



John Keel, CPA
State Auditor

An Audit Report on

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

April 2013
Report No. 13-033



An Audit Report on
***Incentive Compensation at
the Teacher Retirement System,
the Permanent School Fund, and
the Employees Retirement System***

SAO Report No. 13-033
April 2013

Overall Conclusion

Through their incentive compensation plans for plan year 2012, the Teacher Retirement System (TRS) and the Permanent School Fund (PSF) of the Texas Education Agency made incentive compensation awards to employees in accordance with their policies and procedures. However, both TRS and the PSF could strengthen their incentive compensation plan oversight by formally requiring annual approval or confirmation of those plans. Although the TRS board of trustees confirms the continuation of the TRS incentive compensation plan each year, the approved incentive compensation plan does not require that confirmation.

Similarly, although the commissioner of education approved the PSF incentive compensation plan, the commissioner was not required to do so.

The Employees Retirement System (ERS) did not always award incentive compensation in accordance with its policies and procedures. Auditors identified the following:

- ERS did not finalize its written incentive compensation plan until April 2012, which was seven months after the beginning of its plan year. On August 23, 2011, the board of trustees approved certain changes to the incentive compensation plan (see Appendix 2 for an excerpt from the board of trustees meeting minutes). However, ERS subsequently made additional changes and did not present those changes to the board of trustees. Those changes redefined how the amounts of incentive compensation would be calculated for the individuals in those positions for plan year 2012. Those changes modified the incentive compensation calculation metrics for 60 percent of the individuals eligible for incentive compensation.
- The ERS executive director was eligible to receive incentive compensation through the ERS incentive compensation plan. However, the ERS executive director received a one-time 50 percent merit increase of \$162,501 from the ERS board of trustees "...in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership...the interim benefits study, and her skills as a member of the internal investment committee..." ERS paid the executive

Incentive Compensation for Plan Year 2012

TRS, PSF, and ERS awarded a total of \$11,379,096 in incentive compensation to 174 employees through their incentive compensation plans for plan year 2012. Specifically:

- TRS awarded \$8,321,095 to 109 employees.
- The PSF awarded \$1,233,649 to 23 employees.
- ERS awarded \$1,824,352 to 42 employees.

director that merit increase in November 2012. See Appendix 3 for an excerpt from the board of trustees meeting minutes.

Summary of Management's Response

TRS and the PSF agreed with the recommendations in this report; ERS generally agreed with the recommendations in this report.

Summary of Information Technology Review

Auditors tested access controls over spreadsheets containing incentive compensation calculations at TRS, the PSF, and ERS and concluded that access controls at all three entities were adequate.

Summary of Objective, Scope, and Methodology

The objective of this audit was to determine whether incentive compensation at TRS, the PSF, and ERS was calculated and paid in accordance with policies and procedures.

The scope of this audit covered incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

The audit methodology included collecting information and documentation from the audited entities; reviewing incentive compensation plans, policies and procedures, applicable statutes, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests. Auditors selected a judgmental sample of incentive compensation payments at each audited entity and verified that recipients tested were eligible to receive payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the plans. As noted above, auditors also tested access controls at the audited entities.

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Detailed Results

Chapter 1

TRS Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The TRS Incentive Compensation Plan

TRS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: *Pure View Report*, State Street Global Services.

The Teacher Retirement System (TRS) awarded incentive compensation for its plan year ended September 30, 2012, in accordance with its policies and procedures.

TRS awarded a total of \$8,321,095 in incentive compensation to 109 employees.¹ TRS awarded the most incentive compensation to its chief investment officer, who received \$483,754 payable over a two year-year period. That \$483,754 represented 6 percent of the \$8,321,095 in total incentive compensation that TRS awarded.

The TRS incentive compensation plan is based on a combination of investment performance and qualitative performance. The investment performance component compares investment performance with benchmarks and the performance of other large public funds. The qualitative performance component assesses performance in a variety of areas such as ethics, decision making and judgment, and analytical skills.

The TRS incentive compensation plan measures investment performance on both a one-year basis and a three-year basis. For the year ended September 30, 2012, TRS investments generated an excess positive return of 1.17 percent (117 basis points) over the benchmark for the three-year period and an excess positive return of 1.29 percent (129 basis points) over the benchmark for the one-year period. TRS's incentive compensation plan weights the three-year return twice as much as the one-year return. TRS met its goals for both the one-year and three-year periods; therefore, this triggered the awarding of incentive compensation.

