



An Audit Report on

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

September 2017

Report No. 18-001



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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 (PSF) of the Texas Education Agency, the General Land Office (GLO), the Employees Retirement System (ERS), and the Teacher Retirement System (TRS) calculated and paid incentive compensation in accordance with their policies and procedures for plan year 2016.

Plan year 2016 was the first year that TRS implemented its executive performance incentive pay plan.<sup>1</sup> TRS calculated and paid executive incentive compensation in accordance with its executive performance incentive pay plan. However, it should strengthen controls over its executive incentive compensation calculation and review process by (1) developing formal, detailed calculation and review procedures and (2) verifying all source documentation that it uses in its incentive compensation calculation.

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

### Incentive Compensation for Plan Year 2016

Through their incentive compensation plans for plan year 2016, the PSF, GLO, ERS, and TRS awarded a total of \$10,607,058 in incentive compensation to 263 employees. Specifically:

- The PSF awarded \$2,385,729 to 49 employees.
- GLO awarded \$289,691 to 4 employees.
- ERS awarded \$2,656,060 to 69 employees.
- TRS awarded \$5,275,578 to 141 employees.

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

<sup>1</sup> TRS's executive performance incentive pay plan is separate from the incentive compensation plan that TRS had already been administering prior to plan year 2016 and continues to administer.

Table 1 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.)

Table 1

| Summary of Chapters/Subchapters and Related Issue Ratings |   |                           |
|---|---|---------------------------|
| Chapter/<br>Subchapter                                    | Title   | Issue Rating <sup>a</sup> |
| 1   | The PSF Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures  | Low                       |
| 2   | GLO Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures  | Low                       |
| 3   | ERS Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures  | Low                       |
| 4-A   | TRS Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures  | Low                       |
| 4-B   | TRS Calculated and Paid Plan Year 2016 Executive Performance Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Strengthen Controls 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)/functions(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 TRS chapter in this report, auditors made recommendations to address the issues identified during this audit. TRS agreed with the recommendations in this report.

## Audit Objective and Scope

The objective of this audit was to determine whether the PSF, 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 August 31, 2016, at the PSF and ERS; June 30, 2016, at GLO; and September 30, 2016, and June 30, 2016, at TRS.

# Contents

## *Detailed Results*

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|   |   |
|---|---|
| Chapter 1   |   |
| The PSF Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures .....  | 1 |
| Chapter 2   |   |
| GLO Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures .....  | 3 |
| Chapter 3   |   |
| ERS Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures .....  | 5 |
| Chapter 4   |   |
| TRS Calculated and Paid Plan Year 2016 Incentive Compensation Awards in Accordance with Its Policies and Procedures, But It Should Strengthen Controls Over Its Executive Performance Incentive Pay Plan Calculation and Review Process ..... | 8 |

## *Appendices*

---

|   |           |
|---|-----------|
| Appendix 1  |           |
| Objective, Scope, and Methodology .....             | 12        |
| Appendix 2  |           |
| Issue Rating Classifications and Descriptions ..... | 16        |
| Appendix 3  |           |
| <b>Related State Auditor’s Office Work .....</b>    | <b>17</b> |

# Detailed Results

## Chapter 1

### The PSF Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures

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Chapter 1  
Rating:  
Low <sup>2</sup>

The Permanent School Fund (PSF) of the Texas Education Agency calculated and paid incentive compensation for its plan year ended August 31, 2016, in accordance with its policies and procedures.

The PSF awarded a total of \$2,385,729 in incentive compensation to 49 employees. The PSF awarded the most incentive compensation to its chief investment officer, who was awarded \$205,849 payable during a 3-year period. That \$205,849 represented 8.6 percent of the \$2,385,729 in total incentive compensation that the PSF awarded.

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

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

Gross-of-fees indicates that the effect of fees has not been reflected in a return; net-of-fees indicates that the effect of fees has been reflected in a return.

Sources: The PSF and the CFA Institute Web site at <http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1>.

The PSF calculates incentive compensation based on an employee's achievement of goals related to total fund performance and the performance of the employee's assigned asset classes. Except for the performance of certain asset classes that are measured since their inception using an internal rate of return calculation, fund and asset class performance are calculated on a three-year rolling average performance period. The PSF calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis (see text box for more information on gross-of-fees and net-of-fees).

The PSF awards incentive compensation if investment performance exceeds selected benchmarks. Total fund investment performance exceeded the target benchmark by 0.45 percent (45 basis points) for the three-year period from September 1, 2013, to August 31, 2016 (see text box for more information on basis points).

