



An Audit Report on

**Incentive Compensation  
at the Permanent School Fund,  
General Land Office,  
Employees Retirement System,  
and Teacher Retirement System**

September 2018

Report No. 19-003



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# **Incentive Compensation at the Permanent School Fund, General Land Office, Employees Retirement System, and Teacher Retirement System**

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## **Overall Conclusion**

The Permanent School Fund Division (PSF Division) of the Texas Education Agency, the General Land Office (GLO), and the Teacher Retirement System (TRS) calculated and paid incentive compensation in accordance with their policies and procedures for plan year 2017.

The Employees Retirement System (ERS) generally calculated and paid incentive compensation in accordance with its policies and procedures for plan year 2017. However, ERS overpaid two employees a total of \$3,593 because it did not calculate those employees' incentive compensation awards in accordance with its policies and procedures.

TRS calculated and paid executive incentive compensation in accordance with its executive performance incentive pay plan. However, it should ensure that controls have been strengthened over its executive incentive compensation calculation and review process by developing detailed calculation and review procedures.

Auditors communicated other, less significant issues in writing separately to GLO and ERS management.

Table 1 on the next page presents a summary of the findings in this report and the related issue ratings. (See Appendix 2 for more information about the issue rating classifications and descriptions.)

### **Incentive Compensation for Plan Year 2017**

Through their incentive compensation plans for plan year 2017, the PSF Division, GLO, ERS, and TRS awarded a total of \$18,289,957 in incentive compensation to 260 employees. Specifically:

- TRS awarded \$9,099,574 to 135 employees (which included the incentive award to the executive director).
- ERS awarded \$5,300,467 to 71 employees.
- The PSF Division awarded \$3,577,833 to 49 employees.
- GLO awarded \$312,083 to 5 employees.

Sources: TRS, ERS, PSF Division, and GLO.

Table 1

Summary of Chapters/Subchapters and Related Issue Ratings		
Chapter/ Subchapter	Title	Issue Rating <sup>a</sup>
1	The PSF Division Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures	Low
2	GLO Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures	Low
3	ERS Generally Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Strengthen Controls Over Its Incentive Compensation Calculation and Review Process	Low
4-A	TRS Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures	Low
4-B	TRS Calculated and Paid Plan Year 2017 Executive Performance Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Ensure That Controls Have Been Strengthened Over Its Calculation and Review Process	Low

<sup>a</sup> A chapter/subchapter is rated **Priority** if the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern and reduce risks to the audited entity.

A chapter/subchapter is rated **High** if the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern and reduce risks to the audited entity.

A chapter/subchapter is rated **Medium** if the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.

A chapter/subchapter is rated **Low** if the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

## ***Summary of Management's Response***

At the end of the ERS and TRS chapters in this report, auditors made recommendations to address the issues identified during this audit. The agencies agreed with the recommendations in this report.

## ***Audit Objective and Scope***

The objective of this audit was to determine whether the PSF Division, GLO, ERS, and TRS calculate and pay incentive compensation in accordance with policies and procedures.

The scope of this audit covered incentive compensation plan years ending September 30, 2017, at the PSF Division; June 30, 2017, at GLO; August 31, 2017, at ERS; and September 30, 2017, and June 30, 2017, at TRS.

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# Detailed Results

Chapter 1

## The PSF Division Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures

**Chapter 1  
Rating:**

Low <sup>1</sup>

The Permanent School Fund Division (PSF Division) of the Texas Education Agency calculated and paid incentive compensation for its plan year ending September 30, 2017, in accordance with its policies and procedures.

The PSF Division awarded a total of \$3,577,833 in incentive compensation to 49 employees. The PSF Division awarded the most incentive compensation to its chief investment officer, who was awarded \$241,812 payable during a three-year period. That \$241,812 represented 6.8 percent of the \$3,577,833 in total incentive compensation that the PSF Division awarded.

