

TEXAS TREASURY SAFEKEEPING TRUST COMPANY
(A Component Unit of the State of Texas)

Basic Financial Statements

August 31, 2008

(With Independent Auditors' Report Thereon)

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

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Padgett Stratemann & Co. LLP
CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Independent Auditors' Report

Honorable Susan Combs
Comptroller of Public Accounts
State of Texas:

We have audited the accompanying financial statements of the business-type activities, each major fund, and the aggregate remaining fund information of the Texas Treasury Safekeeping Trust Company (Texas Trust), a component unit of the State of Texas, as of and for the year ended August 31, 2008, which collectively comprise Texas Trust's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the management of Texas Trust. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Texas Trust's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As described in Note 1, the financial statements present only the financial statements of Texas Trust and do not purport to, and do not, present fairly the financial position of the State of Texas as of August 31, 2008, and the changes in its financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities, each major fund, and the aggregate remaining fund information of Texas Trust, as of August 31, 2008, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 20, 2008 on our consideration of Texas Trust's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 6 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise Texas Trust's basic financial statements. The accompanying supplemental information on page 29 is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplemental information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Padgett, Stratemann + Co., LLP

Austin, Texas
November 20, 2008

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Management's Discussion and Analysis

August 31, 2008

This section of the Texas Treasury Safekeeping Trust Company's (Texas Trust) annual financial report presents discussion and analysis of its financial performance during the fiscal year ended August 31, 2008, and should be read in conjunction with Texas Trust's financial statements, which follow this section.

Financial Highlights

- Texas Trust's total managed funds, including pooled funds, exceeded sixty (60) billion dollars at August 31, 2008.
- Texas Trust had fees for services in fiscal year 2008 of \$20,229,361 and non-operating revenues of \$410,656 (interest income). Operating expenses were \$15,118,681.

Overview of the Financial Statements

This report consists of four parts that explain some of the information in the financial statements in more detail – Independent Auditors' Report; Management's Discussion and Analysis (this section); Financial Statements; and, Notes to the Financial Statements.

The proprietary fund financial statements presented herein include the operations of the Texas Trust using the approach as prescribed by Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. They present the financial statements of the Texas Trust from the economic resources measurement focus using the accrual basis of accounting.

The Statement of Net Assets presents information on all of the Texas Trust's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Texas Trust is improving or deteriorating. Additionally, certain eliminations have occurred as prescribed by the statement in regards to interfund activity, payables, and receivables.

The Statement of Revenues, Expenses, and Changes in Net Assets presents information showing how the Texas Trust's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the time of related cash flows. Thus, revenues and expenses are reported for some items that will only result in cash flows in future fiscal periods. The business-type activities of Texas Trust include providing investment management and custody services. Management fees charged to customers support these activities.

The fund financial statements include statements for each of the following categories- proprietary and fiduciary.

Within the above listed categories, the Texas Trust's financial statements are comprised of three funds: Enterprise Fund (proprietary), Investment Trust Funds (fiduciary) and Agency Funds (fiduciary). The funds comprising these three categories are provided for by State legislation, which governs the operations and investment parameters within which Texas Trust functions as a custodian and investment service provider.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Management's Discussion and Analysis

August 31, 2008

Enterprise Funds are used to report any activity for which a fee is charged to users for services such as investment management and custodial services. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs. The Texas Trust accounts for its daily operations using an enterprise fund. The Texas Trust performs custodial and investment services for entities in the other two fund categories for a fee designed on a cost recovery basis. In Fiscal Year (FY) 2008, the Texas Trust charged client funds \$20,229,361 in fees and incurred \$15,118,681 in related service expense generating those fees.

Investment Trust Funds are used to report the external portion of investment pools reported by the sponsoring government. The Texas Trust accounts for monies constituting the Texas Local Government Investment Pool and the Texas Local Government Investment Pool Prime in an investment trust fund.

Agency Funds are used to report resources held by the reporting government in a purely custodial capacity. Agency funds typically involve only the receipt, temporary investment, and remittance of fiduciary resources to individuals, private organizations, or other governments. The Texas Trust accounts for monies held for certain state agencies including the Treasury Pool, Tobacco Settlement Permanent Trust Fund and securities held on behalf of their owners or beneficiaries in agency funds. Those agencies contract with the Texas Trust for investment management and custodial services.

The Enterprise Fund, which represents Texas Trust's operating funds, is reported as a proprietary component unit of the State of Texas, and as such is accounted for using the flow of economic resources measurement focus and accrual basis of accounting. Accordingly, revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow, similar to private sector companies.

Condensed Financial Information for 2008 and 2007 (in 000's)

| | 2008 | 2007 |
|----------------------------|-------------------------------------|-------------------------------------|
| | Business-type Activities | Business-type Activities |
| Assets: | | |
| Current assets | \$ 18,039 | 12,769 |
| Capital assets | 1,255 | 458 |
| Noncurrent assets | 5,202 | 5,183 |
| Total assets | 24,496 | 18,410 |
| Current liabilities | 3,379 | 2,838 |
| Noncurrent liabilities | 214 | 182 |
| Total liabilities | 3,593 | 3,020 |
| Invested in capital assets | 1,255 | 458 |
| Unrestricted | 19,648 | 14,932 |
| Total Net Assets | \$ 20,903 | 15,390 |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Management's Discussion and Analysis

August 31, 2008

Condensed Financial Information for 2008 and 2007 (in 000's) (continued)

| | 2008 | 2007 |
|------------------------------|-------------------------------------|-------------------------------------|
| Changes in Net Assets | Business-type Activities | Business-type Activities |
| Charges for service | \$ 20,229 | 18,092 |
| Interest Income | 411 | 599 |
| Total revenues | 20,640 | 18,691 |
| Total expenses | 15,127 | 15,885 |
| Change in net assets | \$ 5,513 | 2,806 |

Overall Financial Analysis

Business-type Activities

Business-type activities generated revenue of \$20.6 million, including charges for services of \$20.2 million, an increase of \$1.9 million during FY 2008. Total expenses for business-type activities were \$15.1 million, a decrease of \$0.8 million during FY 2008. The increase in revenue is primarily a result of the increase in assets under management, which grew from \$45 billion at the end of FY 2007 to \$60 billion at the end of FY 2008. The decrease in expenses is primarily due to a reduction in external funds management fees assessed to the Texas Trust for the Endowment funds. The reduction was due to a decrease in assets under management of these funds managers. In addition, services for professional fees paid under the business planning and systems infrastructure contract decreased from prior year and the contract ended in June 2008. As a result of the above, Texas Trust reported a net gain from business-type activities of \$5.5 million for the year ended August 31, 2008.

Individual Fund Financial Analysis

Investment Trust Fund

The fund balance includes the Texas Local Government Investment Pool (TexPool) and the Texas Local Government Investment Pool Prime (TexPool Prime) that is operated for the benefit of local governments.