#### 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).

The PSF pays incentive compensation awards in installments over time. Specifically, for most employees, the PSF pays 50 percent of an incentive compensation award for the current plan year, 25 percent of that award in the next year, and 25 percent of that

award in the third year. As a result, payments to employees may consist of partial awards from three years.

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<sup>2</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.

Table 2 shows the positions eligible to earn incentive compensation in the PSF incentive compensation plan and the incentive compensation awards for each position for plan year 2016.

Table 2

| PSF Incentive Compensation Awards for Plan Year 2016         |   |
|--|---|
| Eligible Position  | Incentive Compensation Award or Award Range |
| Chief Investment Officer                                     | \$205,849                                   |
| Deputy Chief Investment Officer and Director of Fixed Income | \$150,214                                   |
| Director of Private Markets                                  | \$136,321                                   |
| Director of Equities   | \$138,366                                   |
| Director of Global Risk Control Strategies                   | \$115,680                                   |
| Deputy Executive Administrator                               | \$114,052                                   |
| Portfolio Manager I-IV / Risk Manager                        | \$19,688 to \$105,432                       |
| Investment Analyst I - IV / Risk Analyst                     | \$25,846 to \$47,034                        |
| Director of Investment Operations                            | \$53,003                                    |
| Director of Operational Due Diligence                        | \$47,920                                    |
| Director of Finance  | \$41,671                                    |
| Director of Legal and Compliance                             | \$46,876                                    |
| Financial Analyst I - IV                                     | \$4,383 to \$15,876                         |
| Accountant I - VII   | \$18,175                                    |
| Attorney I - VI  | \$18,400                                    |
| Director of Investment Technology                            | \$26,734                                    |
| Systems Analyst I - VII                                      | \$5,195 to \$9,027                          |
| Program Specialist I - VII                                   | \$4,855                                     |
| Staff Services Officer I - V                                 | \$2,122                                     |
| Executive Assistant I - III                                  | Position was vacant                         |

Source: The PSF.

## GLO Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures

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Chapter 2  
Rating:  
Low <sup>3</sup>

The General Land Office (GLO) calculated and paid incentive compensation for its plan year ended June 30, 2016, in accordance with its policies and procedures.

GLO awarded a total of \$289,691 in incentive compensation to 4 employees. GLO awarded the most incentive compensation to its director of PSF investments, who was awarded \$216,051 payable during a 2-year period. That \$216,051 represented 74.6 percent of the \$289,691 in total incentive compensation that GLO awarded.

The GLO incentive compensation plan compares investment performance of the total fund with a target benchmark on a one-year, three-year, and five-year 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) that is tied to employee job performance during the performance period.

GLO calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis (see text box for more information on gross-of-fees and net-of-fees). Investment portfolio performance exceeded the benchmark, and that triggered the awarding of incentive compensation. Total fund investment performance:

- Exceeded the target benchmark by 5.63 percent (563 basis points) for the five-year period from July 1, 2011, to June 30, 2016.
- Exceeded the target benchmark by 4.03 percent (403 basis points) for the three-year period from July 1, 2013, to June 30, 2016.
- Exceeded the target benchmark by 2.29 percent (229 basis points) for the one-year period from July 1, 2015, to June 30, 2016.

GLO pays incentive compensation awards in installments over time. Specifically, it pays 50 percent of an award on December 1 following the end

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

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

Gross-of-fees indicates that the effect of fees has not been reflected in a return; net-of-fees indicates that the effect of fees has been reflected in a return.

Sources: The GLO and the CFA Institute Web site at <http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1>.

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<sup>3</sup> Chapter 2 is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(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.

of the performance period, and it pays the remaining 50 percent on the anniversary of the first payment. As a result, payments to employees may consist of partial awards from two years.

Table 3 shows the positions eligible to earn incentive compensation in the GLO incentive compensation plan and the incentive compensation awards for each position for plan year 2016.

Table 3

| GLO Incentive Compensation Awards for Plan Year 2016 |   |
|--|---|
| Eligible Position                                    | Incentive Compensation Award                  |
| Director of PSF Investments                          | \$216,051                                     |
| Real Assets Portfolio Manager                        | \$59,683                                      |
| Senior Financial Analyst                             | Participant forfeited award due to retirement |
| Program Specialist                                   | \$11,377                                      |
| Investment Analyst                                   | \$2,580                                       |

Source: GLO.



*ERS Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures*

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Chapter 3  
Rating:  
Low <sup>4</sup>

The Employees Retirement System (ERS) calculated and paid incentive compensation for its plan year ended August 31, 2016, in accordance with its policies and procedures.

