An Audit Report on

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

May 2012
Report No. 12-030
Overall Conclusion

Through their incentive compensation plans for fiscal year 2011, the Teacher Retirement System (TRS), the Employees Retirement System (ERS), and the Permanent School Fund (PSF) of the Texas Education Agency made incentive compensation awards to employees in accordance with their policies and procedures.

Those three entities awarded a total of $9,022,838 in incentive compensation to 180 employees for fiscal year 2011. Those employees worked in each entity’s investment division.

Summary of Management’s Response

TRS, ERS, and the PSF agreed with the respective recommendations addressed to them in this report.

Summary of Information Technology Review

Auditors tested access controls over spreadsheets containing incentive compensation calculations. Additionally, at ERS, auditors tested access controls over the system that ERS used to track employee performance; ERS did not protect the data from unauthorized changes, but auditors did not find any evidence that unauthorized changes had been made to the data in that system (see Chapter 2 for additional details).

Summary of Objective, Scope, and Methodology

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

The scope of this audit covered incentive compensation plan years ending September 30, 2011, at TRS; August 31, 2011, at ERS; and July 31, 2011, at the PSF.

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. As noted above, auditors also tested access controls at the audited entities.
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Detailed Results

Chapter 1

TRS Calculated and Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The Teacher Retirement System (TRS) calculated and awarded incentive compensation for the year ended September 30, 2011, in accordance with its policies and procedures. TRS awarded a total of $6,144,354 in incentive compensation to 112 employees of its investment division. TRS awarded the most incentive compensation to the chief investment officer in the amount of $396,950 payable over a two-year period. The $396,950 represented 6 percent of the $6,144,354 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/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, 2011, TRS investments generated a positive return of 1.04 percent (104 basis points) when compared to the benchmark for all investments over the preceding three-year period and a negative return of 1.36 percent (136 basis points) when compared to the benchmark for all investments over the preceding one-year period. Because TRS’s incentive compensation plan weights the three-year return twice as much as the one-year return, 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 incentive compensation plan did not establish a performance target for the trade management group (one of six TRS profit centers) for the peer group performance component for the year ended September 30, 2011. TRS’s investment accounting unit requested and obtained approval from the TRS executive director to use 0.08 percent (or 8 basis points) as the performance target. The executive director’s decision was consistent with TRS’s incentive compensation plan, which states that the executive director (1) has the sole

1 As of February 1, 2012, TRS paid employees $3,072,177 of the $6,144,354 it awarded; $3,072,177 is due to be paid in 2013.
discretion to administer and interpret the incentive compensation plan and (2) may adopt such procedures and practices as deemed advisable to carry out the incentive compensation plan.

Recommendation

TRS should establish a performance target for its trade management group and update its incentive compensation plan to reflect that target.

Management's Response

TRS agrees with the recommendation to establish a performance target for the trade management group for inclusion in the incentive compensation plan.

Our incentive compensation plan is a collaborative effort between the Investment Management Division, Human Resources, Financial Services, and Legal Services. Once the plan is finalized, it will be presented to our Executive Committee and then to the Board of Trustees for approval.

TRS will ensure that the established performance target for the trade management group is clearly documented in the incentive compensation plan. Further, TRS will ensure that any new organizational units added to an incentive compensation plan in the future will have specific targets clearly documented within the plan.
Chapter 2
ERS Calculated and Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The Employees Retirement System (ERS) calculated and awarded incentive compensation for the year ended August 31, 2011, in accordance its policies and procedures. ERS awarded a total of $1,947,512 in incentive compensation to 42 employees of its investment division. ERS awarded the most incentive compensation to the deputy executive director of investments in the amount of $140,454 payable over a three-year period. The $140,454 represented 7 percent of the $1,947,512 in total incentive compensation that ERS awarded.

ERS’s annual rate of return on investments for fiscal year 2011 was 12.58 percent.

The ERS incentive compensation plan is based on a combination of investment performance and qualitative performance. The investment performance component compares investment performance to industry benchmarks. The qualitative performance component assesses items such as an employee’s development of hedge fund strategy(ies) and implementation of an emerging markets program. The incentive compensation plan specifies that employees will be evaluated on five-year performance goals and/or annual performance goals, depending on their specific positions within the investment division.

Because investment performance exceeded the benchmark for overall performance by 0.42 percent (42 basis points), this triggered the awarding of incentive compensation.