### Gross-of-Fees and Net-of-Fees Basis

The PSF Division calculates incentive compensation awards using investment performance data reported on a gross-of-fees basis.

Gross-of-fees indicates that the return on investment does not include the effect of fees. Net-of-fees indicates that the return on investment does include the effect of fees.

Sources: The PSF Division and the *Guidance Statement on the Application of the [Global Investment Performance Standards] GIPS Standards to Asset Owners* at [https://www.gipsstandards.org/standards/Documents/Guidance/g\\_s\\_revised\\_asset\\_owner.pdf](https://www.gipsstandards.org/standards/Documents/Guidance/g_s_revised_asset_owner.pdf).

The PSF Division calculates incentive compensation based on an employee's achievement of performance goals related to total fund performance and the performance of the employee's assigned asset classes, as applicable. With the exception of the performance of certain asset classes, both fund and asset class performance are calculated based on a three-year rolling average of historical performance data. The PSF Division calculates incentive compensation awards using investment performance data reported on a gross-of-fees basis (see text box for more information on gross-of-fees and net-of-fees).

The PSF Division awards incentive compensation if the performance of the total fund or the individual asset classes, as applicable, exceeds selected benchmarks. Total fund investment performance exceeded the target benchmark by 0.63 percent (63 basis points) (see text box for additional information on basis points) for the three-year period from October 1, 2014, to September 30, 2017.

The PSF Division pays incentive compensation awards for a plan year over a three-year installment schedule. Specifically, for most employees, the PSF Division pays 50 percent of an incentive compensation award at the end of the performance period for the

### Basis Points

One basis point is 0.01 percent or one one-hundredth of a percentage point.

Source: Morningstar, Inc. Web site at [http://www.morningstar.com/Invglossary/basis\\_point\\_definition\\_what\\_is.aspx](http://www.morningstar.com/Invglossary/basis_point_definition_what_is.aspx).

<sup>1</sup> Chapter 1 is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

current plan year, 25 percent of that award at the end of the next year, and 25 percent of that award at the end of the third year. As a result, an employee may receive an incentive award payment that consists of partial awards from three plan years.

Table 2 on the next page presents the positions eligible to earn incentive compensation according to the PSF Division's incentive compensation plan, as well as the incentive compensation award, or award range, for each eligible position for plan year 2017.

Table 2

PSF Division Incentive Compensation Awards for Plan Year 2017	
Eligible Position <sup>a</sup>	Incentive Compensation Award or Award Range <sup>b</sup>
Chief Investment Officer	\$241,812
Deputy Chief Investment Officer and Director of Fixed Income	\$235,276
Director of Equities	\$212,862
Director of Private Markets	\$200,049
Deputy Executive Administrator	\$191,395
Director of Global Risk Control Strategies	\$161,617 to \$167,680
Portfolio Manager I - IV / Risk Manager	\$70,203 to \$128,507
Director of Investment Technology	\$77,798
Director of Operational Due Diligence	\$77,473
Director of Finance	\$73,150
Investment Analyst I - IV / Risk Analyst	\$35,092 to \$45,757
Director II	\$34,895 to \$40,310
Director of Legal and Compliance	\$31,862
Systems Analyst VII	\$31,345
Systems Analyst I - VI	\$17,178 to \$25,307
Attorney I - VI	\$18,822 to \$24,467
Business Analyst III	\$22,404
Financial Analyst I - IV	\$14,576 to \$20,387
Manager II	\$16,330
Staff Services Officer I - V	\$5,613
Director of Investment Operations	Position was vacant
Accountant I - VII	Position was vacant
Program Specialist I - VII	Position was vacant
Executive Assistant I - III	Position was vacant
<p><sup>a</sup> The Business Analyst III, Director II, Manager II, and Systems Analyst VII positions are not specifically listed in the PSF Division's incentive compensation plan as eligible positions. However, according to the PSF Division's incentive compensation plan, positions assigned to the PSF Division's cost center are considered eligible positions, and the State's commissioner of education has discretion to modify the definition of eligible positions.</p> <p><sup>b</sup> Award range applies to multiple employees in an eligible position.</p>	

Source: The PSF Division.