To determine incentive compensation amounts, TRS followed the incentive compensation plan its board of trustees approved. However, the TRS incentive compensation plan does not require the board of trustees to confirm the continuation of that plan annually. Requiring formal confirmation of the continuation of the incentive compensation plan could help to ensure that the plan remains aligned with the intent of the board of trustees. It could also help ensure compliance with Rider 14, pages III-32 through III-33, General Appropriations Act (82nd Legislature), which specifies that the board of trustees may make performance incentive compensation payments "...based on investment performance standards adopted by the Board prior to the beginning of the period for which any additional compensation is paid."

¹ As of February 1, 2013, TRS paid employees \$4,160,547 of the \$8,321,095 it awarded; \$4,160,548 was due to be paid in 2014.

Recommendation

TRS should update its incentive compensation plan to include a requirement for the board of trustees to confirm the continuation of that plan prior to the beginning of each plan year.

Management's Response



www.trs.state.tx.us

800.223.8778
512.542.6400

Brian K. Guthrie
Executive Director
1000 Red River Street
Austin, Texas 78701-2698

April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: TRS Management Response to Audit of Incentive Compensation.

The following is TRS's management response to the recommendation noted in the State Auditor's Office Audit Report on Incentive Compensation.

Recommendation

TRS should update its incentive compensation plan to include a requirement for the board of trustees to confirm the continuation of that plan prior to the beginning of each plan year.

Management's Response

TRS agrees with the recommendation to include a requirement for the board of trustees to confirm the continuation of that plan. We will add language noting the required board of trustee confirmation beginning with the 2013-2014 incentive plan year.

Sincerely,

Brian Guthrie
Executive Director

The PSF Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The PSF Incentive Compensation Plan

The PSF calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis.

Source: Mellon Bank Performance Calculation Worksheet.

The Permanent School Fund (PSF) of the Texas Education Agency awarded incentive compensation for its plan year ended July 31, 2012, in accordance with its policies and procedures.

The PSF awarded a total of \$1,233,649 in incentive compensation to 23 employees.² The PSF awarded the most incentive compensation to its deputy chief investment officer, who received \$126,502 payable over a two-year period. That \$126,502 represented 10 percent of the \$1,233,649 in total incentive compensation that the PSF awarded.

The PSF incentive compensation plan compares investment performance with a target benchmark on a three-year rolling basis. The PSF calculates incentive compensation based on an employee's achievement of goals in fund performance, asset class performance, and portfolio performance. Because investment performance exceeded the benchmark, this triggered the awarding of incentive compensation. Specifically, the total fund investment performance:

- Exceeded the target benchmark by 0.70 percent (70 basis points) for the three-year period from August 1, 2009, to July 31, 2012.
- Exceeded the target benchmark by 0.52 percent (52 basis points) for the two-year period from August 1, 2010, to July 31, 2012.
- Exceeded the target benchmark by 0.52 percent (52 basis points) for the one-year period from August 1, 2011, to July 31, 2012.

The former commissioner of education suspended the PSF incentive compensation plan in August 2011 and reinstated it retroactively with no changes in June 2012. The PSF incentive compensation plan requires the commissioner of education to approve the list of participants who are eligible for the incentive compensation plan within 60 days of the plan's start date. However, because the incentive compensation plan was suspended at the beginning of the plan year, the PSF did not obtain that approval at the beginning of the plan year. The current commissioner of education approved the list of eligible participants on December 5, 2012.

The PSF incentive compensation plan also does not require the commissioner of education to formally approve the incentive compensation plan prior to the beginning of a plan year. Requiring formal approval of the incentive compensation plan could help to ensure that the plan aligns with the intent of the commissioner of education. It also could help ensure compliance with Rider 22,

² As of December 10, 2012, the PSF had paid employees \$616,825 of the \$1,233,649 it had awarded; \$616,824 was due to be paid in late 2013.

page III-11, General Appropriations Act (82nd Legislature), which specifies that payments from the incentive compensation plan "...must be based on investment performance standards set prior to the beginning of the period for which any additional compensation is paid."

