayments they may have received through a decrease in their scheduled distribution payments during the following year. Conversely, if a school district has received too little funding, the Agency pays the school district in one lump sum in the first scheduled payment the following school year.

In fiscal year 2001, this process resulted in a $683.8 million net refund from school districts to the Foundation School Program (in fiscal year 2000, the net refund was $275.1 million). The effect of this refund back to the Foundation School Program is that the State does not receive the interest on these funds. Although the school districts refund this money, they retain the interest that they earn on it during the school year.

School districts generally need to make such refunds when actual property values exceed estimated property values and the resulting overfunding caused by the underestimation of property values is not offset by an underestimation of attendance (if any). When the reverse is the case (that is, if property values are overestimated and the resulting underfunding to the school districts is not offset by an overestimation of attendance), the State would need to refund money to the school districts. In that situation, the State would retain the interest on the money it refunds to the school districts.

Chapter 2

Fluctuations in Economic Conditions Could Require the State to Begin Funding a Larger Share of the Foundation School Program

Historically, economic conditions have led to increasing property values, a key variable in the statutory funding formulas used in the Foundation School Program. As a result of the increases in property values, local revenue provided 59 percent of the total cost for the Foundation School Program in fiscal year 2003, while the State contributed 41 percent. However, if economic conditions deteriorate, property values could decline, leaving the State responsible for funding a larger share of the Foundation School Program.

The State acts as a guarantor for the Foundation School Program and, therefore, ultimately bears the burden of funding for public education if economic conditions deteriorate.

Chapter 2-A

As Property Values Increase, Local Revenue Contributes a Larger Share of Foundation School Program Funding

Because property values have increased during the past decade in step with favorable economic conditions, local revenue has provided an increasingly larger share of the total funding for the Foundation School Program. However, if economic conditions deteriorate and property values decline, statutory funding formulas could require the State to provide a larger share of funding for the Foundation School Program.

The increases in property values correlate directly with the increasing local share of Foundation School Program funding during the past 10 years:

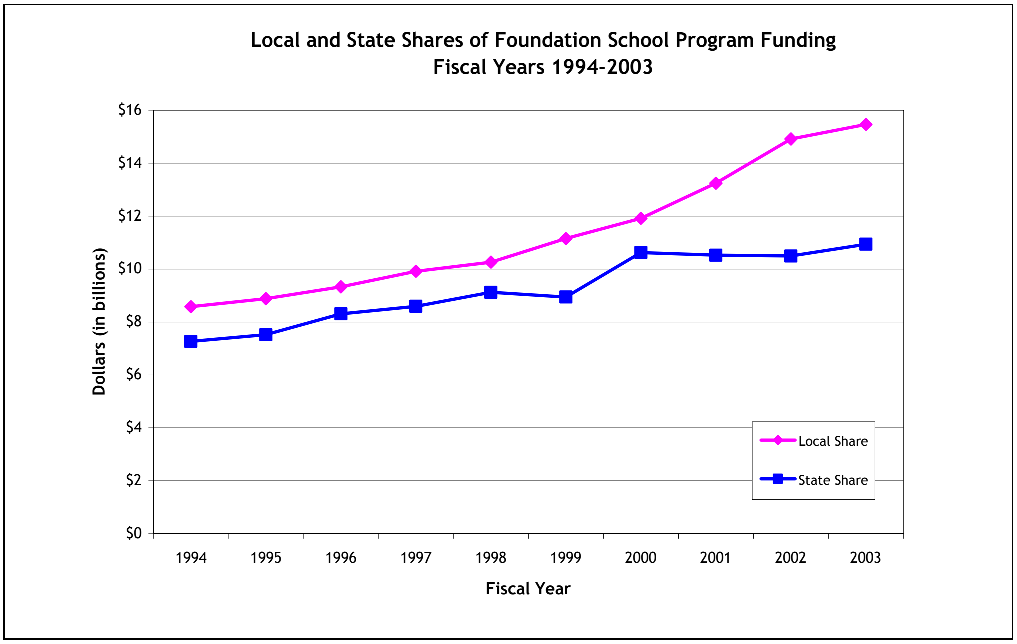
- Since fiscal year 1994, total state and local funding for public education through the Foundation School Program has increased by 67 percent. However, while the State's share of that funding increased by 50 percent, the local share increased by 80 percent.
- In fiscal year 1994, the State contributed 46 percent of the total funding for public education through the Foundation School Program; in fiscal year 2003, the State's share was 41 percent.