### Management's Response

*We wish to thank the SAO for the thorough and professional management of this audit.*

## ***GLO Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures***

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**Chapter 2  
Rating:**  
Low<sup>2</sup>

The General Land Office (GLO) calculated and paid incentive compensation for its plan year ending June 30, 2017, in accordance with its policies and procedures.

GLO awarded a total of \$312,083 in incentive compensation to five employees. GLO awarded the most incentive compensation to its chief investment officer, who was awarded \$221,453 payable during a two-year period. That \$221,453 represented 71 percent of the \$312,083 in total incentive compensation that GLO awarded.

GLO's incentive compensation plan compares investment performance of the total fund against a target benchmark on a one-year, three-year, and five-year performance period basis. GLO calculates incentive compensation based on an employee's achievement of an investment performance component (60 percent) and a qualitative performance component (40 percent).

GLO calculates incentive compensation awards using investment performance data reported on a gross-of-fees basis (see text box for more information on gross-of-fees and net-of-fees). The investment performance of the total fund exceeded the target benchmark; therefore, GLO awarded incentive compensation for plan year 2017. Total fund investment performance:

- Exceeded the target benchmark by 11.72 percent (1,172 basis points) for the one-year period from July 1, 2016, to June 30, 2017.
- Exceeded the target benchmark by 5.41 percent (541 basis points) for the three-year period from July 1, 2014, to June 30, 2017.
- Exceeded the target benchmark by 5.56 percent (556 basis points) for the five-year period from July 1, 2012, to June 30, 2017.

### **Gross-of-Fees and Net-of-Fees Basis**

GLO calculates incentive compensation awards using investment performance data reported on a gross-of-fees basis.

Gross-of-fees indicates that the return on investment does not include the effect of fees. Net-of-fees indicates that the return on investment does include the effect of fees.

Sources: GLO and the *Guidance Statement on the Application of the [Global Investment Performance Standards] GIPS Standards to Asset Owners* at

[https://www.gipsstandards.org/standards/Documents/Guidance/gs\\_revised\\_asset\\_owner.pdf](https://www.gipsstandards.org/standards/Documents/Guidance/gs_revised_asset_owner.pdf).

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<sup>2</sup> Chapter 2 is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

GLO pays incentive compensation awards for a plan year over a two-year installment schedule. Specifically, it pays 50 percent of an incentive compensation award on December 1 following the end of the performance period for the current plan year, and it pays the remaining 50 percent of that award on the anniversary of the first payment. As a result, an employee may receive an incentive award payment that consists of partial awards from two plan years.

Table 3 presents the positions eligible to earn incentive compensation awards according to GLO’s incentive compensation plan and the incentive compensation award for each eligible position for plan year 2017.

Table 3

GLO Incentive Compensation Awards for Plan Year 2017	
Eligible Position	Incentive Compensation Award
Chief Investment Officer	\$221,453
Real Assets Portfolio Manager	\$63,120
Program Specialist	\$12,483
Senior Financial Analyst	\$12,267
Investment Analyst	\$2,760

Source: GLO.

## ***ERS Generally Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Strengthen Controls Over Its Incentive Compensation Calculation and Review Process***

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**Chapter 3  
Rating:  
Low <sup>3</sup>**

The Employees Retirement System (ERS) generally calculated and paid incentive compensation for its plan year ending August 31, 2017, in accordance with its policies and procedures. However, ERS overpaid two employees a total of \$3,593 in incentive compensation because it did not apply the correct lengths of service according to its incentive compensation plan (plan) for the two employees' calculations. Specifically, the two employees obtained five years of service under the plan at the end of plan year 2017; however, ERS applied lengths of service of less than five years to the calculations for those employees. ERS did not detect those errors during its reviews.