The balance in the fund at August 31, 2008 is \$18.9 billion and the net increase in fiduciary net assets for FY 2008 is \$1.5 billion.

Agency Fund

This fund includes assets held by the Texas Trust on behalf of various agencies and special accounts. The balance of funds held for others at August 31, 2008 is \$41.9 billion. There is no change in fund balance as Texas Trust holds these amounts as custodial assets only.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Management's Discussion and Analysis

August 31, 2008

Capital Assets and Long-term Debt

The Texas Trust's investment in capital assets for its business type activities as of August 31, 2008 amounts to \$1.3 million (net of accumulated depreciation). This investment in capital assets includes leasehold improvements, furniture, equipment, and software.

Texas Trust has no long-term debt and only short-term trade payables. The Texas Trust maintains an account with the Federal Reserve and during the year kept an average of \$5 million in reserves. The amount in reserve varies over time and is based upon the average daily balance over a weekly calculated period. The amount of the reserve requirement is based upon the amount required to generate an earnings credit sufficient to offset fees charged by the Federal Reserve for services it provides to the Texas Trust. The Texas Trust also has an account with Depository Trust Company, and maintains the required minimum balance in reserves.

Significant Known Facts, Decisions, or Conditions

Subsequent to August 31, 2008, the credit and liquidity crisis in the United States and throughout the global financial system has resulted in substantial volatility in financial markets and the banking system. These and other economic events have had a significant adverse impact on some investment portfolios. As a result, as of October 31, 2008, the endowment fund component of the Agency Fund has incurred a decline in fair value of its investments of approximately 15% as compared to the recorded value at August 31, 2008. The Texas Trust Enterprise and Investment Trust Funds and the Treasury Pool component of the Agency Fund have not experienced a significant adverse decline in the fair value of their investments subsequent to August 31, 2008.

Contacting Texas Trust's Financial Management

This financial report is designed to provide Texas Trust customers, business partners and creditors with a general overview of its finances. Questions about this report can be directed to Texas Trust's Chief Financial Officer, Frank Zahn at (512) 463-3129.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Statement of Net Assets

Proprietary Fund

August 31, 2008

| Assets | Enterprise Fund |
|--|----------------------------|
| Current assets: | |
| Cash and cash equivalents | |
| Cash in bank | \$ 51,432 |
| Cash in State Treasury | 464,223 |
| Investments in repurchase agreements | 14,573,983 |
| Receivables from: | |
| Management fees | 2,724,638 |
| Interest | 10,676 |
| Other | 50,387 |
| Prepaid expenses | 163,635 |
| Total current assets | <u>18,038,974</u> |
| Non-current assets: | |
| Restricted cash and cash equivalents | |
| Cash in bank | 5,149,970 |
| Restricted investments | 52,314 |
| Capital assets: | |
| Depreciable : | |
| Software (net) | 852,098 |
| Building and building improvements (net) | 140,795 |
| Furniture and equipment (net) | 262,400 |
| Total non-current assets | <u>6,457,577</u> |
| Total assets | <u>24,496,551</u> |
| Liabilities | |
| Current liabilities: | |
| Accounts payable | 2,008,072 |
| Payroll payable | 1,092,398 |
| Employee's compensable leave | 278,305 |
| Total current liabilities | <u>3,378,775</u> |
| Non-current liabilities: | |
| Employee's compensable leave | 214,234 |
| Total non-current liabilities | <u>214,234</u> |
| Total liabilities | <u>3,593,009</u> |
| Net assets: | |
| Invested in capital assets | 1,255,293 |
| Unrestricted: | 19,648,249 |
| Total net assets | <u>\$ 20,903,542</u> |

The accompanying notes are an integral part of the financial statements.

TEXAS TREASURY SAFEKEEPING TRUST COMPANYStatement of Revenues, Expenses, and
Changes in Net Assets

Proprietary Fund

For the Year Ended August 31, 2008

| | Enterprise Fund |
|--------------------------------------|----------------------------|
| Operating revenue - management fees | \$ 20,229,361 |
| Operating expenses: | |
| Salaries and wages | 4,995,937 |
| Payroll related costs | 885,675 |
| Professional fees and services | 7,649,901 |
| Travel | 82,047 |
| Materials and supplies | 101,114 |
| Communication and utilities | 373,749 |
| Repairs and maintenance | 19,151 |
| Rentals and leases | 294,331 |
| Printing and reproduction | 5,273 |
| Depreciation | 340,575 |
| Other operating expenses | 370,928 |
| Total operating expenses | <u>15,118,681</u> |
| Operating income | <u>5,110,680</u> |
| Nonoperating revenue (expenses): | |
| Investment income | 410,656 |
| Settlement of claims | (7,931) |
| Net nonoperating revenues (expenses) | <u>402,725</u> |
| Change in net assets | <u>5,513,405</u> |
| Total net assets - beginning of year | <u>15,390,137</u> |
| Total net assets - end of year | <u>\$ 20,903,542</u> |

The accompanying notes are an integral part of the financial statements.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Statement of Cash Flows

Proprietary Fund

For the Year Ended August 31, 2008

| | Enterprise Fund |
|--|----------------------------|
| Cash flows from operating activities: | |
| Proceeds from management fees | \$ 20,155,255 |
| Payments to employees | (5,162,972) |
| Payments for operating expenses | (9,122,465) |
| Other cash receipts (payments) | (50,387) |
| Net cash provided by operating activities | <u>5,819,431</u> |
| Cash flows from capital and related financing activities: | |
| Payments for additions to capital assets | (1,138,257) |
| Net cash used for capital and related financing activities | <u>(1,138,257)</u> |
| Cash flows from investing activities: | |
| Proceeds from interest and investment income | 404,170 |
| Net cash provided by investing activities | <u>404,170</u> |
| Net increase in cash and cash equivalents | 5,085,344 |
| Cash and cash equivalents-August 31, 2007 | <u>15,154,264</u> |
| Cash and cash equivalents-August 31, 2008 | <u>\$ 20,239,608</u> |
| Reconciliation of operating income to net cash provided by operating activities: | |
| Operating income | \$ 5,110,680 |
| Adjustments to operating income to net cash provided by operating activities: | |
| Classification differences | (7,931) |
| Depreciation expense | 340,575 |
| Changes in assets/liabilities: | |
| Receivables | (124,493) |
| Prepaid expenses | (72,590) |
| Payables | 573,190 |
| Net cash provided by operating activities | <u>\$ 5,819,431</u> |
| Displayed as: | |
| Cash in bank | 51,432 |
| Cash in State Treasury | 464,223 |
| Investments in repurchase agreements | 14,573,983 |
| Restricted cash in bank | 5,149,970 |
| Total cash and cash equivalents | <u>\$ 20,239,608</u> |

The accompanying notes are an integral part of the financial statements.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Statement of Fiduciary Net Assets