In addition, as Figure 1 illustrates, the local share of public education funding through the Foundation School Program has continued to increase since fiscal year 2000, but the State's share of that funding has remained roughly at the same level.[1] While increases in enrollment increase the State's share, relatively greater increases

[1] The State also contributes funding to public education through means other than the Foundation School Program. In fiscal year 2002, the State provided $1.6 billion in contributions for teacher retirement matching funds and retiree health insurance. In addition, according to the Telecommunications Infrastructure Fund Board, that agency provided $81 million to school districts in fiscal year 2002. (The Legislature appropriated an additional $18.9 million from the Telecommunications Infrastructure Fund to the Texas Education Agency that same year.) In fiscal year 2003, the State also began contributing $1,000 per employee for teacher health insurance. The State also receives more than $2.6 billion annually in federal funds for public education.

in property values have offset that effect to the extent that the State's share has remained roughly at the same level.

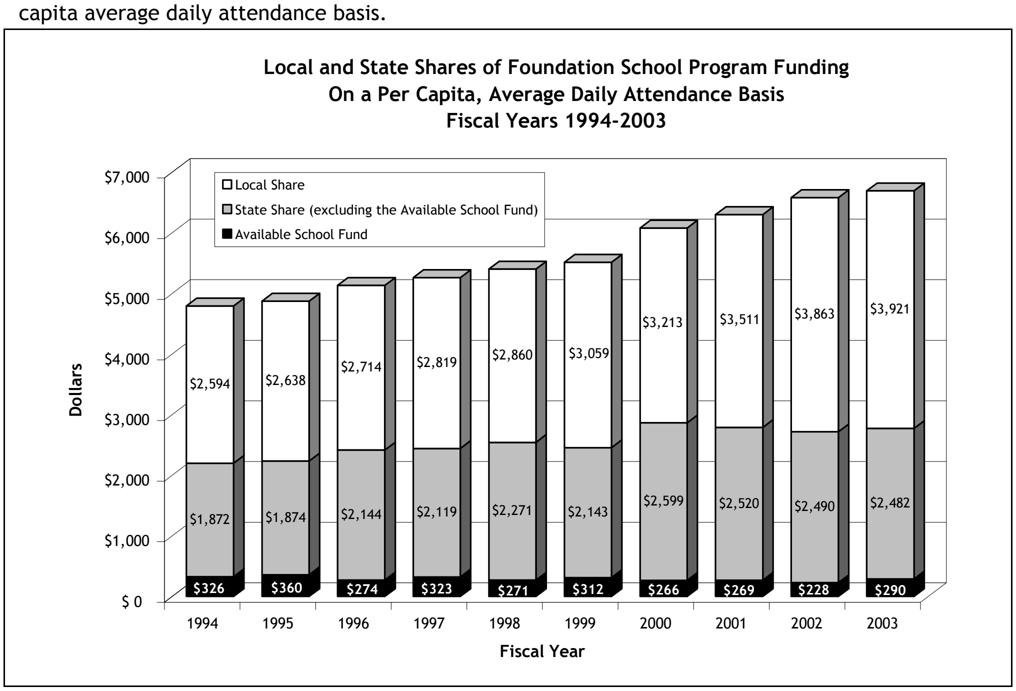
Figure 1 – The local share of Foundation School Program funding exceeds the state share.



Source: Texas Education Agency

Figure 2 shows the state and local shares per average daily attendance (ADA) for the last 10 years. The Available School Fund is separated only to show its relative proportion to the total state share.

Figure 2 – The local share of Foundation School Program funding exceeds the state share on a per capita average daily attendance basis.



Source: Texas Education Agency

The Structure of the Statutory Funding Formulas for the Foundation School Program Demonstrates the Significance of Property Values

The significance of property values is evident in the structure of the Foundation School Program funding formulas. There is a direct relationship between increasing property values and increasing responsibility at the local level for funding public education.