ERS awarded a total of \$5,300,467 in incentive compensation to 71 employees. ERS awarded the most incentive compensation to its chief investment officer, who was awarded \$283,246 payable during a three-year period. That \$283,246 represented 5.3 percent of the \$5,300,467 in total incentive compensation that ERS awarded. In addition, the members of the ERS board of trustees approved the executive director to participate in the incentive compensation plan for plan year 2017.

ERS awards incentive compensation based on an employee's achievement of qualitative and quantitative performance goals. For investment professionals, the qualitative performance goal represents 25 percent of their overall participant goals. The quantitative performance goals represent the remaining 75 percent of those employees' overall participant goals, with a minimum of 25 percent of the overall participant goals to be evaluated based on relative trust fund performance.

For the executive director, the overall participant goals consist of a quantitative component (50 percent) based on relative trust fund performance and a qualitative component (50 percent) reflecting performance in overall agency leadership, management, communications, policy matters, staff development, and implementation of agency strategic initiatives.

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<sup>3</sup> Chapter 3 is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

ERS calculates incentive compensation awards using investment performance data reported on a net-of-fees basis (see text box for more information on gross-of-fees and net-of-fees). ERS calculates the investment performance goals based on (1) an employee's achievement of benchmarks related to the relative trust fund performance and (2) the performance of the employee's individual assigned asset classes for one-year, three-year, and five-year periods, depending on the employee's length of service. The total relative trust fund investment performance:

- Exceeded the target benchmark by 1.30 percent (130 basis points) for the one-year period from September 1, 2016, to August 31, 2017.
- Exceeded the target benchmark by 0.31 percent (31 basis points) for the three-year period from September 1, 2014, to August 31, 2017.
- Exceeded the target benchmark by 0.23 percent (23 basis points) for the five-year period from September 1, 2012, to August 31, 2017.

**Gross-of-Fees and Net-of-Fees Basis**

ERS calculates incentive compensation awards using investment performance data reported on a net-of-fees basis.

Gross-of-fees indicates that the return on investment does not include the effect of fees. Net-of-fees indicates that the return on investment does include the effect of fees.

Sources: ERS' Incentive Compensation Plan for Key Investment Professionals and the *Guidance Statement on the Application of the [Global Investment Performance Standards] GIPS Standards to Asset Owners* at [https://www.gipsstandards.org/standards/Documents/Guidance/g\\_s\\_revised\\_asset\\_owner.pdf](https://www.gipsstandards.org/standards/Documents/Guidance/g_s_revised_asset_owner.pdf).

ERS pays incentive compensation awards for a plan year over a three-year installment schedule. Specifically, for most employees, ERS pays 50 percent of an incentive compensation award at the end of the performance period for the current plan year, 25 percent of that award at the end of the next plan year, and 25 percent of that award at the end of the third plan year. As a result, an employee may receive an incentive award payment that consists of partial awards from three plan years. For investment operations specialists, ERS pays 50 percent of an incentive compensation award at the end of the performance period for the current plan year, and it pays the remaining 50 percent of that award at the end of the next plan year. For investment administrative support staff, ERS pays 100 percent of an incentive compensation award at the end of the performance period for the current plan year.

Table 4 on the next page presents the positions eligible to earn incentive compensation according to ERS' incentive compensation plan and the incentive compensation award, or award range, for each eligible position for plan year 2017.