Fiduciary Funds

August 31, 2008

| | Investment Trust Fund | Agency Fund |
|---|----------------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Assets | | |
| Cash in bank | \$ 188 | 7,845,360 |
| Securities lending collateral | — | 50,164,753 |
| Deposits | — | 589,633,563 |
| Investments | 18,882,383,209 | 41,180,572,218 |
| Accrued interest receivable | 19,237,430 | 118,189,895 |
| Trades pending settlement | — | 1,798,460 |
| | <u> </u> | <u> </u> |
| Total assets | <u>18,901,620,827</u> | <u>41,948,204,249</u> |
| Liabilities | | |
| Accounts payable | 48,236 | 1,701,371 |
| Interest payable | — | 31,803 |
| Amounts payable to participants | 37,744,350 | — |
| Trades pending settlement | — | 3,708,827 |
| Management fees reserved for operating expenses | 751,084 | — |
| Obligations under securities lending | — | 50,164,753 |
| Obligations under reverse repurchase agreements | — | 146,752,655 |
| Funds held for others | — | 41,745,844,840 |
| | <u> </u> | <u> </u> |
| Total liabilities | <u>38,543,670</u> | <u>41,948,204,249</u> |
| Net Assets | | |
| Held in trust for pool participants and other purposes | <u>\$ 18,863,077,157</u> | |

The accompanying notes are an integral part of the financial statements.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Statement of Changes in Fiduciary Net Assets

Fiduciary Funds

For the Year Ended August 31, 2008

| | Investment Trust Fund |
|--|----------------------------------|
| Additions: | |
| Investment income: | |
| From investing activities | |
| Interest and dividends | \$ 716,731,091 |
| Expenses - management fees | <u>(10,292,955)</u> |
| Net investment income | <u>706,438,136</u> |
| Deductions: | |
| Distributions | <u>(706,460,757)</u> |
| Earnings on management fees reserved for operating expenses | 22,621 |
| Net increase in net assets from contributions/disbursements | <u>1,509,301,962</u> |
| Change in net assets | <u>1,509,301,962</u> |
| Net assets - beginning of year | <u>17,353,775,195</u> |
| Net assets - end of year | <u><u>\$ 18,863,077,157</u></u> |

The accompanying notes are an integral part of the financial statements.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

(1) Summary of Significant Accounting Policies

(a) Reporting Entity

In 1986, the 69th Texas Legislature authorized the incorporation of the Texas Treasury Safekeeping Trust Company (Texas Trust) to give the Treasurer of the State of Texas access to the Federal Reserve System. The 77th Legislature amended the Texas Trust statute and the Texas Trust began operations as a separate State entity on September 1, 2001. The Comptroller of Public Accounts (Comptroller) is the single shareholder of the Texas Trust and is charged with managing the Texas Trust. Texas Trust is reported as a blended, proprietary component unit of the State of Texas.

The Texas Trust is authorized to manage, disburse, transfer, safekeep, and invest funds and securities provided by statute or belonging to state and local entities and gives the Comptroller direct access to services provided by the Federal Reserve System. The enabling legislation also provides for:

- Specifically exempting the Texas Trust from other state laws regulating or limiting state purchasing or a purchasing decision if it is determined the purchase or decision relates to its fiduciary duties.
- The Texas Trust to enter into contracts, trust agreements, or other fiduciary instruments with the Comptroller, the Federal Reserve System, the Depository Trust Company and other third parties.
- The Comptroller appointing an investment advisory board to advise the Comptroller with respect to managing the assets held by the Texas Trust.
- The Comptroller appointing a person to serve as Chief Executive Officer in managing the Texas Trust and carrying out its duties.
- The development of a fee schedule in the amount necessary to recover costs of service and to retain adequate reserves to support the operations of the Texas Trust.

The Texas Trust is exempt from federal income taxation as a governmental entity under Internal Revenue Code Section 115. The accompanying financial statements present the activities and operations of the Texas Trust. The primary business functions provided by the Texas Trust are investment management and custodial services and therefore, the majority of the funds accounted for by the Texas Trust are fiduciary in nature. Separate audited financial statements are available for the Texas Local Government Investment Pool (TexPool), the Texas Local Government Investment Pool Prime (TexPool Prime) and the Tobacco Settlement Permanent Trust Fund (Tobacco Trust) and may be obtained from the Comptroller's Office by writing:

Texas Comptroller of Public Accounts
Post Office Box 13528
Austin, Texas 78711-3528

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

(b) Financial Statements

The Texas Trust financial statements report information on all of the non-fiduciary activities of the Texas Trust. Separate financial statements are provided for Texas Trust's proprietary fund and fiduciary funds. All capital asset depreciation is reported as a direct expense of the proprietary fund. Operating revenues include charges for services relating to assets under management.

(c) Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The Texas Trust financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, as are the fiduciary fund financial statements. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

The Texas Trust has adopted the provisions of Governmental Accounting Standards Board (GASB) Statement Number 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting*, which specifies that in addition to adopting all applicable GASB pronouncements, the Texas Trust has adopted Statements and Interpretations of the Financial Accounting Standards Board, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure issued prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. Texas Trust has elected to follow only GASB Standards issued subsequent to November 30, 1989.

The Texas Trust financial statements include financial statements for each of the following fund classifications: a proprietary fund and fiduciary funds.

The Texas Trust reports the following major proprietary fund:

Enterprise Fund. Enterprise funds are used to report any activity for which a fee is charged to external users for services such as investment management and custodial services. The Texas Trust accounts for its daily operations using an enterprise fund. Operating revenues result from exchange transactions associated with the principal activity of the fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Non-operating revenues, such as investment earnings, result from non-exchange transactions or ancillary activities. Operating expenses include the cost of services, administrative expenses, and depreciation of capital assets.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

The Texas Trust reports the following fiduciary funds:

Investment Trust Fund. Investment trust funds are used to report the external portion of investment pools reported by the sponsoring government. The Texas Trust accounts for monies constituting TexPool and TexPool Prime in an investment trust fund.

Agency Fund. Agency funds are used to report resources held by the reporting government in a purely custodial capacity. Agency funds typically involve only the receipt, temporary investment, and remittance of fiduciary resources to individuals, private organizations, or other governments. The Texas Trust accounts for monies for individual state agencies contracting with the Texas Trust for investment management and custodial services in agency funds.

(d) *Cash and Cash Equivalents*

For purposes of the statement of cash flows, demand deposits and short-term highly liquid investments in the Enterprise Fund with an original maturity of three months or less are considered cash equivalents. For purposes of the statement of net assets presentation, overnight repurchase agreements and cash in state treasury are included in cash and cash equivalents.

(e) *Restricted Cash and Cash Equivalents*

The Texas Trust maintains an account with the Depository Trust Company (DTC). In accordance with the agreement between DTC and the Texas Trust, \$152,129 in cash was held at DTC as of August 31, 2008, in order to maintain the account.