The Foundation School Program distributes funds to school districts through two "tiers" established in statute:

- **Tier I Funding.** Tier I formulas calculate a basic allotment (adjusted for district characteristics and student attributes) from the Foundation School Program for each school district. The Tier I calculation for a school district's share of this allotment is 86 cents per each $100 of valuation of the district's property values. The State's share is the basic allotment minus the school district share of that allotment. Therefore, as property values increase, the portion of Tier I funding a school district must pay increases and the State's share of Tier I funding decreases.

  It is also important to note that Texas Education Code, Section 42.252(d), requires school districts to contribute their share of public education funding to be eligible to receive payments from the Foundation School Program.

- **Tier II Funding.** Alternatively known as the Guaranteed Yield Amount, Tier II calculates the amount of funding each district will receive per penny of tax effort. This funding also is offset by local revenue. The calculation for the local share of Tier II funding is as follows: (school district tax rate) × (taxable value of property in the school district for the preceding tax year /100). Therefore, as with Tier I funding, state funding is reduced when property values increase.

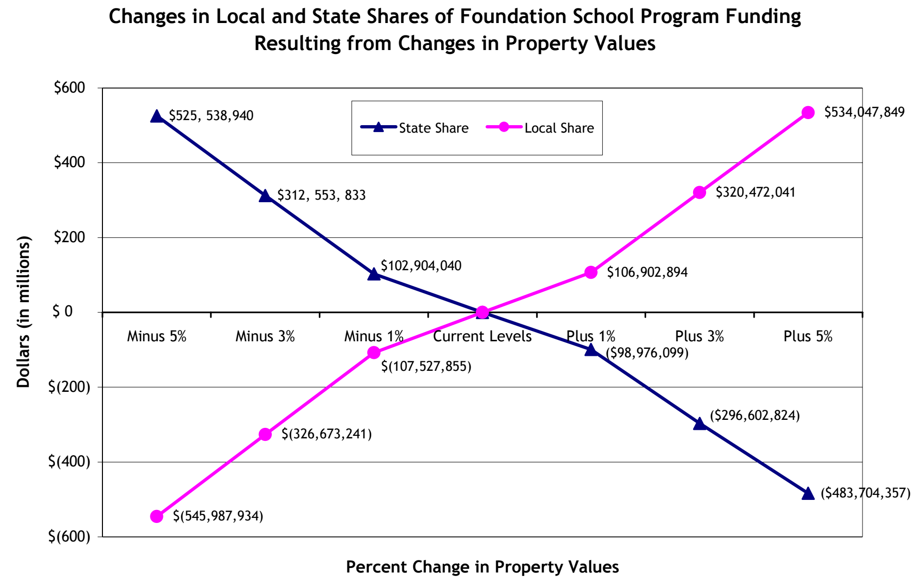
The ultimate result of using the Tier I and Tier II funding formulas is that, as property values increase, there is approximately a dollar-for-dollar trade-off between the State's share of funding for the Foundation School Program and the local share. Likewise, if property values decreased, the State's share of Foundation School Program funding would increase on approximately a dollar-for-dollar basis.

Even Small Changes in Property Values Can Have a Significant Effect on State and Local Shares of Foundation School Program Funding

Figure 3 illustrates the sensitivity of the Foundation School Program to changes in property values. For example, if property values increased by 5 percent, the State's share of Foundation School Program funding would decrease by $483.7 million. On the other hand, if property values decreased by 5 percent, the State's share of Foundation School Program funding would increase by $525.5 million. This could place the State at risk of being required to provide additional school funding if economic conditions declined enough to cause property values to decrease. It is important to note that, in reality, property values in school districts would not respond in a uniform way to changes in economic conditions, and economic conditions vary across the state.

In addition, the State acts as a guarantor for the Foundation School Program. Therefore, the State is vulnerable to shifting economic conditions and must contribute more or less to the Foundation School Program in response to these conditions. The State ultimately bears the burden of funding for public education if economic conditions deteriorate.

Figure 3 – Even small changes in property values can have a significant effect on state and local shares of Foundation School Program funding.