Table 4

ERS Incentive Compensation Awards for Plan Year 2017	
Eligible Position	Incentive Compensation Award or Award Range <sup>a</sup>
Chief Investment Officer	\$283,246
Executive Director	\$247,179
Deputy Chief Investment Officer	\$228,825
Asset Class Portfolio Managers/Directors	\$132,722 to \$209,651
Supervising Portfolio Manager	\$83,991 to \$135,417
General Counsel	\$127,337
Investments and Securities, Attorney	\$93,336 to \$105,313
Director of Investment Services	\$101,962
Portfolio Manager I - V	\$60,546 to \$101,255
Risk Management and Applied Research Portfolio Manager	\$89,069
Chief Trader I - II	\$64,190 to \$80,197
Investment Analyst III - IV	\$14,877 to \$62,814
Trader I - II	\$42,253
Financial Analyst I - IV (Investment Operations Specialist)	\$6,612 to \$24,980
Investment Analyst I - II	\$618 to \$24,021
Investment Administrative Support	\$967 to \$2,538
Investments and Securities, Paralegal	Position was vacant
<sup>a</sup> Award range applies to multiple employees in an eligible position.	

Source: ERS.

## Recommendation

ERS should strengthen controls over its incentive compensation calculation and review process to ensure accurate application of all variables used in the calculation.

## Management's Response

*ERS agrees with the recommendation and will continue to enhance its control and review process over the incentive compensation program. In the past few years the following key enhancements have been implemented to ensure alignment with program objectives and accuracy of incentive compensation awards:*

- *Human Resources Division now the primary division responsible for program implementation to ensure appropriate segregation of duties*
- *Additional divisions and staff members assigned to assist with incentive compensation award reviews and program evaluation*
- *Development of formal and documented incentive compensation award calculation procedures and guidelines*
- *Development of a centralized data warehouse for improved efficiency*

*In addition, per ERS' Incentive Compensation Plan policy, the clawback provision was exercised to obtain reimbursements to ERS for overpayments identified.*

***Responsible Position: Director of Human Resources***

***Implementation Date: Completed***

***TRS Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Ensure That Controls Have Been Strengthened Over Its Executive Incentive Compensation Calculation and Review Process***

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The Teacher Retirement System (TRS) calculated and paid incentive compensation in accordance with its policies and procedures for plan year 2017. TRS also calculated and paid executive incentive compensation in accordance with its executive performance incentive pay plan. However, it should ensure that controls have been strengthened over its executive incentive compensation calculation and review process by developing formal, detailed calculation and review procedures.

Chapter 4-A

**TRS Calculated and Paid Plan Year 2017 Incentive Compensation in Accordance with Its Policies and Procedures**

**Chapter 4-A  
Rating:  
Low <sup>4</sup>**

TRS calculated and paid incentive compensation for its plan year ending September 30, 2017, in accordance with its policies and procedures.

TRS awarded a total of \$9,083,202 in incentive compensation to 134 employees (excluding \$16,372 awarded to the executive director as part of the separate executive performance incentive pay plan discussed in Chapter 4-B). TRS awarded the most incentive compensation to a senior managing director, who was awarded \$318,136 payable during a two-year period. That \$318,136 represented 3.5 percent of the \$9,083,202 in total incentive compensation that TRS awarded. In addition, the executive director, exercising his authority to interpret the incentive compensation plan (plan), added the general counsel as a participant to the plan under the eligible position of senior associate effective January 1, 2017.

TRS awards incentive compensation based on an employee's achievement of investment performance and qualitative performance components. The investment performance component consists of two categories: (1) performance measured against established benchmarks (50 percent) and (2) performance measured against selected peer groups (30 percent). The qualitative performance component (20 percent) measures an employee's performance in a variety of areas such as interpersonal relationship skills, accountability, and teamwork.

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<sup>4</sup> Chapter 4-A is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

TRS's plan measures investment performance for both the benchmark and peer group categories on a one-year (33 percent) and three-year (67 percent) performance period basis. TRS awards incentive compensation if investment performance exceeds selected benchmarks or peer group performance for the one-year or three-year performance periods. Additionally, TRS evaluates the performance of internal public markets portfolio managers and sector managers based on their respective assigned regions and industry sectors.