Recommendations

The PSF should:

- Ensure that the commissioner of education approves the list of participants eligible for the incentive compensation plan within 60 days of the plan's start date.
- Update its incentive compensation plan to include a requirement for the commissioner of education to formally approve that plan prior to the beginning of a plan year.

Management's Response



1701 North Congress Ave. • Austin, Texas 78701-1494 • 512 463-9734 • 512 463-9838 FAX • www.tea.state.tx.us

Michael L. Williams
Commissioner

April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: TEA Management Response for an Audit of Incentive Compensation at the Teacher Retirement System, the Employees Retirement System, and the Permanent School Fund.

Dear Mr. Clayton:

The following responses are provided in relation to SAO recommendations:

- TEA management agrees with this recommendation and will establish procedures to ensure that the Commissioner timely approves the list eligible Incentive Compensation Plan Permanent School Fund (PSF) employees for each cycle.
- TEA management will consider combining the annual approval of eligible PSF plan participants with an annual approval of the plan by the commissioner of education. Global Governance Advisors, the consultant hired by TEA management, is making recommendations for amending the current plan language and this matter will be provided to them for their consideration.

Please let me know if you require anything further.

Sincerely,

A handwritten signature in blue ink, appearing to read "Lizzette C. González Reynolds".

Lizzette C. González Reynolds
Chief Deputy Commissioner

LCGR/cc

cc: Michael L. Williams
Holland Timmins
William Wilson

ERS Did Not Always Award Incentive Compensation in Accordance With Its Policies and Procedures

The ERS Incentive Compensation Plan

ERS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: ERS incentive compensation plan.

The Employees Retirement System (ERS) did not always award incentive compensation for its plan year ended August 31, 2012, in accordance with its policies and procedures.

ERS awarded a total of \$1,824,352 in incentive compensation to 42 employees.³ ERS awarded the most incentive compensation to its director of public equities, who received \$118,298 payable over a three-year period. That \$118,298 represented 6 percent of the \$1,824,352 in total incentive compensation that ERS awarded.

The ERS incentive compensation plan is based on a combination of investment performance and, for certain employees, qualitative performance. The investment performance component compares investment performance to a benchmark. The qualitative performance component assesses items such as an employee's development of hedge fund strategies and implementation of an emerging manager program. Although ERS did not meet its performance benchmark of 8.11 percent, the total fund performance was positive 8.04 percent (804 basis points), which triggered the awarding of incentive compensation.

Auditors identified the following:

- ERS did not finalize its written incentive compensation plan until April 2012, which was seven months after the beginning of its plan year. On August 23, 2011, the board of trustees approved certain changes to the incentive compensation plan (see Appendix 2 for an excerpt from the board of trustees meeting minutes). However, ERS subsequently made additional changes and did not present those changes to the board of trustees. Those changes redefined how the amounts of incentive compensation would be calculated for the individuals in those positions for plan year 2012. Those changes modified the incentive compensation calculation metrics for 60 percent of the individuals eligible for incentive compensation.
- The ERS executive director was eligible to receive incentive compensation through the ERS incentive compensation plan. However, the executive director received a one-time 50 percent merit increase of \$162,501 from the ERS board of trustees "...in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership... the interim benefits study, and her skills as a member of the internal investment committee..." ERS paid the executive director that merit increase in November 2012. While ERS asserted that merit increase was not paid

³ As of December 1, 2012, ERS paid employees \$912,602 of the \$1,824,352 it awarded; \$446,510 is due to be paid in late 2013, and \$446,510 is due to be paid in 2014.

through the incentive compensation plan, its accounting records indicated that ERS charged that merit increase to the expense object code used to record incentive compensation plan payments. The executive director's merit increase was the only non-incentive-compensation bonus charged to that expense object code during the plan year. See Appendix 3 for an excerpt from the board of trustees meeting minutes.

- ERS calculated two employees' incentive compensation based on the full plan year when those employees were not eligible to participate in the incentive compensation plan until November 2011, which was two months after the beginning of the plan year. As a result, those employees received a total of \$21,372 or 16.7 percent more in incentive compensation than they should have received. A third employee's incentive compensation should have been between \$56,762 and \$73,790; however, ERS awarded that employee \$37,460 in incentive compensation and did not provide documentation explaining that amount.
- The ERS incentive compensation plan does not require the board of trustees to formally approve the incentive compensation plan prior to the beginning of a plan year. This increases the risk that the incentive compensation may not align with the intent of the board of trustees.