Note: The "what if" scenario presented in Figure 3 is intended to show the estimated effects of changes in property values on the statutory Foundation School Program funding formulas; it is not intended to make projections.

Source: Texas Education Agency

Chapter 2-B

Statutory Wealth Equalization Requirements Extend the Reliance on Property Values to Fund the Foundation School Program

The effect of increasing property values on the Foundation School Program is not limited to the impact on the Foundation School Program funding formulas discussed in Chapter 2-A. Increasing property values extend the reliance on local funding for the Foundation School Program through their effect on the wealth equalization process required by Texas Education Code, Chapter 41. The risk to the State grows larger if property values decline because (1) the amount of funds returned through wealth equalization would decrease and (2) if property values decline enough, the State may be required to start funding school districts that were formerly, but are no longer, property wealthy.

School districts return local revenue in excess of the statutory equalized level to the State through specific options outlined in statute. As a result, property-wealthy school districts are funded entirely from local funds, except for a constitutionally mandated allotment from the Available School Fund (ASF) and a $30 per-student technology allotment. If property values decline, however, the number of property-wealthy school districts could decrease, which in turn would lead to a decrease in the amount of funds school districts return to the State through wealth equalization.

School Districts Have Several Statutory Options for Wealth Equalization

> **Texas Education Code, Section 41.003 Options to Achieve Equalized Wealth Level**
>
> A district with a wealth per student that exceeds the equalized wealth level may take any combination of the following actions to achieve the equalized wealth level:
>
> (1) consolidation with another district as provided by Subchapter B;
>
> (2) detachment of territory as provided by Subchapter C;
>
> (3) purchase of average daily attendance credit as provided by Subchapter D;
>
> (4) education of nonresident students as provided by Subchapter E; or
>
> (5) tax base consolidation with another district as provided by Subchapter F.

Texas Education Code, Chapter 41, requires school districts whose property values per student in weighted average daily attendance (WADA) exceed $305,000 to reduce their wealth through one of or a combination of five options (see text box). Through these options, the State receives any school district property tax revenue that exceeds the equalized wealth level.

According to the Texas Education Agency, school districts whose property values per student in WADA exceed $305,000 have predominantly used only the following two statutory options to date:

- **Option 3 – Purchase of average daily attendance credit.** Through this option, property-wealthy school districts provide funds directly to the Foundation School Program. Specifically, a property-wealthy school district purchases the number of WADA credits from the State that reduces its property value per student in WADA to $305,000. The State then deposits the proceeds from this transaction into the State Treasury, and the Foundation School Program distributes these funds through the Foundation School Program funding formulas described in Chapter 2-A.

- **Option 4 – Education of nonresident students.** Through this option, property-wealthy school districts (also referred to as Chapter 41 districts) provide funds to the Foundation School Program in an indirect fashion. Specifically, a property-wealthy school district purchases WADA credits directly from another "partner" school district whose wealth per student is less than $305,000 (also referred to as a Chapter 42 district). The State then reduces the Foundation School Program payments it makes to the Chapter 42 district.

  It is important to note that the mechanics of this option may not completely achieve the intent of wealth equalization because, through this option, the partner school district receives additional funding in excess of the amount allocated through the Foundation School Program. This occurs because:

  - The property-wealthy school district purchases WADA credits from the partner school district *at the property-wealthy school district's cost* to divest excess funds. (For example, it purchases WADA at $4,000 per credit.)