TRS calculates incentive compensation awards using investment performance data reported on a net-of-fees basis (see text box for more information on gross-of-fees and net-of-fees). The total fund investment performance:

- Exceeded the target benchmark by 1.68 percent (168 basis points) for the one-year period from October 1, 2016, to September 30, 2017.
- Exceeded the target benchmark by 0.58 percent (58 basis points) for the three-year period from October 1, 2014, to September 30, 2017.

Moreover, TRS pays incentive compensation awards for a plan year over a two-year installment schedule. Specifically, TRS pays 50 percent of an incentive compensation award on or about February 1 following the end of the performance period for the current plan year, and it pays the remaining 50 percent of that award on the anniversary of the first payment. As a result, an employee may receive an incentive award payment that consists of partial awards from two plan years.

Table 5 on the next page presents the positions eligible to earn incentive compensation according to TRS's incentive compensation plan and the incentive compensation award, or award range, for each eligible position for plan year 2017.

**Gross-of-Fees and Net-of-Fees Basis**

TRS calculates incentive compensation awards using investment performance data reported on a net-of-fees basis.

Gross-of-fees indicates that the return on investment does not include the effect of fees. Net-of-fees indicates that the return on investment does include the effect of fees.

Sources: TRS and the *Guidance Statement on the Application of the [Global Investment Performance Standards] GIPS Standards to Asset Owners* at [https://www.gipsstandards.org/standards/Documents/Guidance/gips\\_revised\\_asset\\_owner.pdf](https://www.gipsstandards.org/standards/Documents/Guidance/gips_revised_asset_owner.pdf).

Table 5

TRS Incentive Compensation Awards for Plan Year 2017	
Eligible Position	Incentive Compensation Award or Award Range <sup>a</sup>
Senior Managing Director	\$174,841 to \$318,136
Deputy Chief Investment Officer	\$275,411
Senior Director	\$84,250 to \$231,033
Managing Director	\$145,186 to \$183,323
Director	\$90,976 to \$150,823
Senior Investment Manager	\$63,475 to 139,074
Investment Manager	\$41,527 to \$112,016
Senior Associate	\$23,900 to \$82,052
Associate	\$14,885 to \$36,197
Senior Analyst	\$9,048 to \$25,770
Analyst	\$2,437 to \$14,058
Junior Analyst	\$5,205
Administrative Assistant	\$1,219 to \$2,009
Chief Investment Officer	Position was vacant
<sup>a</sup> Award range applies to multiple employees in an eligible position.	

Source: TRS.

**TRS Calculated and Paid Plan Year 2017 Executive Performance Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Ensure That Controls Have Been Strengthened Over Its Calculation and Review Process**

**Chapter 4-B  
Rating:  
Low <sup>5</sup>**

TRS calculated and paid executive incentive compensation for its plan year ending June 30, 2017, in accordance with its executive performance incentive pay plan (executive plan). However, TRS did not have detailed policies and procedures that document its calculation and review processes for the executive plan, which increases the risk of inaccurate incentive award payouts. That finding was originally reported in the State Auditor’s Office’s 2016 incentive compensation audit report.<sup>6</sup> TRS had not addressed that prior year finding for plan year 2017 because its executive plan year ended before the release of that report.

According to the executive plan, the TRS board of trustees selects the individual positions that will participate in the executive plan and may add or remove individual positions in the executive plan at any time. The TRS executive director was the only executive plan participant for the 2016-2017 performance period covering July 1, 2016, to June 30, 2017. TRS awarded \$16,372 in incentive compensation to its executive director.

TRS pays executive incentive compensation for a plan year over a two-year installment schedule. Specifically, TRS pays 50 percent of an incentive compensation award on or about October 1 following the end of the performance period for the current plan year, and it pays the remaining 50 percent of that award on the first anniversary of the first payment.