Recommendations

ERS should:

- Finalize its incentive compensation plan prior to the beginning of a plan year.
- Calculate and award incentive compensation based on its incentive compensation plan, and consistently document its reasons for any deviation from that plan.
- Update its incentive compensation plan to include a requirement for the board of trustees to formally approve that plan prior to the beginning of a plan year.

Management's Response



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April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: SAO Incentive Compensation Audit – Management Responses

ANN S. BISHOP
EXECUTIVE DIRECTOR

CHERYL MACBRIDE
CHAIR

BRIAN D. RAGLAND
VICE-CHAIR

BOARD OF TRUSTEES
CYDNEY C. DONNELL
YOLANDA GRIEGO
I. CRAIG HESTER
FREDERICK E. ROWE, JR.

In response to the State Auditor's Office recommendation to finalize its incentive compensation plan prior to the beginning of a plan year, the Employees Retirement System of Texas (ERS) considered the 2011 Incentive Compensation Plan (ICP) to be (1) the plan document adopted by the ERS Board of Trustees' (Board) as of August 19, 2008 (2008 Plan Document) and (2) the revisions adopted by the Board in the 2011 ICP Matrix (portions of what is documented in Appendix 2 of the report). The Board's motion (enclosed as item 15) adopting revisions to the 2008 Plan Document, in the form of the 2011 ICP Matrix, provided the delegation of authority to the Executive Director to document the revisions in a single plan document and make any additional revisions the Executive Director deemed necessary. The ICP adopted on August 23, 2011 revised the 2008 Plan Document for best practices by: (1) requiring investment division expenses to be netted before performance is calculated for award payments; (2) instituting a clawback¹; (3) providing more detailed documentation in the plan document of the calculation methodology; and (4) allowing awards to be earned during negative absolute trust fund performance, but paid only in a year with positive absolute trust fund performance. The changes made during fiscal year 2012 to individual incentive compensation calculation metrics were consistent with the 2011 ICP Matrix and authority delegated by the Board to the Executive Director.

In regards to the SAO's recommendation requiring the Board to formally approve the ICP prior to the beginning of a plan year, Section 7.3 of the Incentive Compensation Plan requires the Board of Trustees to review the plan at least every 5 years and any changes to the plan document would be presented to the Board of Trustees for review and approval. In response to recommendation, ERS will present a revision to Section 7.3 of the Incentive Compensation Plan to have the Board of Trustees affirm and approve the plan document prior to the beginning of a plan year. Per Section 4.4 of the Incentive Compensation Plan, the Executive Director will approve individual incentive compensation metrics.

¹ Section 6.9 of the ICP provides that under certain circumstances, an incentive compensation award paid to a plan participant may be reduced, forfeited and/or required to be repaid by the participant.

State Auditor's Office
April 23, 2013
Page 2

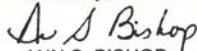
We are in agreement with the recommendation related to the overpayment of two individuals. ERS will pursue a clawback of the overpayments per Section 6.9 of the ICP. ERS has already begun implementing new procedures to ensure proper payment of incentive compensation for employees who did not participate in the ICP for a full plan year. The enhancements include:

- Increased automation within the calculation process to prorate payment based on date of eligibility
- Enhancing the review process to include additional Investment Division review and approval
- Leverage SharePoint to provide quality documentation of the payout process,

The third employee's difference in the amount awarded was authorized under the discretion allowed in the ICP under Section 6.4. The authorization of discretion being utilized for the revised amount was documented by the Executive Director's approval of the final payment packet. A discretion documentation memo will be included in the future.