ERS awarded a total of \$2,656,060 in incentive compensation to 69 employees. ERS awarded the most incentive compensation to an asset class portfolio director, who was awarded \$149,511 payable during a 3-year period. That \$149,511 represented 5.6 percent of the \$2,656,060 in total incentive compensation that ERS awarded. Effective September 1, 2015, the members of the ERS board of trustees gave approval for the executive director (who was appointed on June 1, 2015) to participate in the incentive compensation plan for fiscal year 2016.

ERS awards incentive compensation based on a combination of quantitative (75 percent) and qualitative (25 percent) performance goals. It awards a quantitative performance component based on overall participant goals, with a minimum of 25 percent of overall participant goals to be evaluated based on relative trust fund performance. Of the 69 employees who received incentive compensation, 28 did not achieve any quantitative goals; therefore, their incentive compensation was based solely on the achievement of their qualitative goals.

In managing the trust fund, the Investments Division assigns individual investment professionals responsibility for managing subcategories of asset classes, individual portfolios, and individual research coverage. ERS uses a qualitative performance component in the areas of individual achievement, position-specific performance objectives, and ERS's strategic and operational goals.

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<sup>4</sup> Chapter 3 is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(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.

Gross-of-Fees and  
Net-of-Fees

ERS calculates total trust fund performance returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis. Gross-of-fees indicates that the effect of fees has not been reflected in a return; net-of-fees indicates that the effect of fees has been reflected in a return.

Sources: The ERS Incentive Compensation Plan for Key Investment Professionals and Leadership Employees and the CFA Institute Web site at <http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1>.

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. ERS calculates total trust fund performance returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis (see text box for more information on gross-of-fees and net-of-fees). If the one-year, three-year, or five-year investment performance exceed the target benchmarks, ERS takes that into account in each employee's overall participant goals component.

ERS did not outperform its target benchmarks for plan year 2016 for the one-year and three-year periods; however, it outperformed its target benchmark for the five-year period. In addition, participants received incentive compensation based on other quantitative goals related to subcategories of asset classes, individual portfolios, or individual research coverage, as well as qualitative goals. The total relative trust fund investment performance:

- Exceeded the target benchmark by 0.0005 percent (.05 basis points) for the five-year period from September 1, 2011, to August 31, 2016.
- Was less than the target benchmark by 0.18 percent (18 basis points) for the three-year period from September 1, 2013, to August 31, 2016.
- Was less than the target benchmark by 1.81 percent (181 basis points) for the one-year period from September 1, 2015, to August 31, 2016.

ERS pays incentive compensation awards in installments over time. Specifically, for most employees, ERS pays 50 percent of an incentive compensation award for the current plan year, 25 percent of that award in the next year, and 25 percent of that award in the third year. As a result, payments to employees may consist of partial awards from three years. ERS pays investment operations team members in 2 installments of 50 percent each, and investment administrative support team members in 1 installment.

Table 4 shows the positions eligible to earn incentive compensation in the ERS incentive compensation plan and the incentive compensation awards for each position for plan year 2016.

Table 4

| ERS Incentive Compensation Awards for Plan Year 2016   |   |
|--|---|
| Eligible Position                                      | Incentive Compensation Award or Award Range |
| Investment Analyst I - II                              | \$4,132 to \$21,093                         |
| Investment Analyst III - IV                            | \$10,540 to \$47,581                        |
| Portfolio Manager I - V                                | \$10,978 to \$70,226                        |
| Supervising Portfolio Manager                          | \$32,852 to \$107,259                       |
| Trader I - II  | \$20,991                                    |
| Chief Trader I - II                                    | \$39,259 to \$47,662                        |
| Asset Class Portfolio Managers/Directors               | \$45,330 to \$149,511                       |
| Risk Management and Applied Research Portfolio Manager | \$27,149                                    |
| Financial Analyst I-IV                                 | \$2,735 to \$5,231                          |
| Investment Administrative Support                      | \$233 to \$794                              |
| Director of Investment Services                        | \$32,735                                    |
| Chief of Staff   | Position was vacant                         |
| Deputy Chief Investment Officer                        | \$44,424                                    |
| Investments and Securities, Paralegal                  | Position was vacant                         |
| Investments and Securities, Attorney                   | \$65,817 to \$74,071                        |
| General Counsel and Chief Compliance Officer           | \$88,536                                    |
| Chief Investment Officer                               | \$90,645                                    |
| Executive Director                                     | \$89,636                                    |

Source: ERS.