TRS awards executive incentive compensation based on an eligible participant’s total evaluation, which comprises four main qualitative performance categories, each representing 25 percent. Those qualitative performance categories are: (1) member satisfaction, (2) leadership effectiveness, (3) operational effectiveness, and (4) employee engagement. The executive incentive compensation calculation does not include a category for investment performance.

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<sup>5</sup> Chapter 4-B is rated Low because the audit identified strengths that support the audited entity’s ability to administer the program(s)/function(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity’s ability to effectively administer the program(s)/function(s) audited.

<sup>6</sup> From *An Audit Report on Incentive Compensation at the Permanent School Fund, General Land Office, Employees Retirement System, and Teacher Retirement System* (State Auditor’s Office Report No. 18-001, September 2017).

## **Recommendation**

TRS should ensure that written policies and procedures for its executive incentive compensation calculation and review process have been developed and implemented.

## **Management's Response**

*TRS agrees with the audit recommendation. Management has developed written policies and procedures for its executive performance incentive pay plan calculation and review process. The written Compensation Plan calculation and review procedures were finalized in December 2017. These procedures will be reviewed by the Talent Acquisition and Compensation Manager and updated as necessary on an annual basis.*

# Appendices

Appendix 1

## **Objective, Scope, and Methodology**

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### **Objective**

The objective of this audit was to determine whether the Permanent School Fund Division (PSF Division) of the Texas Education Agency, the General Land Office (GLO), the Employees Retirement System (ERS), and the Teacher Retirement System (TRS) calculate and pay incentive compensation in accordance with policies and procedures.

### **Scope**

The scope of this audit covered incentive compensation plan years ending September 30, 2017, at the PSF Division; June 30, 2017, at GLO; August 31, 2017, at ERS; and September 30, 2017, and June 30, 2017, at TRS.

### **Methodology**

The audit methodology included collecting information and documentation from the audited agencies; reviewing incentive compensation plans, policies, procedures, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests.

Auditors tested sample items to determine whether selected recipients were eligible to receive incentive compensation payments, payment calculation data inputs were correct, payment calculations were correct based on the terms of the incentive compensation plans, and payment amounts distributed to recipients were properly recorded and matched amounts calculated for each recipient.

Auditors reviewed incentive compensation plans, calculations, personnel files, payroll data, and externally calculated fund performance results to determine whether the audited agencies calculated and paid incentive compensation in accordance with their policies and procedures. Auditors also tested access controls over the spreadsheets and data that the audited agencies used to calculate incentive compensation.

### **Data Reliability and Completeness**

Auditors assessed the reliability of the incentive compensation award data used in this audit by tracing the data to supporting documentation and by reviewing access to the data. Auditors verified the completeness of the incentive compensation award data by comparing pay calculation

information in the incentive compensation award spreadsheets that the audited agencies used to calculate payments to payment data in the Uniform Statewide Accounting System and the Uniform Statewide Payroll/Personnel System. Auditors determined that the incentive compensation award data was sufficiently reliable for the purposes of this audit.

#### **Sampling Methodology**

Auditors selected risk-based samples of incentive compensation awards for testing for the PSF Division, ERS, and TRS incentive compensation plans. Auditors tested the entire population of incentive compensation awards for the GLO incentive compensation plan and the TRS executive performance incentive pay plan.

Information collected and reviewed included the following:

- Incentive compensation plan documentation at the PSF Division, GLO, ERS, and TRS.
- TRS and ERS boards of trustees meeting minutes.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending September 30, 2017, at the PSF Division; June 30, 2017, at GLO; August 31, 2017, at ERS; and September 30, 2017, and June 30, 2017, at TRS.
- Incentive compensation recipients' personnel files.
- Payroll data related to incentive compensation recipients.
- Investment performance reports from custodian banks.