While the SAO reported a merit payment to the Executive Director was charged to the object code used to record incentive compensation plan payments, no instance of non-compliance was reported by the SAO nor recommendations related to this observation provided. For fiscal year 2012, the ERS Executive Director did not receive an award under the incentive compensation plan. As documented in Appendix 3 of the Report, the Board did award a merit payment to the Executive Director at its public Board meeting held on September 26, 2012. To ensure proper recording of this merit payment, ERS staff contacted the Texas Comptroller of Public Accounts (CPA) Fiscal Management Division for guidance. The CPA's Fiscal Management Division is responsible for establishing the State's accounting policies including codes used to record expenditures. The CPA's Fiscal Management Division suggested ERS record this payment under the newly established special pay code called the "ERS Bonus code." The ERS Bonus code was established to record bonuses for leadership positions in addition to incentive compensation payments. The CPA does not have a designated expenditure object code for incentive compensation payments, nor does the CPA restrict the ERS Bonus code only to payments made under the incentive compensation plan. Based on guidance from the CPA, ERS recorded this merit payment under the code as suggested.

Sincerely,


ANN S. BISHOP
Executive Director

Enclosures

retirees of \$2,500. Employees have the option to take Optional Life and AD&D plan of 1x, 2x, 3x or 4x earnings to a maximum of \$400,000. Life insurance is a fully insured program under a minimum funding arrangement. The AD&D program is fully insured.

CURRENT PARTICIPATION

Coverage	Members Participating	Life Insurance Volume
Basis Life	300,031	\$1,294,042,500
Basic AD&D (Actives Only)	217,587	\$1,087,935,000
Optional Life 1X earnings	47,514	\$1,963,930,000
Optional Life 2X earnings	113,496	\$9,963,644,000
Optional Life 3X earnings	5,401	\$867,449,000
Optional Life 4X earnings	20,421	\$4,096,912,000
Dependent Life	118,850	\$534,502,500
Voluntary AD&D	131,920	\$17,777,607,000
Short Term Disability	109,684	\$378,809,748
Long Term Disability	92,165	\$349,198,072

Mr. Rob Kukla reported that Benefit Contracts issued an RFP on June 9, 2011, requesting bids for life, AD&D and short and long-term disability coverage. Two bids were received for Life and AD&D Insurance: Minnesota Life Insurance and Fort Dearborn Life. One bid was received for administration of the disability plans. ERS exercised its option within the RFP and will re-bid the short and long-term disability contract at a later date.

ERS staff in conjunction with Rudd & Wisdom received the bids for compliance with the RFP contracting and financial information. A financial comparison of the two bids show the administrative cost and the maximum liability in their projection. As a result on the RFP responses, their financial offering and service capabilities staff is recommending that ERS award the Life and Accidental Dismemberment to Minnesota Life effective January 1, 2012.

The Board then took the following actions:

MOTION made by Ms. Cheryl MacBride, seconded by Ms. Yolanda Griego, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas select Minnesota Life Insurance Company as the provider of all Group Term Life Insurance and Accidental Death and Dismemberment Insurance coverage's offered to the Texas Employees Group Benefits Program (GBP) members effective January 1, 2012.

XV. REVIEW, DISCUSSION AND CONSIDERATION OF PROPOSED REVISIONS TO INCENTIVE COMPENSATION PLAN TERMS

During the background discussion of this agenda item it was noted that ERS enlisted Investment Advisory Committee (IAC) Chair Vernon Torgerson, IAC Vice-Chair Milton Hixson and investment consultants from Hewitt EnnisKnupp to review ERS' current Incentive Compensation Plan (ICP) and make recommendation to assist ERS in offering more a competitive plan. The committee's

recommended changes to the ICP were presented to an internal review group consisting of Executive management and staff from Internal Auditing, Investments, Legal Services and Human Resources.

Ms. Ann Fuelberg then presented a list of issues related to the ICP³ for the Board's comments and consideration. Following Ms. Fuelberg's presentation of the various questions and issues, the Board took the following actions:

MOTION made by Mr. Craig Hester, seconded by Mr. Owen Whitworth, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas approve the proposed revised terms of the Incentive Compensation Plan to take effect upon the Executive Director's approval of all applicable performance standards and metrics, the manner of calculating and determining the payout of incentive compensation awards, and any other issues that are still under consideration following the Board's consideration of this agenda item, and include the Executive Director based on the same general terms as the Chief Investment Officer effective September 1, 2011. It was further moved that the Board of Trustees authorize the Executive Director to incorporate the Board's approved terms and revisions into the Incentive Compensation Plan, to reword and revise the Plan as necessary consistent with the Board's decision, the Investment Policy and applicable law, and thereafter implement the Plan as revised.