The Texas Trust maintains an average \$5,000,000 clearing balance within its Federal Reserve account. Earnings on the clearing balance are used to offset fees associated with its use of Federal Reserve services. The Texas Trust Federal Reserve account balance reported in restricted cash on August 31, 2008 was \$4,997,841 and is comprised exclusively of Texas Trust funds.

(f) *Deposits and Investments*

Investments, other than money market instruments in the Investment Trust Fund and the Treasury Pool, are reported at fair value based upon quoted market prices, or when quoted market prices are not readily determinable, estimated fair values based on market conditions and information provided by the investment administrators are used. For investments in limited partnerships where no readily determinable fair value exists, the fair value of the investment is based on the most recent capital account balance of each limited partnership as communicated by the investment administrator, adjusted for subsequent contributions, distributions, and withdrawals and adjusted as necessary by Texas Trust for current market conditions. For investments in fund of hedge funds, the fair value is based on net asset value information provided by the designated fund administrator and adjusted as necessary by Texas Trust for current market conditions. Money market instruments in the Investment Trust Fund and the Treasury Pool are reported at amortized cost.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

The Texas Trust manages the fiduciary funds and enterprise fund investments in accordance with the Comptroller's Investment Policy and Government Code §404.024. The portfolio of investments may include:

1. Direct security repurchase agreements;
2. Reverse security repurchase agreements;
3. Obligations of the United States or its agencies and instrumentalities, other than mortgage-backed securities interest only and principal only strips;
4. Bankers' acceptances that:
 - (a) do not exceed 270 days to maturity; and
 - (b) are issued by a bank that has received the highest short-term credit rating by a nationally recognized investment rating firm;
5. Commercial paper that:
 - (a) does not exceed 270 days to maturity; and
 - (b) except as provided by Subsection (i) of Government Code §404.024, has received the highest short-term credit rating by a nationally recognized investment rating firm;
6. Contracts written by the treasury in which the treasury grants the purchaser the right to purchase securities in the treasury's marketable securities portfolio at a specified price over a specified period and for which the treasury is paid a fee and specifically prohibits naked-option or uncovered option trading;
7. Direct obligations of or obligations guaranteed by the Inter-American Development Bank, the International Bank for Reconstruction and Development (the World Bank), the African Development Bank, the Asian Development Bank, and the International Finance Corporation that have received the highest credit rating by a nationally recognized investment rating firm;
8. Bonds issued, assumed, or guaranteed by the State of Israel;
9. Obligations of a state or an agency, county, city, or other political subdivision of a state that have received at least a single A rating or its equivalent by a nationally recognized investment rating firm as provided for by Government Code §404.024, Subsection (i);
10. Mutual funds secured by obligations that are described by Subdivisions (1) through (6); and
11. Foreign currency for the sole purpose of facilitating investment by state agencies that have the authority to invest in foreign securities.
12. Such other investments as may be authorized by Government Code §404.024.

Fiduciary funds are managed in accordance with the respective entities' investment policy and governing statutes.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Security transactions are recorded on a trade date basis. Investments in securities traded on a national securities exchange are stated at the last reported sales price on the day of valuation. TexPool and TexPool Prime are short-term investment pools that operate in a manner consistent with the Securities and Exchange Commission's Rule 2a-7 of the Investment Company Act of 1940. The investments in TexPool and TexPool Prime along with Rule 2a-7 like pools and money market mutual funds are carried at amortized cost, which approximates fair value.

In connection with transactions in repurchase agreements, it is the Texas Trust's policy to take physical possession of the underlying collateral securities, the fair value of which exceeds the principal amount of the repurchase transaction, including accrued interest, at all times. Where tri-party agreements have been executed, the Texas Trust may enter into repurchase agreements whereby a third party custodian holds the collateral in a segregated account in Texas Trust's name. As of August 31, 2008 the Texas Trust had no tri-party agreements outstanding.

If the seller defaults, and the fair value of the collateral declines, realization of the collateral held by the Texas Trust may be delayed or limited. Repurchase agreements may be entered into only with State or National banks doing business in Texas or with primary dealers approved by the Federal Reserve System.

Government Code §404.024 provides for the use of reverse repurchase agreements by the Comptroller. In connection with transactions in reverse repurchase agreements (reverse), it is the Texas Trust's policy, consistent with Government Code §404.024, to match the maturity of the reverse with the maturity of securities purchased with the proceeds from the reverse. Further, proceeds from reverses are used to purchase securities. At August 31, 2008, the Agency Fund had \$146,752,655 in reverse repurchase agreements.

In accordance with Government Code §404.021 and the State Depository Handbook, the Texas Trust may deposit state funds with approved national and state banks, savings and loan associations and credit unions doing business in Texas through a main office or one or more branches. Any entity where total deposits are in excess of \$95,000 requires acceptable collateral in an amount not less than 105% of the total deposit balance held in the Texas Trust's account at the Federal Reserve. Collateralization of 125 percent is required for any securities pledged that have a declining principal balance.

(g) *Receivables and Payables*

All trade receivables are shown net of an allowance for uncollectible amounts. The liabilities are for the value of assets or services received at or before year-end for which payment was not made as of year-end.

(h) *Capital Assets*

Assets with an initial, individual cost of more than \$5,000 and an estimated useful life in excess of one year are capitalized. Assets are capitalized at cost when acquired, or estimated historical cost, if actual historical cost is not available. Donated assets are reported at fair value on the acquisition date. All capital assets are depreciated using the straight-line method over the following estimated useful lives:

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

| <u>Asset Class</u> | <u>Estimated Useful Lives (in years)</u> |
|-----------------------|--|
| Software | 3 |
| Office equipment | 5 |
| Computer equipment | 5 |
| Building improvements | 10 |

(i) *Compensable Leave*

A state employee is entitled to be paid for all unused vacation time accrued, in the event of the employee's resignation, dismissal, or separation from state employment, provided the employee has had continuous employment with the state for six months. Therefore, the liability for unused vacation time has been recorded. No liability is recorded for non-vesting accumulating rights to receive sick pay benefits.

(j) *Common Stock*

One share of common stock issued and outstanding at August 31, 2008 is held by the Comptroller with a par value of \$1,000,000. This amount is reflected in the Proprietary Fund's Statement of Net Assets within the unrestricted net asset balance.

(k) *Use of Estimates*

The preparation of the Texas Trust financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and fund equity at the date of the financial statements. Actual results could differ from those estimates.

(l) *Risk Management*

The Texas Trust provides investment management and custodial services. Investments are managed for other State agencies in accordance with their applicable investment guidelines. Although every effort is made to preserve principal, the Texas Trust does not provide any guarantee or insurance against loss.