Auditors identified opportunities to strengthen ERS’s review of incentive compensation calculations and provided information on those opportunities to ERS; however, the weaknesses identified did not have a significant effect on the amount of incentive compensation ERS awarded.

ERS did not protect the data in one system it uses to track employee performance from unauthorized changes. Therefore, auditors could not verify the accuracy of the data in that system for this audit. ERS used the data in that system to support $271,533 (14 percent) of the $1,947,512 in incentive compensation it awarded. Auditors did not find any evidence that unauthorized changes had been made to that data.

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2 As of March 7, 2012, ERS paid employees $973,756 of the $1,947,512 it awarded; $474,262 is due to be paid in 2013, $474,262 is due to be paid in 2014, and $25,232 will not be paid because an employee resigned before that amount was due to be paid.
Recommendations

ERS should:

- Improve its review process to help ensure the accuracy of its incentive compensation calculations.
- Protect the data it uses to track employee performance from unauthorized changes.

Management's Response

- ERS management agrees the review process could be improved and will take further steps to ensure the accuracy of the incentive compensation calculations. The Human Resources Director will verify all participants’ start dates at the beginning of the plan year and again after the end of the plan year. Investments staff will use the Excel “formulas paste” option when supervisors’ spreadsheets are merged into the master spreadsheet so that calculations can be easily verified and will thoroughly review the spreadsheet for accuracy and compliance with the approved incentive compensation plan before it is submitted to Internal Audit for review. Internal Audit will clearly document the final assessment by highlighting all cells reviewed.

- ERS management agrees. The system noted is used by portfolio managers and analysts to monitor projected tracking error and performance for individual companies. On February 13, 2012, ERS implemented system controls to limit the ability to reassign covered securities among the analysts. Rights to make changes are now limited to two Investment Operations staff.
Chapter 3

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

The Permanent School Fund (PSF) of the Texas Education Agency calculated and awarded incentive compensation for the year ended July 31, 2011, in accordance with its policies and procedures. The PSF awarded a total of $930,972 to 26 employees.3 PSF awarded the most incentive compensation to the director of private market alternatives in the amount of $103,659 payable over a two-year period. The $103,659 represented 11 percent of the $930,972 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 0.41 percent (41 basis points) for the three-year period from August 1, 2008, to July 31, 2011.
- Exceeded the target benchmark by 0.79 percent (79 basis points) for the two-year period from August 1, 2009, to July 31, 2011.
- Exceeded the target benchmark by 0.51 percent (51 basis points) for the one-year period from August 1, 2010, to July 31, 2011.

Auditors identified opportunities to strengthen the PSF’s review of incentive compensation calculations and provided information on those opportunities to the PSF; however, the weaknesses identified did not have a significant effect on the amount of incentive compensation the PSF awarded.

Recommendation

The PSF should improve its review process to help ensure the accuracy of its incentive compensation calculations.

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3 As of November 1, 2011, the PSF paid employees $465,486 of the $930,972 it awarded; $465,486 is due to be paid in November 2012.
Management’s Response

Management is in agreement that the incentive compensation calculations should be reviewed by individuals external to the department who have expertise in the use of MS Excel spreadsheets. Management is also in agreement that implementing automated data loads, when appropriate, will reduce and/or eliminate typing and transference errors.
Appendix

Objective, Scope, and Methodology

Objective

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

Scope

The scope of this audit covered incentive compensation plan years ending September 30, 2011, at TRS; August 31, 2011, at ERS; and July 31, 2011, at the PSF.

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 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 and applicable systems that the audited entities used in calculating incentive compensation for authorized personnel.

Information collected and reviewed included the following:

- Policies and procedures for incentive compensation at TRS, ERS, and the PSF.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending September 30, 2011, at TRS; August 31, 2011, at ERS; and July 31, 2011, at the PSF.
- 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 ERS, TRS, and the PSF.
- Analyzed and recalculated incentive compensation payments for incentive compensation plan years ending September 30, 2011, at TRS; August 31, 2011, at ERS; and July 31, 2011, at the PSF.
- 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.
- Employees Retirement System of Texas Incentive Compensation Plan.
- Texas Permanent School Fund Performance Incentive Pay Plan.

Project Information

Audit fieldwork was conducted from January 2012 through March 2012. 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:

- Amadou N’gaide, MBA, CFE, CIDA (Project Manager)
- Adam Wright, CFE, CGAP, CIA (Assistant Project Manager)
- Monte McComb
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Angelica M. Ramirez, CPA (Audit Manager)
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