XVI. REVIEW, DISCUSSION AND CONSIDERATION OF PROPOSED OPERATING BUDGET FOR THE EMPLOYEES RETIREMENT SYSTEM OF TEXAS FOR FISCAL YEAR 2012

Mr. Larry Zeplin reported that while the fiscal year 2012 proposed operating budget is higher than the fiscal year 2011 forecast, at \$52.3 million, the fiscal year 2012 proposed operating budget remains relatively flat compared to the fiscal year 2011 approved budget in all areas. Mr. Zeplin highlighted the multiple major initiatives identified by ERS' strategic directions of Increasing Retirement Security, Optimizing the Group Benefits Program, Engaging Stakeholders, and Enhancing Agency Performance and Accountability.

Mr. Mike Wheeler, Chief Financial Officer, provided a comparison of the fiscal year 2011 operating budget forecast to the fiscal year 2012 proposed operating budget stating the fiscal year forecast is approximately \$4 million dollars, or 7.7%, below budget, and about 88% of that amount relates to vacant positions and unspent funds for the Incentive Compensation Plan. Consistent with state leadership's requirement to reduce budgets for fiscal year 2011, ERS filled vacant positions only if an immediate need could be justified.

Ms. Debbie Leatham, Manager of Budget & Special Projects, discussed financial reporting changes. Retiree insurance was removed from other salary costs consistent with other state agencies' reporting, and investment banking was added as a line item for more transparency and better comparison reporting.

Mr. Craig Hester congratulated Mr. Zeplin and the Finance staff for their hard work in presenting the budget document to the board. Ms. Cydney Donnell echoed Mr. Hester's comment and announced that ERS received the Government Financial Officers Association (GFOA) Certificate of Achieving Excellence in Financial Reporting. Mr. Zeplin then commented that ERS has received the GFOA Certificate of Excellence for 22 years in a row.

There being no further questions or discussion, the Board took the following action:

MOTION made by Ms. Cheryl MacBride, seconded by Ms. Yolanda Griego, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas approve the Fiscal Year 2012 Proposed Operating Budget, for the Employees

³ Exhibit C – Pages 13 – 25

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The objective of this audit was to determine whether incentive compensation at the Teacher Retirement System (TRS), the Permanent School Fund (PSF) of the Texas Education Agency, and the Employees Retirement System (ERS) was calculated and paid in accordance with policies and procedures.

Scope

The scope of this audit covered incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

Methodology

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

Auditors selected a judgmental sample of incentive compensation payments at each entity and verified that recipients tested were eligible to receive payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the plans. Auditors also tested access controls at the audited entities.

Auditors reviewed calculations, personnel files, payroll data, and externally reported fund performance results to determine whether the audited entities calculated and paid incentive compensation in accordance with policies and procedures. Auditors also tested access controls over the spreadsheets used in calculating incentive compensation for authorized personnel.

Auditors did not conduct data reliability assessments. Those assessments were not necessary for the purposes of this audit because data was used only as support for testing information available at the audited entities.

Information collected and reviewed included the following:

- Incentive compensation plan at TRS, the PSF, and ERS.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

- Incentive compensation recipients' personnel files.
- Payroll data related to incentive compensation recipients.
- Investment performance reports from investment custodian banks.

Procedures and tests conducted included the following:

- Interviewed management and key personnel at TRS, the PSF, and ERS.
- Analyzed and recalculated incentive compensation payments for incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.
- Reviewed and tested compliance with the audited entities' policies and procedures.

Criteria used included the following:

- Teacher Retirement System of Texas Performance Incentive Pay Plan.
- Texas Permanent School Fund Performance Incentive Pay Plan.
- Employees Retirement System of Texas Incentive Compensation Plan.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 14, pages III-32 through III-33, and Rider 22, III-11, General Appropriations Act (82nd Legislature).
- Attorney General opinions related to incentive compensation.

Project Information

Audit fieldwork was conducted from February 2013 through April 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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

- Michael O. Clayton, CPA, CISA, CIDA, CFE (Project Manager)
- Amadou N'gaide, MBA, CFE, CIDA (Assistant Project Manager)
- Roger Ferris, CPA
- Michelle Ann Duncan Feller, CPA, CIA (Quality Control Reviewer)
- Angelica M. Ramirez, CPA (Audit Manager)

Excerpts from August 23, 2011, ERS Board of Trustees Meeting Minutes

Below are excerpts from the minutes of the August 23, 2011, meeting of the Employees Retirement System board of trustees.