### Management's Response

*ERS management agrees with the report and would like to thank the State Auditor's Office for its review. We appreciate the opportunity to work with SAO staff and value your expertise.*

*TRS Calculated and Paid Plan Year 2016 Incentive Compensation Awards in Accordance with Its Policies and Procedures, But It Should Strengthen Controls Over Its Executive Performance Incentive Pay Plan 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 2016. TRS also calculated and paid executive incentive compensation in accordance with its executive performance incentive pay plan. However, it should strengthen controls over its executive incentive compensation calculation and review process by (1) developing formal, detailed calculation and review procedures and (2) verifying all source documentation that it uses in its incentive compensation calculation.

Chapter 4-A

TRS Calculated and Paid Plan Year 2016 Incentive Compensation in Accordance with Its Policies and Procedures

Chapter 4-A  
Rating:  
Low <sup>5</sup>

TRS calculated and paid incentive compensation for its plan year ended September 30, 2016, in accordance with its policies and procedures.

TRS awarded a total of \$5,266,028 in incentive compensation to 140 employees (excluding \$9,550 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 its chief investment officer, who was awarded \$237,023 payable during a 2-year period. That \$237,023 represented 4.5 percent of the \$5,266,028 in total incentive compensation that TRS paid.

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 (50 percent) and the performance of peer groups (30 percent). The qualitative performance component (20 percent) assesses performance in a variety of areas such as candor, curiosity, accountability, teamwork and leadership, and constructive work environment.

The TRS incentive compensation plan measures investment performance for both benchmark and peer group categories on both a 1-year (33 percent)

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<sup>5</sup> Chapter 4-A is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(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.

and 3-year (67 percent) basis. If investment performance exceeds the benchmarks or the peer group performance, that triggers the awarding of incentive compensation. TRS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis (see text box for more information on gross-of-fees and net-of-fees). In addition, internal public markets portfolio and sector managers are measured by their respective assigned regions and sectors. The total fund investment performance:

Gross-of-Fees and  
Net-of-Fees

TRS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis. Gross-of-fees indicates that the effect of fees has not been reflected in a return; net-of-fees indicates that the effect of fees has been reflected in a return.

Sources: TRS and the CFA Institute Web site at <http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1>.

- Exceeded the benchmark by 0.22 percent (22 basis points) for the 3-year period from October 1, 2013, to September 30, 2016.
- Was less than the benchmark by 0.35 percent (35 basis points) for the 1-year period from October 1, 2015, to September 30, 2016.

TRS pays incentive compensation awards in installments over time. Specifically, it pays 50 percent of an award approximately on February 1 following the end of the performance period, and it pays the remaining 50 percent approximately on the anniversary of the first payment. As a result, payments to employees may consist of partial awards from two years.

Table 5 shows the positions eligible to earn incentive compensation in the TRS incentive compensation plan and the incentive compensation awards for each position for plan year 2016.

Table 5

| TRS Incentive Compensation Awards for Plan Year 2016 |   |
|--|---|
| Eligible Positions                                   | Incentive Compensation Award or Award Range |
| Chief Investment Officer                             | \$ 237,023                                  |
| Deputy Chief Investment Officer                      | \$153,501                                   |
| Senior Managing Director                             | \$86,159 to \$124,856                       |
| Managing Director                                    | \$91,811 to \$116,267                       |
| Senior Director                                      | \$50,250 to \$109,260                       |
| Director   | \$54,390 to \$83,751                        |
| Senior Investment Manager                            | \$34,416 to \$69,449                        |
| Investment Manager                                   | \$27,106 to \$50,345                        |
| Senior Associate                                     | \$2,653 to \$34,521                         |
| Associate  | \$918 to \$21,787                           |
| Senior Analyst                                       | \$6,636 to \$12,194                         |
| Analyst  | \$2,321 to \$7,279                          |

| TRS Incentive Compensation Awards for Plan Year 2016 |   |
|--|---|
| Eligible Positions                                   | Incentive Compensation Award or Award Range |
| Junior Analyst                                       | \$3,597                                     |
| Administrative Assistants                            | \$113 to \$1,052                            |

Source: TRS.

Chapter 4-B

TRS Calculated and Paid Plan Year 2016 Executive Performance Incentive Compensation in Accordance with Its Policies and Procedures, But It Should Strengthen Controls Over Its Calculation and Review Process

Chapter 4-B  
Rating:  
Low <sup>6</sup>

In November 2015, the TRS board of trustees approved the implementation of an executive performance incentive pay plan (separate from the incentive compensation plan discussed in Chapter 4-A) and approved the executive director to be a participant. Plan year 2016 (specifically, December 1, 2015, through June 30, 2016) was the first year that TRS implemented its executive performance incentive pay plan. The subsequent performance period began on July 1, 2016, and ended on June 30, 2017.