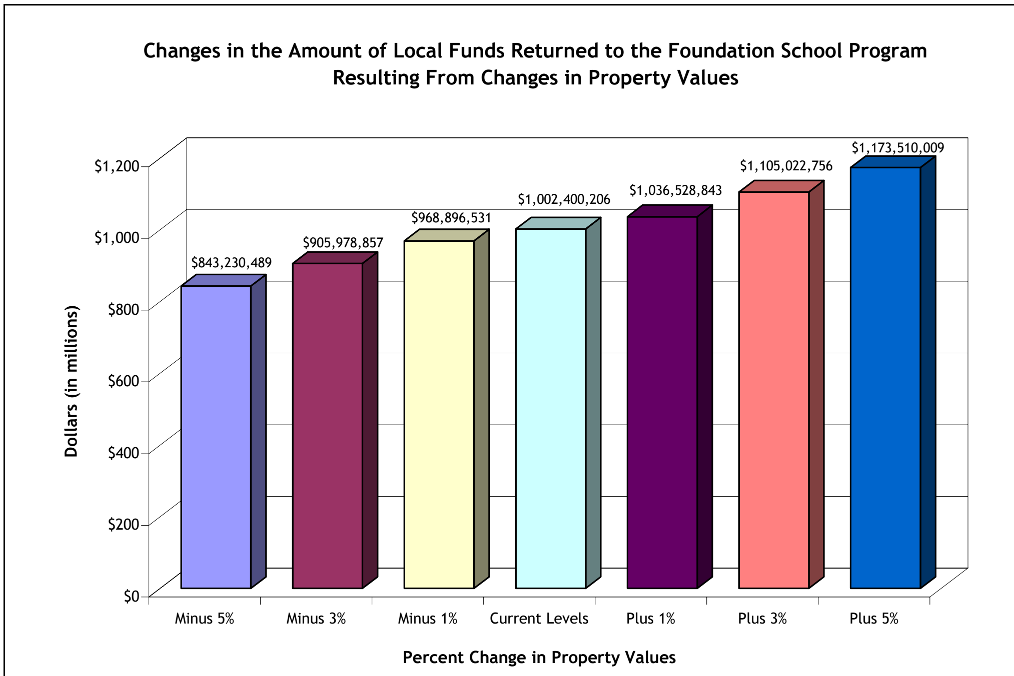
  - The State then reduces Foundation School Program funding of the partner school district *at the partner district's cost of WADA.* (For example, the State reduces the partner school district's funding by $3,000 per WADA credit. This difference of $1,000 between the two school districts' costs is a profit or "net gain" to the partner school district.)

  This arrangement has an unintended consequence of creating a potential reverse equity issue because the partner school district is receiving funding above the statutory funding formulas prescribed through the Foundation School Program. School districts that do not have the opportunity to enter into these partnerships will not receive additional funding above the amount allocated through the statutory formulas. In addition, the school districts are allowed to retain this profit or "net gain," which represents a loss of revenue to the State. In fiscal years 1999 through 2002, this loss totaled approximately $200 million. The Legislative Budget Board has previously reported on this issue in an April 2002 report titled *Regional Education Service Centers and Wealth Equalization "Option 4" Arrangements.* See Chapter 2-C for additional information on that report.

Even Small Changes in Property Values Can Have a Significant Effect on the Amount of Local Funds that Property-Wealthy School Districts Provide Directly or Indirectly to the Foundation School Program

Figure 4 illustrates how the amount of local funds that school districts provide to the Foundation School Program under the wealth equalization options changes when property values change. For example, if property values increased by 5 percent, the amount of local funding that property-wealthy school districts would provide to the Foundation School Program would increase by $171.1 million. On the other hand, if property values decreased by 5 percent, the amount of local funding school districts would provide to the Foundation School Program would decrease by $159.2 million. This could place the State at risk of being required to provide additional school funding if economic conditions declined enough to cause property values to decrease.

Figure 4 – Even small changes in property values can have a significant effect on the amount of local funds school districts return directly or indirectly to the Foundation School Program under wealth equalization requirements.



Note: The "what if" scenario presented in Figure 4 is intended to show the estimated effects of changes in property values on the amount of funds school districts would return to the Foundation School Program under wealth equalization; it is not intended to make projections. In reality, the property values in school districts would not respond in a uniform way to changes in economic conditions, and economic conditions vary across the state.

Source: Texas Education Agency

In fiscal year 2002, a total of 101 property-wealthy school districts provided $676.9 million directly or indirectly to the Foundation School Program under the two options discussed previously.[2]

- Using option 3, property-wealthy districts provided $142.7 million directly to the Foundation School Program through purchases of WADA credits from the State.
- Using option 4, property-wealthy districts indirectly provided $534.2 million to the Foundation School Program through partnerships with other school districts. Through those arrangements, the partner school districts also retained $87.3 million in net gains that did not go back to the Foundation School Program.