(2) *Deposits and Investments*

(a) *Deposits*

Cash deposits (CD's) are made in state or national banks, savings and loan associations, or credit unions doing business in Texas through a main office or one or more branches. Single direct placements of \$95,000 or less made with any qualifying institution are fully insured by the Federal Deposit Insurance Corporation (FDIC). Deposits made in any single financial institution, which are in excess of \$95,000, may be made only if fully collateralized in accordance with the State Depository Handbook. Collateral is held in the Texas Trust's Federal Reserve account. Cash in State Treasury is not considered a deposit with a financial institution for Texas Trust reporting purposes since the State Treasury is not a bank.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Securities pledged as collateral on August 31, 2008 were categorized under the Political Subdivision Securities or U.S. Government Securities as U.S. Treasury Bills or U.S. Treasury Notes and Bonds.

All bank balances were either insured or collateralized with securities held by the Texas Trust. The following schedule reflects the bank balance and the carrying amount of deposits held by the Texas Trust.

| | |
|--|-----------------------|
| Bank Balance | \$ 602,834,936 |
| Carrying Amount | 602,680,513 |
| Consists of the Following: | |
| Proprietary Cash in Bank | \$ 51,432 |
| Proprietary Fund Non-current Restricted Cash in Bank | 5,149,970 |
| Investment Trust Fund Cash in Bank | 188 |
| Agency Fund Cash in Bank | 7,845,360 |
| Agency Funds Deposits | 589,633,563 |
| Total Deposits Carrying Amount | <u>\$ 602,680,513</u> |

b) Investments

Custodial Credit Risk. The Texas Trust's investments are insured or registered or the securities are held by the Texas Trust or its agent in the Texas Trust's name.

Credit risk, interest rate risk, concentration risk and foreign currency risk, if applicable, are disclosed by the investment policy.

Enterprise Fund

Investments for the Enterprise Fund, as of August 31, 2008 are as follows:

| Investment Type | Fair Value |
|------------------------|----------------------|
| Repurchase Agreements | \$ 14,573,983 |
| Equity | 52,314 |
| | <u>\$ 14,626,297</u> |

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. The Enterprise Fund invests in the Texas Trust's repurchase agreements various pool ("REPO Various"). The underlying securities in the various repurchase agreement pools are rated AAA by Standard & Poor's and Aaa by Moody's.

Interest Rate Risk. All repurchase agreement pools are in overnight repurchase agreements. The weighted average maturity of the repurchase agreement pools are one day.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

TexPool Pool and TexPool Prime

Investments for the TexPool and TexPool Prime, as of August 31, 2008 are as follows:

| Investment Type | Carrying Value | Fair Value |
|--|---------------------------|--------------------------|
| Repurchase agreements | \$ 9,024,250,181 | \$ 9,024,270,631 |
| Commercial paper | 666,034,894 | 665,742,491 |
| Mutual funds | 50,000,000 | 50,000,000 |
| U.S. Government agencies | \$ 9,142,098,134 | \$ 9,138,122,282 |
| Total Texpool & Texpool Prime | \$ 18,882,383,209 | \$ 18,878,135,404 |

Credit risk. TexPool and TexPool Prime portfolios are designed and managed to ensure that they maintain an AAAM rating (or the equivalent) by a nationally recognized statistical rating organization (“NRSRO”). As of August 31, 2008 TexPool and TexPool Prime’s investments in US government securities and repurchase agreements were rated AAA by Standard & Poor’s, Aaa by Moody’s and AAA by Fitch. TexPool Prime’s commercial paper investments were rated A1 by Standard & Poor’s, P-1 by Moody’s Investors Service, and F-1 by Fitch ratings. Standard & Poor’s ranks both TexPool and TexPool Prime with the highest principal stability rating of AAAM.

Concentration of credit risk: No more than 5% of TexPool Prime assets at the time of purchase may be invested in a single corporate entity. As of August 31, 2008, 5.03% of the TexPool Prime assets were invested in commercial paper issued by Fairway Finance Company. The percentage ownership was below 5% at the time of purchase. TexPool and TexPool Prime’s investment policy has no limit on the amount it may invest on any single Governmental Sponsored Enterprise. More than 5% of the TexPool investments are with the Federal Home Loan Bank the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. These investments are 29.32%, 7.56% and 15.18%, respectively, at August 31, 2008.

Interest rate risk. TexPool and TexPool Prime are operated as 2a7-like pools. The weighted average maturity of the portfolio is limited to 60 days calculated using the reset date for variable rate notes (“VRNs”) and 90 days or fewer using the final maturity date for VRNs, with the maximum maturity for any individual security in the portfolio not exceeding 397 days for fixed rate securities and 24 months for VRNs. The following schedule reflects the weighted average maturity by investment type and as a whole:

| Investment Type | Weighted Average Maturity (Days) | |
|-----------------------------------|---|----------------------|
| | TexPool | TexPool Prime |
| Repurchase agreements | 5 | 4 |
| Commercial paper | - | 72 |
| U.S. Government agency securities | 81 | 293 |
| Mutual Funds | - | 7 |
| Weighted average maturity | 44 | 42 |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Treasury Pool

Investments for the Treasury Pool, as of August 31, 2008 are as follows:

| | Carrying Value | Fair Value |
|---|---------------------------|-----------------------|
| U.S. Government agencies | 12,341,145,320 | 12,341,050,223 |
| U.S. Government treasuries | 842,735,243 | 842,735,223 |
| Government mortgage backed securities | 3,386,963,431 | 3,386,963,431 |
| Commercial paper | 3,160,714,247 | 3,160,714,247 |
| Repurchase agreements | 6,131,000,000 | 6,131,000,000 |
| Israel bonds | 23,948,910 | 23,948,910 |
| Corporate obligations | 1,015,416,749 | 1,015,416,749 |
| Asset backed securities | 1,681,783,428 | 1,681,783,428 |
| Small business administration | 15,299,155 | 15,299,155 |
| Stock In Texas Trust | 1,000,000 | 1,000,000 |
| Money market mutual funds | 5,338,000,000 | 5,338,000,000 |
| Total Treasury Pool without Lottery Securities | 33,938,006,483 | 33,937,911,366 |
| U.S. Government Agencies-Refco | 1,156,562,360 | 1,156,562,360 |
| U.S. Government Agencies-Lottery-Treasury Strips | 129,976,402 | 129,976,402 |
| Total Treasury Pool | 35,224,545,245 | 35,224,450,128 |

