



Lawrence F. Alwin, CPA
State Auditor

An Audit of

The Financial Statements of the Teacher Retirement System for the Fiscal Year Ended August 31, 2001

December 17, 2001

Members of the Legislative Audit Committee:

In our audit report dated November 9, 2001, we concluded that the financial statements of the Teacher Retirement System (System) for the fiscal year ended August 31, 2001, are materially correct in accordance with accounting principles generally accepted in the United States.

Our audit opinion is included in the financial section of the System's *Comprehensive Annual Financial Report*, which the System released on November 16, 2001. We have also provided the System with a management letter and a report on compliance and internal control. This is the fourth consecutive year that we found no instances of significant noncompliance or material weaknesses in internal control.

We noted no problems with the System's financial statements, compliance, or internal control. However, we want to inform the Legislature of a situation that could negatively affect future pension plan benefit increases without an increase in contribution rates and/or improvements in investment returns. The following information highlights this potential issue and key financial results for fiscal year 2001.

Potential Future Issue and Key Fiscal Year Results

- The System's pension plan remains actuarially fully funded for the fourth consecutive year. The actuary's report indicates that, as of August 31, 2001, the pension plan's assets plus future required contributions are sufficient to pay benefits to retirees and current active members upon retirement. However, the pension plan's funding surplus (the amount by which actuarial assets exceed actuarial liabilities) declined to \$2.1 billion as of August 31, 2001, a \$3.3 billion decrease from the prior year. According to the actuary's report, this decline was primarily due to the cost of recent benefit increases.
- Benefit increases caused the pension plan's normal cost rate (the actuarial cost of benefits for newly hired participants) to rise from 12.16 percent of pay to 12.68 percent. The combined employer and employee contribution rate of 12.40 percent of pay is now 0.28 percent less than the normal cost. If the plan's current funding surplus ceases to exist in the future and the contribution rate remains below the pension plan's normal cost, statute would preclude further benefit increases.
- Largely because of adverse market conditions resulting in unfavorable investment returns, the net assets of the pension trust fund decreased by \$10.6 billion to \$79.4 billion. This is an 11.7 percent decrease compared to a 12.6 percent increase in fiscal year 2000.

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- Retiree insurance plan expenses exceeded revenues by \$60 million during the fiscal year, resulting in a \$36 million deficit fund balance as of August 31, 2001. The 77th Legislature appropriated \$410 million to the program to help it continue operating through the next biennium.

The attachment to this letter contains further explanation regarding the future actuarial soundness of the pension plan. It also contains additional statistical and financial information.

We thank management and staff of the System for their cooperation during this audit. If you have any questions, please contact Carol A. Smith, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

cc: Teacher Retirement System
Chair and Members of the Board
Mr. Charles L. Dunlap, Executive Director

Section 1:

Future Pension Plan Benefit Increases Might Not Be Statutorily Permitted Without an Increase in Contribution Rates and/or Improvements in Investment Returns

As a result of recent Teacher Retirement System (System) pension benefit increases, a contribution shortfall arose in which the annual actuarial cost of benefits increased above the contribution rate. Specifically, the actuarially determined normal cost rate (the cost of benefits for new hires) rose to 12.68 percent of pay. This now exceeds the 12.40 percent combined contribution rate from the State and employees. The System's actuary reports that the pension plan currently has a sufficient actuarial surplus to offset this 0.28 percent contribution shortfall. However, this surplus could be eliminated soon if future investment returns are unfavorable or other actuarial losses occur.

The Teacher Retirement System's actuary defines "actuarially sound" as follows:

A condition existing when the unfunded actuarial accrued liability can reasonably be expected to be funded or amortized over a determinable number of years. Such funding or amortization is accomplished as a result of the excess of total contributions over the normal cost of expected benefits.

The Teacher Retirement System is considered actuarially sound as long as the length of time required to fund the unfunded actuarially accrued liability does not exceed 31 years.

If the pension plan's actuarial assets fall below its actuarial liabilities (for example, if an unfunded actuarial accrued liability occurs) and contributions do not increase sufficiently, the plan would no longer meet the actuary's definition of an "actuarially sound" plan. In that scenario, future benefit improvements would be prohibited by statute.

Currently, there is no contribution excess. Without a contribution excess, an unfunded actuarial liability could not be amortized. Should such a liability develop, statute would prohibit the Legislature from providing further pension benefit improvements without increasing the contribution rate to provide an amortization period of less than 31 years.

Although the System experienced unusually low investment returns in fiscal year 2001 primarily because of market downturn, the System maintained its actuarially sound status. However, it should be noted that the pension plan's actuarial valuation has not yet incorporated all of the fiscal year's 10.6 percent investment loss. The actuary uses a five-year smoothing methodology to value actuarial assets. The actuarial asset value is compared to actuarial liabilities to determine the status of the plan's actuarial liability (unfunded versus fully funded). In the smoothing process, the actuary recognizes only 20 percent of each year's investment gains or losses in the year earned. The remaining 80 percent is deferred and recognized equally over the next four years. Although the System began the fiscal year with \$10.7 billion in net deferred gains, the pension plan ended the fiscal year with \$6.9 billion in net deferred investment losses.

Unless the System exceeds the 8 percent actuarial assumed rate of return on investments during the next few years, periodic recognition of the existing net deferred losses could significantly reduce or entirely eliminate the current funding surplus. The System's actuary reported that the pension plan would need to average a return of 13.2 percent in the next four fiscal years to achieve an 8 percent rate for the five-year period including fiscal year 2001. We cannot predict whether the System

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will meet or exceed its actuarial investment target during the next few years. However, if the current economic and investment trend continues, the Legislature might not be able to increase benefits to the pension plan in the future without increasing the contribution rate above normal cost.

Section 2:

Key Fiscal Year Statistical and Financial Information

Pension Plan

The pension plan membership increased by 3.9 percent to surpass one million members at August 31, 2001. Current members increased by 3.6 percent to 817,293, while retirement recipients increased by 5.3 percent to 188,882. Pension plan deductions, primarily consisting of benefit payments, increased by 8.5 percent to \$3.9 billion for the fiscal year. Partial lump sum benefit payments increased by 52.3 percent to \$281 million compared with fiscal year 2000, the first year this benefit option became available.

The plan's investments lost 10.6 percent for the fiscal year ending August 31, 2001, compared with a gain of 14.0 percent in the prior fiscal year. Average annual investment returns of 10.8 percent and 10.9 percent for the most recent five and ten fiscal years, respectively, exceeded the 8.0 percent actuarially assumed rate of return.

Retired Insurance Plan

The Retired Insurance Plan membership increased by 5.0 percent to 138,040 members in fiscal year 2001, while plan expenditures increased by 23.6 percent to \$409 million.

Financial Reporting

The System received the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting for each of the past 11 years.

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Objective, Scope, and Methodology

Our objective was to express an opinion on the Teacher Retirement System's (System) general purpose financial statements for the fiscal year ended August 31, 2001.

The scope of this audit included expressing an opinion on the System's general purpose financial statements in accordance with auditing standards generally accepted in the United States and *Government Auditing Standards*.

We gained an understanding of the System's overall control environment and internal controls to the extent necessary to plan the audit. We tested internal controls and significant accounts as deemed necessary to support our opinion.

Tests of accounts primarily included tests of details supporting transactions, confirmations of investments, and analytical review. In addition, we tested compliance with laws and regulations primarily related to investments, pension fund reserve account balances, and benefit payments. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated significant amounts.

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