TRS calculated and paid executive incentive compensation for its plan year 2016 in accordance with its executive performance incentive pay plan. However, it did not have formal, detailed policies and procedures for the calculation and review process for its executive performance incentive pay plan that required TRS to document its calculation and review processes. In addition, TRS did not verify source documentation from a third party for one input into its incentive compensation calculation; however, auditors determined that the input TRS used in that calculation was accurate. Those issues increase the risk of making inaccurate award payouts due to undetected mistakes in the inputs, calculations, and review process.

The TRS board of trustees may add to or remove individual positions from participation in the executive performance incentive pay plan at any time. The TRS executive director was the only participant for the 2016 performance period. TRS awarded \$9,550 in incentive pay to its executive director. TRS pays executive incentive compensation in installments over time. Specifically, it pays 50 percent of an award on approximately October 1

<sup>6</sup> Chapter 4-B is rated Low because the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(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.

following the end of the performance period, and it pays the remaining 50 percent on approximately the anniversary of the first payment.

The TRS executive performance incentive pay plan is based on four main qualitative performance categories: member satisfaction (25 percent), leadership effectiveness (25 percent), operational effectiveness (25 percent), and employee satisfaction (25 percent). The executive performance incentive compensation calculation does not include a category for investment performance.

#### Recommendations

TRS should:

- Develop formal written policies and procedures for its executive performance incentive pay plan compensation calculation and review process.
- Verify all source documentation that it uses in its executive performance incentive compensation calculation.

#### Management's Response

*TRS agrees with both audit recommendations. Management has already taken steps to develop written policies and procedures for its executive performance incentive pay plan compensation calculation and review process, including controls surrounding verification of all source documentation used in the executive performance incentive compensation calculation. An initial draft of the Incentive Compensation Plan's calculation and review procedures have been completed and TRS expects to have a finalized document by December 31, 2017.*

# 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 (PSF) 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 their policies and procedures.

#### Scope

The scope of this audit covered incentive compensation plan years ending August 31, 2016, at the PSF and ERS; June 30, 2016, at GLO; and September 30, 2016, and June 30, 2016, 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 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 ERS and TRS incentive compensation plans. Auditors tested the entire population of incentive compensation awards for the PSF incentive compensation plan, 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, GLO, ERS, and TRS.
- TRS and ERS board of trustees meeting minutes.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending August 31, 2016, at the PSF and ERS; June 30, 2016, at GLO; and September 30, 2016, and June 30, 2016, 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, GLO, ERS, and TRS.
- Tested and recalculated incentive compensation awards for recipients of incentive compensation for incentive compensation plan years ending August 31, 2016, at the PSF and ERS; June 30, 2016, at GLO; and September 30, 2016, and June 30, 2016, 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:

- *Texas Education Agency Permanent School Fund Division Performance Incentive Pay Plan*, effective September 1, 2015.
- *General Land Office Performance Incentive Pay Plan*, effective July 1, 2015.
- *Employees Retirement System of Texas Incentive Compensation Plan for Key Investment Professionals and Leadership Employees*, effective September 1, 2015.
- *Teacher Retirement System of Texas Performance Incentive Pay Plan*, effective October 1, 2015.
- *Teacher Retirement System of Texas Executive Performance Incentive Pay Plan*, effective December 1, 2015.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 13, page III-33, and Rider 22, pages III-9 and III-10, General Appropriations Act (84th Legislature).
- Texas attorney general opinions related to incentive compensation.
- Teacher Retirement System of Texas Performance Incentive Calculation and Verification, revised April 23, 2015.
- Employees Retirement System of Texas Incentive Compensation Plan – Procedure Reference.
- Employees Retirement System of Texas Incentive Compensation Plan Calculations Finance Process.

#### Project Information

Audit fieldwork was conducted from March 2017 through August 2017. 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, CFE (Project Manager)
- Bianca F. Pineda, CGAP (Assistant Project Manager)
- Doug Stearns, CISA
- George D. Eure, CPA (Quality Control Reviewer)
- Michael Owen Clayton, CPA, CISA, CFE, CIDA (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)/functions(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. |
| Medium                   | 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(s) and reduce risks to a more desirable level.  |
| High                     | 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(s) and reduce risks to the audited entity.                               |
| Priority                 | 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(s) and reduce risks to the audited entity.                                |

## **Related State Auditor's Office Work**

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| <b>Related State Auditor's Office Work</b> |   |              |
|--|---|--------------|
| Number                                     | Product Name  | Release Date |
| 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 Dennis Bonnen, House Ways and Means Committee

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