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. Pursuant to section 404.024(a) and (b), treasury funds may be invested in fully collateralized repurchase agreements secured by obligations of the U.S., its agencies, or Government Sponsored Enterprises (GSEs), including mortgage-backed securities of such agencies and GSEs, as set out in section 404.001 of the Government Code. The Comptroller may purchase direct obligations of or obligations, the principal and interest of which are guaranteed by the U.S.; and direct obligations of, or obligations guaranteed by U.S. agencies or GSEs. Mortgage-backed securities are eligible for purchase except those specifically prohibited by section 404.024 (e) of the Government Code. Treasury funds may invest in commercial paper that, has received the highest short-term credit rating by a nationally recognized investment rating organization or "NRSRO". "Highest short-term credit rating" includes at least one of the following short-term credit ratings, Moody's (P-1), Standard & Poor's (A-1), or Fitch, Inc. (F-1). Money market funds must be rated AAAM by a NRSRO. The Government mortgage-backed securities, that are not rated, are issued by Government Sponsored Enterprises that are rated AAA. The Treasury portfolio is rated AAAM by Standard & Poor's. The following table lists Standard & Poor's credit rating by investment type for the Treasury Pool securities that are subject to credit risk. The U.S. government agencies and the underlying securities on the Repurchase agreements not rated by Standard & Poor's were rated were either rated Aaa by Moody's or AAA by Fitch.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

| Investment Type | AAA | AA | A | A-1 | Not Rated |
|---------------------------------------|-----------------------|--------------------|--------------------|----------------------|----------------------|
| U.S. Government agencies | \$ 8,648,049,869 | | | | \$ 3,693,000,354 |
| Government mortgage backed securities | 270,479,363 | | | | 3,116,484,068 |
| Commercial paper | | | | 3,160,714,247 | |
| Corporate obligations | 220,018,931 | 401,540,527 | 393,857,291 | | |
| Asset backed securities | 1,681,783,428 | | | | |
| Repurchase agreements | 4,570,343,140 | | | | 1,560,656,860 |
| Small business administration | | | | | 15,299,155 |
| Israel bonds | | | 23,948,910 | | |
| Mutual funds (2A 7-Like) | 5,338,000,000 | | | | |
| Total | 20,728,674,731 | 401,540,527 | 417,806,201 | 3,160,714,247 | 8,385,440,437 |

Concentration of credit risk: The Comptroller places no limit on the amount the Treasury Pool may invest on any one issuer. More than 5 percent of the Treasury Pool investments are with the Federal Home Loan Bank, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. These investments are 15.59%, 15.29% and 9.23% respectively.

Interest rate risk. In accordance with its investment policy, the Treasury Pool manages its exposure to interest rate risk by maintaining a weighted-average maturity of no more than two (2) years. The following schedule reflects the average modified duration (a measure of the price sensitivity of a bond to interest rate movements) of the Treasury Pool by investment type and as a whole:

Modified Duration

| Investment Type | (Years) |
|---|----------------|
| U.S. Government agencies | 1.020 |
| U.S. Government treasuries | 1.175 |
| Government mortgage backed securities | 2.261 |
| Commercial paper | 0.097 |
| Corporate obligations | 1.584 |
| Asset backed securities | 1.705 |
| Repurchase agreements | 0.039 |
| Small business administration | 13.564 |
| Israel bonds | 1.653 |
| Placement of deposits with financial institutions | 0.326 |
| Treasury Portfolio Modified Duration | 0.919 |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Reverse Repurchase Agreements. The Treasury Pool may enter into reverse repurchase agreements for up to 35% of the pools assets. The Treasury Pool's aggregate amount of reverse repurchase agreement obligations at August 31, 2008 was \$146,784,458 including accrued interest. The aggregate fair value of the securities underlying those agreements, including accrued interest, was \$147,627,965. The credit exposure at year end was \$843,507.

Endowment Funds

Investments for the Endowment Funds, as of August 31, 2008 are as follows:

| Investment Type | Fair Value |
|--|--------------------------------|
| Corporate obligations | \$ 107,880,826 |
| International corporate obligations | 10,883,125 |
| Exchange traded note-commodities | 16,872,200 |
| Equities | 239,135,094 |
| International equities | 3,358,151 |
| Mutual funds - domestic equities | 444,791,255 |
| Mutual funds - global equities | 430,048,899 |
| Mutual funds - fixed income | 457,456,192 |
| Mutual funds - real estate | 15,163,289 |
| Securities lending cash collateral | 50,164,753 |
| Hedge funds-absolute return | 661,509,917 |
| Hedge funds-equities | 475,842,366 |
| Alternative investments domestic | 299,764,638 |
| Alternative investments international | 62,427,493 |
| Investment in short-term investment fund | 103,128,540 |
| Total Endowment Fund Investments | <u>\$ 3,378,426,738</u> |
| Consisting of the following: | |
| Endowment fund securities lending collateral | \$ 50,164,753 |
| Endowment fund investments | 3,328,261,985 |
| Total as presented on the Financial statements | <u>\$ 3,378,426,738</u> |

Credit Risk. Corporate obligations must be rated investment grade by at least one NRSRO and not rated below investment grade by any NRSRO. Short-term securities must be rated in the highest rating category by an NRSRO. The average quality rating of the high-yield fixed income portfolio shall be B1/B+ or higher. All high-yield securities when purchased must be rated at least CCC. The following schedule lists Standard & Poor's credit rating by investment type for the Endowment Fund securities that are subject to credit risk. The high-yield securities not rated by Standard & Poor's are rated Ba or B by Moody's. The investments in the short-term investment fund are investments in Northern Trust's Institution Government Portfolio fund which is rated Aaa by Moody's.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

| Investment Type | BBB | BB | B | CCC | Not Rated |
|---|---------------------|----------------------|----------------------|-------------------|-----------------------|
| Corporate obligations | \$ 7,514,677 | \$ 42,808,436 | \$ 55,286,053 | \$ 468,875 | 1,802,785 |
| International corporate obligations | | 8,614,250 | 2,268,875 | | |
| Mutual Funds - fixed income | | | | | 457,456,192 |
| Exchange Traded Note-Commodities | | | | | 16,872,200 |
| Investments in short-term investment fund | | | | | 103,128,540 |
| Total Endowment Funds | \$ 7,514,677 | \$ 51,422,686 | \$ 57,554,928 | \$ 468,875 | \$ 579,259,717 |

Concentration Risk: Excluding securities issued or guaranteed by the U.S. Government, its agencies, instrumentalities, and GSE's, no more than 5 percent of the portfolio at the time of purchase, shall be invested in securities of one issuer.

Interest Rate Risk: The endowment funds do not have a formal investment policy that limits investment maturities. The following schedule reflects the average modified duration of the Endowment Funds by investment type. The investments in the securities lending cash collateral pool and the short-term investment fund use a weighted average maturity to reflect the interest rate risk.

Modified Duration

| Investment Type | (Years) |
|-------------------------------------|----------------|
| Corporate obligations | 4.67 |
| International corporate obligations | 4.22 |
| Mutual funds – fixed income | 4.99 |

Weighted Average Maturity

| | |
|---|----|
| Investments in short-term investment fund | 34 |
| Securities lending cash collateral pool | 43 |

Foreign Currency Risk. The endowment funds exposure to foreign currency risk derives from its position in foreign currency-denominated investment in Alternative Investments.

| Currency | Alternative Investment | Total |
|-----------------|-------------------------------|--------------|
| European Euro | \$62,427,493 | \$62,427,493 |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Securities Lending

Section 404.102 of the Texas Government Code and the Endowment Funds' Investment Policies permit the lending of specific endowment fund securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The endowment funds' custodian, as security lending agent, lends securities of the type on loan at year-end for collateral in the form of cash or other securities that exceed the value of the securities on loan.