In fiscal years 1999 through 2002, property-wealthy school districts returned $2 billion directly or indirectly to the Foundation School Program.

The Number of School Districts Subject to Wealth Equalization Requirements Is Increasing, but These Districts' Property Tax Rates Are Also Approaching the Statutory Maximum

As Table 1 shows, the number of school districts that have been required to exercise statutory wealth equalization options has increased since 1999. At the same time, the subset of those districts whose property tax rates are already at the statutorily established maximum of $1.50 per $100 of valuation increased from 11 in fiscal year 1999 to 26 in 2003. (On average, however, the property tax rates of property-wealthy school districts have decreased since fiscal year 1999.)

As these school districts' property values rise, any increase in local revenue generated will be returned to the Foundation School Program (assuming student attendance holds constant). However, as more school districts reach the $1.50 maximum, their ability to earn local revenue becomes more limited. In addition, if economic conditions deteriorated, the amount of revenue returned to the Foundation School Program would decrease, as discussed previously.

Texas Education Code, Section 45.003(d) Bond and Tax Elections

(d) A proposition submitted to authorize the levy of maintenance taxes must include the question of whether the governing board or commissioners court may levy, assess, and collect annual ad valorem taxes for the further maintenance of public schools, at a rate not to exceed the rate, which may be not more than $1.50 on the $100 valuation of taxable property in the district, stated in the proposition.

[2] The amount that property-wealthy school districts will provide directly or indirectly to the Foundation School Program in fiscal year 2003 is estimated to be $967 million.

Table 1 – The number of school districts required to exercise statutory wealth equalization options is increasing.

Schools Districts Required to Exercise Statutory Wealth Equalization Options for Fiscal Years 1999-2003			
Fiscal Year	Number of School Districts Whose Property Values per Student in WADA Exceeded the Statutory Maximum	Average Property Tax Rate	Number of School Districts Whose Property Tax Rate Equaled the Statutory Maximum of $1.50 per $100 Valuation
1999	93	$1.34	11
2000	88	$1.34	14
2001	84	$1.37	25
2002	101	$1.35	19
2003	118	$1.33	26

Source: Texas Education Agency

Chapter 2-C

Two Other Reports Have Highlighted Challenges Facing the Foundation School Program

The 76th Legislature directed the Charles A. Dana Center at The University of Texas at Austin to conduct a study on regional price variations in resource costs and costs of education that are beyond the control of a school district. In its report to the 77th Legislature (*A Study of Uncontrollable Variations in the Costs of Texas Public Education*, November 2000), the Charles A. Dana Center provided analyses and associated costs for updating the Cost-of-Education Index (CEI), a factor used to determine the amount of funding that school districts receive through the Foundation School Program (see text box).

Texas Education Code, Sections 42.102(a) and (b)
Cost of Education Adjustment

(a) The basic allotment for each district is adjusted to reflect the geographic variation in known resource costs and costs of education due to factors beyond the control of the school district.

(b) The cost of education adjustment is the cost of education index adjustment adopted by the foundation school fund budget committee and contained in Chapter 203, Title 19, Texas Administrative Code, as that chapter existed on March 26, 1997.

The Charles A. Dana Center's study found that the CEI the State currently uses is based on a cost analysis that is more than 10 years old. During the 1999–2000 biennium, the CEI affected approximately $1.23 billion of the Foundation School Program funding distributed annually to school districts. The study specified that to update the CEI, however, the State would have to provide an additional $296 million to $368 million to fund public education (based on index values generated using 1998–1999 data).

During our audit, we applied the updated CEI the Charles A. Dana Center calculated to the Foundation School Program funding model used for the 2002–2003 school year, using projected index values by school district for 1999–2000. We estimated that the net increase in state funding would have been $442 million for the 2002–2003 school year. (CEI values increased funding for 689 school districts by $463 million and decreased funding for 114 school districts by $21 million, for a net increase of $442 million.)

Under a directive from the Joint Select Committee on Public School Finance, the Legislative Budget Board issued the previously mentioned report, *Regional Education Service Centers and Wealth Equalization "Option 4" Arrangements,* in April 2002, which identified several findings relating to the option 4 wealth equalization arrangement. Focusing on the 2001–2002 school year, the report identified key findings such as the following:

- Partner school districts experienced $84 million in net gain from 164 option 4 arrangements. The report specified that "Net gain is the total amount paid by Chapter 41 districts above what the partner district would have received from the state in Tier I and Tier 2."

