



A Report on

The Audit of the Teacher Retirement System's Fiscal Year 2018 Financial Statements

December 20, 2018

Members of the Legislative Audit Committee:

In our audit report dated November 20, 2018, we concluded that the Teacher Retirement System's (the System) basic financial statements for fiscal year 2018 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. The System published our audit report as part of its basic financial statements, which it has posted on its Web site at https://www.trs.texas.gov/TRS%20Documents/cafr_2018.pdf.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards (that report, including responses from management, is presented in the attachment to this letter). In that report, auditors determined that the System should strengthen controls to help ensure (1) the completeness and accuracy of the active employee census data that employers submit through the Teacher Retirement Unified System for Technology (TRUST), and (2) that unfunded commitment amounts are properly reported in the notes to its financial statements.

Our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting or on compliance with laws and regulation.

Testing of Plan Member Census Data

Auditors conducted census data testing for fiscal year 2018 (see text box for the key data elements tested) as part of this audit. The completeness and accuracy of employees' census data is important because the System uses that data to calculate the System's pension and other post-employment liabilities (OPEB).

As in previous years, the auditors implemented a risk-based approach for selecting employers (including school districts, charter schools, and higher education institutions) for fiscal year 2018 census data testing as required by American Institute of Certified Public Accountants guidance. That resulted in auditors selecting 33 employers for which census data was tested.

Active Employee Census Data

Active employee census data is key demographic data that affects the actuarial estimate of the pension liability amount that the System presents in its financial statements.

Key data elements include:

- Name.
- Gender.
- Date of birth.
- Pensionable earnings.
- Service credits.

Source: Chapter 13 in *State and Local Governments - Audit and Accounting Guide*, American Institute of Certified Public Accountants.

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However, the System chose to calculate the pension and other post-employment liability using the roll forward method for fiscal year 2018, as allowed by Government Accounting Standards¹. Following this method, the System rolled forward the actuarial valuation as of August 31, 2017, and adjusted the liabilities based on any significant economic or plan demographic changes that occurred during fiscal year 2018. One of the adjustments, which affected the pension liability included the System reducing its projected long-term expected rate of return on investments from 8.00 percent in fiscal year 2017 to 7.25 percent in fiscal year 2018.

Other Issues

Auditors communicated certain issues that were not material or significant to the audit objectives separately in writing to the System's management.

As required by auditing standards, we will also communicate to the System's Board of Trustees certain matters related to the conduct of a financial statement audit.

We appreciate the System's cooperation during this audit. If you have any questions, please contact Michael O. Clayton, Audit Manager, or me at (512) 936-9500.

Sincerely,

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

Attachment

cc: The Honorable Greg Abbott, Governor
Members of the Teacher Retirement System Board of Trustees
Mr. Jarvis V. Hollingsworth, Chairman
Ms. Dolores Ramirez, Vice Chair
Mr. Joe Colonnetta
Mr. David Corpus
Mr. John Elliott
Dr. Greg Gibson
Mr. Christopher Moss
Mr. James D. Nance
Ms. Nanette Sissney
Mr. Brian Guthrie, Executive Director, Teacher Retirement System

¹ Governmental Accounting Standards Board (GASB) Statement No. 67, *Financial Reporting for Pension Plans*.



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Attachment

Section 1

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters as Required by Auditing Standards



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

Independent Auditor's Report

Teacher Retirement System Board of Trustees

Mr. Jarvis V. Hollingsworth, Chairman

Ms. Dolores Ramirez, Vice Chair

Mr. Joe Colonna

Mr. David Corpus

Mr. John Elliott

Dr. Greg Gibson

Mr. Christopher Moss

Mr. James D. Nance

Ms. Nanette Sissney

We have audited, in accordance with the 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, the financial statements of the major enterprise fund and the aggregate remaining funds information, consisting of the fiduciary funds and the non-major enterprise fund, of the Teacher Retirement System (System), a component unit of the State of Texas as of and for the year ended August 31, 2018, and the related notes to the financial statements, which collectively comprise the System's basic financial statements and have issued our report thereon dated November 20, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System's internal control.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be

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

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

Phone:
(512) 936-9500

Fax:
(512) 936-9400

Internet:
www.sao.texas.gov

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prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control described in the accompanying schedule of findings and responses that we consider to be significant deficiencies.

Summary of Findings and Responses
Finding Numbers
2018-1
2018-2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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*.


Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the System's management.

System's Response to Findings

System's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. The System's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely 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 effectiveness of the entity's internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control over financial reporting and compliance. Accordingly, this communication is not suitable for any other purpose.



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

November 20, 2018

Schedule of Findings and Responses

Section 1

The System Should Strengthen Controls to Help Ensure the Completeness and Accuracy of the Active Employee Census Data That Employers Submit Through TRUST

Reference No. 2018-1

Type of finding: Significant Deficiency

The Teacher Retirement System (System) should strengthen controls over active employee census data submitted through the Teacher Retirement Unified System for Technology (TRUST) to help ensure that data is complete and accurate (see text box for additional information about the census data). More than 1,300 school districts, colleges, and universities submit data regarding the active members who participate in the System's pension plan. The completeness and accuracy of the active employees' census data is important because the System uses that data to calculate (1) member pension benefits and (2) the pension and Other Post-employment Benefits (OPEB) liability amounts that the System presents in its financial statements.

Active Employee Census Data

Active employee census data is key demographic data that affects the actuarial estimate of the pension liability amount that the System presents in its financial statements.