Types of securities loaned include U.S. equities, U.S. government fixed income, U.S. agencies and corporate fixed income. On August 31, 2008 the fund received \$50,164,753 in cash collateral in exchange for securities with a fair value of \$48,760,709. The cash collateral is presented as an unclassified custodial credit risk. In addition the fund received \$2,809,591 in non-cash collateral in exchange for securities with a fair value of \$2,745,239.

Collateral includes U.S. government securities and irrevocable letters of credit. U.S. securities are loaned versus collateral valued at 102% of the market value of the securities plus any accrued interest. Non-U.S. government securities are loaned versus collateral valued at 105% of the market value of the securities plus any accrued interest. At year-end, the endowment funds that participate in securities lending have no risk exposure to borrowers because the amounts the endowment funds owe the borrowers exceed the amounts the borrowers owe the endowment funds. The contract with the endowment funds' lending agent allows for indemnification where a client's securities are not returned due to insolvency of a borrower and the lending agent has failed to live up to its contractual responsibilities relating to the lending of those securities. There were no violations of legal or contractual provisions, any borrower or lending agent default losses. The agent's responsibilities include performing appropriate borrower and collateral investment credit analysis, demanding adequate types and levels of collateral, and complying with applicable Federal Financial Institutions Examinations Council regulations concerning securities lending.

All securities on loan can be terminated on demand by either Texas Trust or the borrower. The average term for the Texas Trust's overall loans was 64 days as of August 31, 2008. Cash collateral is invested in the lending agent's short-term investment fund, which at year-end has a weighted average maturity of 43 days, or in Term Loans in which the maturity of the cash investment follows the expected maturity of the loan. Collateral values are estimated by the custodian based on program wide collateralization levels. The endowment funds cannot pledge or sell collateral securities received unless the borrower defaults.

Repurchase Agreement Pools

The Texas Treasury Safekeeping Trust Company operates a Repurchase Agreement Pool in which state entities may invest non-appropriated funds. Investments for the Repurchase Agreement Pool, as of August 31, 2008 are as follows:

| Investment Type | Fair Value |
|------------------------|-------------------|
| Repurchase Agreements | \$ 673,040,349 |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Credit Risk. The credit rating on the underlying securities that are subject to credit risk for repurchase agreements are rated AAA by Standard & Poor's.

Interest Rate Risk. All Repurchase agreement pools are in overnight repurchase agreements. The weighted average maturity of the Repurchase agreement pool is four days.

Other Trust activities

The Texas Trust functions as a custodian and/or depository to several state agencies. The functions are strictly fiduciary. Credit risk, interest rate risk, and concentration risk are not risks of the Texas Trust but of the clients its serves as a custodian or depository. Each respective state agency performs their own investment management activities within the parameters of their own respective investment policies. Investments for these other trust activities, as of August 31, 2008 are as follows:

| Investment Type | Fair Value |
|---|-------------------------|
| U.S. Government treasuries | \$ 423,898,198 |
| U.S. Government agencies | 445,487,752 |
| REFCO strips | 3,610 |
| Government mortgage backed securities | 5,002,268 |
| Commercial mortgage backed securities | 4,189,057 |
| Non-agency collateral mortgage obligation | 1,629,268 |
| Asset backed securities | 14,187,911 |
| Political subdivision bonds | 4,804,089 |
| Corporate obligations | 113,742,061 |
| Repurchase agreements | 496,201,042 |
| Commercial paper | 94,755,203 |
| Equities | 160,591,106 |
| Mutual funds | 61,249 |
| Investment in real estate trust fund | 230,016 |
| Investment in guaranteed investment contracts | 189,941,809 |
| Total Other Trust Activities | <u>\$ 1,954,724,639</u> |

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

(3) Capital Assets

Capital asset activity for the year ended August 31, 2008, was as follows:

| | Primary Government | | | | Balance 08/31/08 |
|--|-----------------------------|-------------------------|------------------|------------------|-----------------------------|
| | Balance 08/31/07 | Reclassification | Additions | Deletions | |
| Business-type activities: | | | | | |
| Depreciable assets: | | | | | |
| Buildings and building improvements | 311,520 | - | - | - | 311,520 |
| Furniture and equipment | 341,993 | - | 161,413 | - | 503,406 |
| Software | 497,165 | - | 976,844 | - | 1,474,009 |
| Total depreciable assets at historical cost | <u>1,150,678</u> | <u>-</u> | <u>1,138,257</u> | <u>-</u> | <u>2,288,935</u> |
| Less accumulated depreciation for: | | | | | |
| Buildings and building improvements | (139,573) | - | (31,152) | - | (170,725) |
| Furniture and equipment | (184,063) | - | (56,943) | - | (241,006) |
| Software | (369,431) | - | (252,480) | - | (621,911) |
| Total accumulated depreciation | <u>(693,067)</u> | <u>-</u> | <u>(340,575)</u> | <u>-</u> | <u>(1,033,642)</u> |
| Total depreciable assets, net | <u>457,611</u> | <u>-</u> | <u>797,682</u> | <u>-</u> | <u>1,255,293</u> |
| Business-type activities: capital assets, net | <u>457,611</u> | <u>-</u> | <u>797,682</u> | <u>-</u> | <u>1,255,293</u> |

(4) Contributions to Pension Plan

The Employees Retirement System of Texas (ERS) operates under Title 8 of the Texas Government Code. ERS operates as an agent multiple-employer defined benefit plan and provides retirement, disability, and death benefits for qualified employees of the State. ERS issues a separate comprehensive annual financial report. Copies of the annual financial report may be obtained by requesting a copy through ERS:

ERS of Texas
Customer Service Division
18th and Brazos Streets
P.O. Box 13207
Austin, Texas 78711-3207

Active plan members in ERS are required to contribute a percentage of their annual covered salary. Currently, state employees and judges contribute 6% and elected officials contribute 8%. The State provides a matching contribution of not less than 6% or more than 10% of the employees' current annual compensation. Texas Trust recognized \$273,420 in expense for the year ended August 31, 2008 for its share of ERS required contributions.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

(5) Related-party transactions

The Texas Trust has entered into a services agreement with the Comptroller of Public Accounts (CPA). The agreement provides for specified rates based on hours of utilization. For the fiscal year ended August 31, 2008, the Texas Trust paid CPA \$56,701 for services provided. At August 31, 2008, the Texas Trust had accrued \$2,103 for services provided by CPA and this amount is included in accounts payable.