Procedures and tests conducted included the following:

- Interviewed management and key personnel at the PSF Division, GLO, ERS, and TRS.
- Tested and recalculated recipients' incentive compensation awards for incentive compensation plan years ending September 30, 2017, at PSF; June 30, 2017, at GLO; August 31, 2017, at ERS; and September 30, 2017, and June 30, 2017, at TRS.
- Verified that incentive compensation award payments matched award calculations.
- Reviewed and tested compliance with the audited agencies' policies and procedures.

- Reviewed access controls over the spreadsheets and data that the audited agencies used to calculate incentive compensation.

Criteria used included the following:

- PSF Division's *Performance Incentive Pay Plan*, effective October 1, 2016.
- GLO's *Performance Incentive Pay Plan*, effective July 1, 2016.
- ERS's *Incentive Compensation Plan for Key Investment Professionals and Leadership Employees*, effective September 1, 2016.
- TRS's *Performance Pay Plan*, effective October 1, 2016.
- TRS's *Executive Performance Incentive Pay Plan*, effective July 1, 2016.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 13, page III-33, and Rider 21, pages III-9 and III-10, General Appropriations Act (84th Legislature).
- Texas attorney general opinions related to incentive compensation.
- TRS's *Performance Incentive Calculation and Verification* procedures.
- ERS's *Incentive Compensation Plan – Procedure Reference*.
- ERS's *Incentive Compensation Plan Calculations Finance Process*.

## **Project Information**

Audit fieldwork was conducted from March 2018 through August 2018. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

- Sarah Jane M. Puerto, CGAP, CFE (Project Manager)
- Kelly Bratton, CFSA, CRMA, MBA (Assistant Project Manager)
- Deepa M. Titus

- Tony White, CFE
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Hillary Eckford, CIA, CFE (Audit Manager)

## Issue Rating Classifications and Descriptions

Auditors used professional judgement and rated the audit findings identified in this report. Those issue ratings are summarized in the report chapters/sub-chapters. The issue ratings were determined based on the degree of risk or effect of the findings in relation to the audit objective.

In determining the ratings of audit findings, auditors considered factors such as financial impact; potential failure to meet program/function objectives; noncompliance with state statute(s), rules, regulations, and other requirements or criteria; and the inadequacy of the design and/or operating effectiveness of internal controls. In addition, evidence of potential fraud, waste, or abuse; significant control environment issues; and little to no corrective action for issues previously identified could increase the ratings for audit findings. Auditors also identified and considered other factors when appropriate.

Table 6 provides a description of the issue ratings presented in this report.

Table 6

Summary of Issue Ratings	
Issue Rating	Description of Rating
Low	The audit identified strengths that support the audited entity's ability to administer the program(s)/function(s) audited <u>or</u> the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.
Medium	Issues identified present risks or effects that if not addressed could <u>moderately affect</u> the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.
High	Issues identified present risks or effects that if not addressed could <u>substantially affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.
Priority	Issues identified present risks or effects that if not addressed could <u>critically affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity.

## Related State Auditor's Office Work

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Related State Auditor's Office Work		
Number	Product Name	Release Date
18-001	An Audit Report on Incentive Compensation at the Permanent School Fund, General Land Office, Employees Retirement System, and Teacher Retirement System	September 2017
16-030	An Audit Report on Incentive Compensation at the Permanent School Fund, General Land Office, Employees Retirement System, and Teacher Retirement System	June 2016
15-032	An Audit Report on Incentive Compensation at Selected Agencies	May 2015
14-033	An Audit Report on Incentive Compensation at the Teacher Retirement System, the Permanent School Fund, the General Land Office, and the Employees Retirement System	May 2014
13-033	An Audit Report on Incentive Compensation at the Teacher Retirement System, the Permanent School Fund, and the Employees Retirement System	April 2013

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

The Honorable Jane Nelson, Senate Finance Committee

The Honorable Robert Nichols, Member, Texas Senate

The Honorable John Zerwas, House Appropriations Committee

The Honorable Dennis Bonnen, House Ways and Means Committee

### Office of the Governor

The Honorable Greg Abbott, Governor

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