- Regional Education Service Centers (ESC) were involved with $57 million of the net gain and served as fiscal agents in 109 of these arrangements.

Appendix

Objective, Scope, and Methodology

Objective

The objective of the audit was to determine how the Texas Education Agency's (Agency) cash management processes affect funds available to support public education. To accomplish this overall objective, we determined whether the Agency:

- Has information technology systems adequate to support the administration of the Foundation School Program.
- Inputs accurate data into its Foundation School Program model.
- Incorporates all legislative mandates in its funding model (and whether that model functions properly).
- Distributes funds to school districts in a timely and accurate manner.
- Accurately adjusts school districts' funding through a post-funding adjustment process.

Scope

The scope of this audit included funding allocations and settle-up processes with school districts and charter schools for fiscal year 2001. We also tested a sample of payments to school districts for fiscal year 2002 for timeliness and accuracy.

Statutes addressed during this audit included:

- Texas Education Code, Chapter 42 – Foundation School Program
- Texas Education Code, Chapter 41 – Equalized Wealth Level
- Texas Education Code, Section 12.106 (State Funding) – Charter Schools

Methodology

The audit methodology consisted of collecting information, performing selected tests and other procedures, analyzing and evaluating the results against statutes, and conducting interviews with Agency management and staff.

<u>Information collected</u> to accomplish our objectives included the following:

- Interviews with Agency staff and members of the Agency
- Texas Education Code, Chapters 12, 41, 42, and 46
- General Appropriations Acts (76th and 77th Legislatures)

- Statistical Analytical Software (SAS) programs
- Texas Education Agency *School Finance Handbook*
- Texas Education Agency Division of State Funding *Summary of Finances Report*
- Texas Education Agency Internal Audit Report on the State Funding Division
- *A Study of Uncontrollable Variations in the Costs of Texas Public Education*, Charles A. Dana Center, The University of Texas at Austin, November 2000
- *Regional Education Service Centers and Wealth Equalization "Option 4" Arrangements*, Legislative Budget Board, April 2002
- *Financing Public Education in Texas Kindergarten through Grade 12 Legislative Primer, Third Edition*, Legislative Budget Board, April 2001
- Texas Education Agency *Internal Accounting Procedure Manual*

<u>Procedures, tests and analyses performed</u> included the following:

- Recalculation of one school district's Tier I and Tier II funding
- Completeness test to determine whether the school districts reporting attendance to the Public Education Information Management System (PEIMS) were included in the funding allocation model
- Statistical test of school district and charter school inputs and comparison to *Summary of Finance* report
- Random sample of payments made to school districts
- Analysis of the Cost-of-Education Index
- Analysis of option 4 arrangements
- Analysis of proportionate growth in local and state funding
- Sensitivity analysis of attendance and district property values
- Sensitivity analysis of Chapter 41 school districts
- Review of automated information system for allocations and payment processes
- Physical security review

<u>Information resources reviewed</u> included the following:

- Requirements in Texas statutes
- Requirements in the General Appropriations Act

Criteria used to accomplish our objectives included the following:

- Statutory requirements
- Foundation School Program system
- Texas Education Agency *School Finance Handbook*
- Texas Education Agency Division of State Funding *Summary of Finances Report*

Other Information

We conducted fieldwork from October 2002 through March 2003. We conducted this audit in accordance with generally accepted government auditing standards.

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- Ed Santiago
- Worth Ferguson, CPA (Quality Control Reviewer)
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Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Tom Craddick, Speaker of the House, Chair
The Honorable David Dewhurst, Lieutenant Governor, Vice Chair
The Honorable Teel Bivins, Senate Finance Committee
The Honorable Bill Ratliff, Senate State Affairs Committee
The Honorable Talmadge Heflin, House Appropriations Committee
The Honorable Ron Wilson, House Ways and Means Committee

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Texas Education Agency

Dr. Felipe Alanis, Commissioner of Education