The Texas Trust utilizes the Comptroller of Public Accounts Payroll Department to service its payroll. Prior to the end of each month, the approximate amount of the Texas Trust's monthly payroll is transferred from the Texas Trust to the Comptroller's Office. At August 31, 2008, the Comptroller held \$464,223 to pay for the Texas Trust's September 1, 2008 payroll.

(6) Changes in Long-term Liabilities

During the year ended August 31, 2008 the following changes occurred in long-term liabilities:

| | <u>Balance 08/31/07</u> | <u>Additions</u> | <u>Reductions</u> | <u>Balance 08/31/08</u> | <u>Amounts Due Within One Year</u> |
|-------------------|-----------------------------|------------------|-------------------|-----------------------------|--|
| Compensable Leave | \$ 465,248 | 407,767 | 380,476 | 492,539 | 278,305 |
| Total | <u>\$ 465,248</u> | <u>407,767</u> | <u>380,476</u> | <u>492,539</u> | <u>278,305</u> |

7) Subsequent Events

Investment Trust Fund

As of August 31, 2008, the administrative and investment services to TexPool and TexPool Prime were provided by Federated Investors, Inc. (performing investment management and reporting services) and Lehman Brothers, Inc. (performing marketing and client services) under an agreement with Texas Trust, effective April 8, 2002, renewed on November 9, 2007.

Lehman Brothers, Inc. is owned by Lehman Brothers Holding, Inc. which filed for Chapter 11 bankruptcy protection on September 15, 2008. The Comptroller terminated the marketing and client services contract with Lehman Brothers, Inc. effective October 17, 2008. The marketing and client services previously provided by Lehman Brothers, Inc. under the contract were transferred by the Texas Trust to Federated Investors, Inc.

Endowment Fund Component of the Agency Fund

Subsequent to August 31, 2008, the credit and liquidity crisis in the United States and throughout the global financial system has resulted in substantial volatility in financial markets and the banking system. These and other economic events have had a significant adverse impact on investment portfolios. As a result, as of October 31, 2008 the endowment fund component of the Agency fund has incurred a decline in fair value of its investments of approximately 15% as compared to the recorded value at August 31, 2008.

TEXAS TREASURY SAFEKEEPING TRUST COMPANY

Notes to the Financial Statements

August 31, 2008

Treasury Pool Component of the Agency Fund

The Treasury Pool has not experienced a significant adverse decline in the fair value of its investments subsequent to August 31, 2008. As of August 31, 2008 the fair value of the Treasury Pool investments was 1.002% of amortized cost and as of October 31, 2008 the fair value was 99.83% of amortized cost.

In addition, on September 15, 2008, one of the investments in the Treasury Pool, the Reserve Fund, announced that it had “broken the buck” in one of its funds, the Primary Fund, which was used by the Texas Trust to invest Treasury Pool assets. On that date, the Primary Fund, had a \$785 million face value position in Lehman Brothers Holdings, Inc. (LBH) commercial paper and medium term notes which they wrote down to zero after LBH filed for bankruptcy protection. The write down caused the Net Asset Value (NAV) of the Primary Fund to drop to \$0.97. Market conditions created an illiquid market for many securities in the Fund as well as an unprecedented number of requests for redemptions. The United States Securities and Exchange Commission (SEC) granted the Reserve Fund’s application to suspend all rights of redemption from the Primary Fund effective September 17 in order to protect the rights of all shareholders by allowing it to pursue an orderly sales process that seeks to obtain the best pricing for its shareholders. As of October 31, 2008, the Texas Trust had a balance in the Primary Fund of \$197,747,851. The Primary Fund no longer publishes its NAV. As of the date of this report, the Texas Trust is unable to determine when the remainder of the balance in the Fund will be distributed or the extent of the write down that will be incurred. Based upon the information the Texas Trust has received from the Primary Fund, Texas Trust management estimates that as the remaining assets in the Primary Fund mature or are sold, the Treasury Pool will receive between 97% and 98.5% of the balance in the Primary Fund.

SUPPLEMENTAL INFORMATION

TEXAS TREASURY SAFEKEEPING TRUST COMPANY
 Combining Schedule – Balance Sheet Information – Agency Fund
 August 31, 2008

| Assets | Endowment Funds | Treasury Pool | Repurchase Agreement Pool | Other Agency Funds | Totals |
|--|----------------------------|--------------------------|--|-----------------------------------|-----------------------|
| Current assets: | | | | | |
| Cash in bank | \$ — | 904,311 | 608,079 | 6,332,970 | 7,845,360 |
| Securities lending collateral | 50,164,753 | — | — | — | 50,164,753 |
| Deposits | — | 589,633,563 | — | — | 589,633,563 |
| Investments | 3,328,261,985 | 35,224,545,245 | 673,040,349 | 1,954,724,639 | 41,180,572,218 |
| Receivables from: | | | | | |
| Interest and dividends | 4,213,715 | 106,589,779 | 116,560 | 7,269,841 | 118,189,895 |
| Trades pending settlement | 1,798,460 | — | — | — | 1,798,460 |
| Total assets | \$ 3,384,438,913 | 35,921,672,898 | 673,764,988 | 1,968,327,450 | 41,948,204,249 |
| Liabilities | | | | | |
| Liabilities: | | | | | |
| Accounts payable | \$ 1,701,321 | — | 50 | — | 1,701,371 |
| Interest payable | — | 31,803 | — | — | 31,803 |
| Trades pending settlement | 3,708,827 | — | — | — | 3,708,827 |
| Obligations under securities lending | 50,164,753 | — | — | — | 50,164,753 |
| Obligations under reverse repurchase agreements | — | 146,752,655 | — | — | 146,752,655 |
| Funds held for others | 3,328,864,012 | 35,774,888,440 | 673,764,938 | 1,968,327,450 | 41,745,844,840 |
| Total liabilities | \$ 3,384,438,913 | 35,921,672,898 | 673,764,988 | 1,968,327,450 | 41,948,204,249 |

See accompanying independent auditors' report.



Padgett Stratemann & Co. LLP

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Honorable Susan Combs
Comptroller of Public Accounts
State of Texas:

We have audited the financial statements of the business-type activities, each major fund, and the aggregate remaining fund information of the Texas Treasury Safekeeping Trust Company (Texas Trust) as of and for the year ended August 31, 2008, which collectively comprise Texas Trust's basic financial statements, and have issued our report thereon dated November 20, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Texas Trust's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Texas Trust's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Texas Trust's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Texas Trust's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Texas Trust's financial statements that is more than inconsequential will not be prevented or detected by the Texas Trust's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Texas Trust's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Texas Trust's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of Comptroller of Public Accounts, the State Auditor of Texas, and management and is not intended to be and should not be used by anyone other than these specified parties.

Padgett, Stratemann + Co., LLP

Austin, Texas
November 20, 2008