FINAL DRAFT 8/18/11

**PUBLIC AGENDA ITEM - #15
EXHIBIT A
MATRIX OF ICP ISSUES TO BE CONSIDERED BY BOARD OF TRUSTEES
AUGUST 23, 2011**

EXHIBIT C

Abbreviations Used: MC = McLagan; OC = Outside Counsel (Ice Miller)

Section references are to the ERS Incentive Compensation Plan with specific references to current policy annotated.

ISSUES	CURRENT POLICY	COMMENTS	RECOMMENDATIONS
		compensation TCDRS (\$17.7 Billion**): No incentive compensation Safekeeping Trust (\$49.4 Billion**): 30% - 100% Perm. School Fund (\$22.1 Billion*): 25% - 60% UTIMCO (\$17.2 Billion*): 25% - 200% *As of 8/31/10 **As of 12/31/10	
SECTION 4. ESTABLISHMENT OF PERFORMANCE GOALS AND PLAN FUNDING			
Earned Incentive Compensation Awards During Negative or Zero Trust Fund Returns	Neither earned nor paid when total trust fund returns are zero or less. (4.6)	<p>Investments: Awards <u>may be earned</u> for excess return even if negative or zero trust fund returns but <u>may not be paid</u> until a future Plan Year when there is positive trust fund performance.</p> <p>MC: During years when absolute returns are negative, about half of competitor public funds have a mandatory deferral feature. In about half of those public funds, boards retain the discretion to defer, reduce, eliminate or payout.</p> <p>OC: Preferable just to keep the limit based on positive trust fund performance and allow the Board and/or Executive Director to exercise negative discretion due to the trust's financial condition.</p>	<p>Revise Plan so awards <u>may be earned</u> for excess return even if negative or zero trust fund returns but <u>will not be paid</u> until the future Plan Year when there is positive trust fund performance.</p> <p>Earned awards may be deferred <u>up to 3 years</u> if payment cannot be made because of negative or zero trust fund performance. <u>After 3 years</u>, earned awards will be automatically forfeited.</p> <p>Refer to the earlier point regarding discretion.</p>

**PUBLIC AGENDA ITEM - #15
EXHIBIT A
MATRIX OF ICP ISSUES TO BE CONSIDERED BY BOARD OF TRUSTEES
AUGUST 23, 2011**

EXHIBIT C

Abbreviations Used: MC = McLagan; OC = Outside Counsel (Ice Miller)

Section references are to the ERS Incentive Compensation Plan with specific references to current policy annotated.

ISSUES	CURRENT POLICY	COMMENTS	RECOMMENDATIONS
		<p>Deferral periods for incentive compensation are consistent with Dodd-Frank even outside of times of negative performance.</p>	
<p>Simplify Performance Standards/Metrics</p>	<p>Not specifically addressed in the current Plan. Approved at the beginning of each Plan Year. (Section 4)</p> <p>Currently Investments presents spreadsheet for review and approval by Executive Director prior to each Plan Year.</p>	<p>Investments: Performance standards should be simplified and documented at a high-level in the Plan with focus on measuring for total trust, asset class and individual portfolio performance during the one, three and five year discrete time periods.</p> <p>Change will add clarity and transparency to performance measurement while reducing the complexity of metrics used previously.</p> <p>Asset class performance will be directly based on the asset class/strategies in the Active Risk Budget incorporated in the Investment Policy.</p> <p>MC: ERS should exercise discipline in not adding additional investment-related sub-goals, especially given that, with initiatives already split into one year and three year components, and then into total fund, asset class and portfolio components, and then into relative and risk-adjusted components, the final weighted components are fairly small bordering on inconsequential.</p>	<p>Revise Plan to adopt a high-level structure for the performance standards/metrics with weightings for total trust, asset class and individual portfolio performance as an appendix to the Plan.</p> <p>Investments will provide this appendix for review and approval by the Executive Director prior to the effective date of the revised Plan to avoid issues raised by Art. III, § 44 of the Texas Constitution and applicable Attorney General Opinions that require performance standards/metrics to be in effect prior to service being performed.</p> <p>Prior to each Plan Year, Investments will provide a more detailed listing of performance standards for each individual participant, including a discretionary component for certain positions, in adequate time for approval by the Executive Director prior to the beginning of the Plan Year and consistent with the appendix in and the terms of the Plan and the Active Risk Budget in the Investment Policy.</p>

Excerpt from September 26, 2012, ERS Board of Trustees Meeting Minutes

Below is an excerpt from the minutes of the September 26, 2012, joint meeting of the Employees Retirement System investment advisory committee and board of trustees.