Key data elements include:

- Name.
- Gender.
- Date of birth.
- Pensionable earnings.
- Service credits.

Source: Chapter 13 in *State and Local Governments - Audit and Accounting Guide*, American Institute of Certified Public Accountants.

During the audits of the System's financial statements for fiscal years 2014, 2015, 2016, and 2017,¹ auditors reported findings related to the System's controls over the completeness and accuracy of active employee census data. Since the initial finding in 2014, the System has begun performing audits on a limited basis of the employer census data information submitted. In addition, for fiscal year 2018, the System implemented TRUST, a new employer census data reporting system. TRUST was designed to (1) collect the entire payroll data from participating employers and (2) allow the System to perform a comprehensive review of the employer data submitted to the System. However, the System's controls over TRUST do not adequately ensure the completeness and accuracy of active employee census data.

¹ See *A Report on the Audit of the Teacher Retirement System's Fiscal Year 2014 Financial Statements* (State Auditor's Office Report No. 15-010, November 2014); *A Report on the Audit of the Teacher Retirement System's Fiscal Year 2015 Financial Statements* (State Auditor's Office Report No. 16-009, December 2015); *A Report on the Audit of the Teacher Retirement System's Fiscal Year 2016 Financial Statements* (State Auditor's Office Report No. 17-015, November 2016), and *A Report on the Audit of Teacher Retirement System's Fiscal Year 2017 Financial Statements* (State Auditor's Office Report No. 18-005, November 2017).

TRUST replaced the Teacher Retirement Reporting and Query System (TRAQS). TRUST collects all payroll data from the employers participating in the System's plans. While TRUST collects comprehensive employee information, auditors identified the following areas in which the System should strengthen its controls:

- The System does not have sufficient processes to ensure that reporting entities review and correct data elements that TRUST identifies as potential errors. In addition, TRUST allows reporting entities to delete records instead of requiring the records to be corrected.
- The System did not transfer the ending balances from the TRAQ system as beginning balances in TRUST. As a result, the System's general ledger balances do not agree with the TRUST system balances. Because TRUST contains the detailed contribution information for each employer and is a sub-ledger system for the general ledger, the balances should match.
- The System did not have adequate access controls to TRUST to ensure that only necessary personnel have the ability to edit the data.

The lack of sufficient controls over the active employee census data in TRUST represent a significant deficiency in internal control over financial reporting, as noted in guidance issued by the American Institute of Certified Public Accountants.²

Recommendation

The System should strengthen controls over active employee census data in the TRUST system.

² See Chapter 13 in *State and Local Governments – Audit and Accounting Guide*, American Institute of Certified Public Accountants.

Management's Response

Implemented in 2018, TRUST is a complete Pension line of Business solution that includes a benefit calculation and payroll reporting system for TRS, as well as census data. TRUST is in the first year of implementation and management agrees with the control deficiencies outlined above. In addition to expected difficulties implementing large systems responsible for integrating highly complex data relationships, TRS must contend with the responsibility shift introduced under GASB 67/68. TRS will take several actions to correct the noted deficiencies:

- 1. TRS will implement additional review processes to identify likely reporting entity errors and take further steps to contend with the additional requirements imposed by GASB 67/68. Estimated completion date August 2020*
- 2. TRS will complete an analysis of employer opening balances and book any necessary correcting entries. Estimated completion date August 2019.*
- 3. TRS will institute detective controls to identify unauthorized modifications to member records. Estimated completion date August 2019.*

Section 2

The System Should Strengthen Controls to Help Ensure that Unfunded Commitment Amounts Are Properly Reported in the Notes to Its Financial Statements

Reference No. 2018-2

Type of finding: Significant Deficiency

The Teacher Retirement System (System) should strengthen controls for its reporting and review of unfunded investment commitments disclosed in the notes to its financial statements to help ensure that amounts are properly reported. The System manages unfunded capital commitments (see text box) that it is legally obligated to fund when an external fund manager requests those funds.

Unfunded Investment Commitments

Unfunded investment commitments represent the committed capital (contractual agreement to pay) that investors have not contributed to a private equity fund.

Source: U.S. Securities and Exchange Commission's Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors.

The funding of committed capital may occur over an extended time period and can take several years before the total allocation to each asset class or manager is fully invested. Because an individual investment may begin to return capital to the System prior to the full funding of the System's commitment, there may be times when the outstanding invested capital of the investment is substantially less than the total commitment. It is important to accurately track and

report the amount of unfunded capital commitments outstanding to ensure that the System (1) does not provide more capital to an asset class or manager than required by legal agreements and (2) accurately reports investment allocation information to external parties.

In determining the unfunded capital commitment for its fiscal year 2018 financial statements, the System miscalculated the totals for several investments types and did not update the unfunded commitment when new agreements were signed or terminated, which resulted in some amounts being reported too high and some amounts being reported too low. Those errors resulted in the the System overstating the total unfunded capital commitment by \$636 million. After auditors brought the errors to the Systems attention, it corrected them in the notes to its financial statements for fiscal year 2018.

Recommendation

The System should strengthen its controls for its reporting and review of unfunded capital commitments disclosed in the notes to its financial statements.

Management's Response

Process and control gaps resulted in delayed reporting of unfunded commitments on a total unfunded commitment balance of \$33,100,158,756. In response to these deficiencies, TRS will revise processes and controls to timely identify unfunded commitments. Estimated completion date March 2019.