The next steps for the asset allocation include benchmarks, risk management, implementation considerations and policy revisions. These items will be taken up at the December Working Session on December 6 – 7, 2012.

There were no questions or further discussion, and no action was required on this item.

II. ADJOURNMENT OF THE INVESTMENT ADVISORY COMMITTEE

The ERS Investment Advisory Committee adjourned at 11:34 a.m.

III. EXECUTIVE SESSION

At 12:12 p.m., Chair Cheryl MacBride announced that the Board of Trustees (Board) will meet in Executive Session in accordance with Section 551.074, Texas Government Code, to review and consider the duties, performance and compensation of the ERS Executive Director; and to discuss the appointment of the Internal Auditor. The Board will not be interviewing applicants for the Internal Auditor position at this time. Thereafter, the Board may consider appropriate action in open session, and in accordance with statute, a certified agenda will be kept of the Executive Session.

The Executive Session concluded at 1:27 p.m., at which time the Trustees returned to open session. Chair Cheryl MacBride stated that while in Executive Session, no action, decision or vote was taken by the Board. She then opened the floor for a motion.

Trustee Craig Hester stated that in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership, a copy of which we would like attached to the minutes², the interim benefits study, and her skills as a member of the internal investment committee, he would like the Board of Trustees to consider the following motion:

MOTION made by Craig Hester that the Board of Trustees of the Employees Retirement System of Texas award ERS Executive Director Ann Bishop an increase in her annual compensation by 4.167% of her Fiscal Year 2012 annual salary effective October 1, 2012. I further move that the Executive Director receive a merit payment equal to 50% of her Fiscal Year 2013 annual salary effective October 1, 2012.

The motion was subsequently seconded by Trustee Yolanda Griego and carried unanimously by the members of the Board of Trustees.

The foregoing is a true and accurate statement of the action taken by the Board of Trustees regarding the compensation of ERS Executive Director, Ann S. Bishop.

IV. ADJOURNMENT OF THE BOARD OF TRUSTEES

The Board of Trustees adjourned at 1:29 p.m.

² Exhibit B – Page 10 - 20

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Thomas “Tommy” Williams, Senate Finance Committee
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Harvey Hilderbran, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Teacher Retirement System

Members of the Teacher Retirement System Board of Trustees

Mr. R. David Kelly, Chairman
Ms. Charlotte Clifton, Vice Chair
Mr. Todd Barth
Ms. T. Karen Charleston
Mr. Joe Colonna
Mr. Eric C. McDonald
Mr. Christopher Moss
Ms. Anita Smith Palmer
Ms. Nanette Sissney
Mr. Brian Guthrie, Executive Director

Texas Education Agency

Members of the State Board of Education

Ms. Barbara Cargill, Chair
Mr. Thomas Ratliff, Vice Chair
Mrs. Mavis B. Knight, Secretary
Mr. Lawrence A. Allen, Jr.
Mrs. Donna Bahorich
Mr. David Bradley
Mr. Ruben Cortez, Jr.
Dr. Martha M. Dominguez
Ms. Patricia Hardy
Mr. Tom Maynard
Ms. Sue Melton
Mr. Ken Mercer
Mrs. Geraldine “Tincy” Miller
Ms. Marisa B. Perez
Mr. Marty Rowley
Mr. Michael Williams, Commissioner of Education

Employees Retirement System

Members of the Employees Retirement System Board of Trustees

Ms. Cheryl MacBride, Chair
Mr. Brian D. Ragland, Vice-Chair
Ms. Cydney Donnell
Ms. Yolanda Griego
Mr. I. Craig Hester
Mr. Frederick E. Rowe, Jr.
Ms. Ann Bishop, Executive Director



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