An Audit Report on

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

June 2016

Report No. 16-030

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Overall Conclusion

The Permanent School Fund (PSF) of the Texas Education Agency and the General Land Office (GLO) calculated and paid incentive compensation awards in accordance with their policies and procedures for plan year 2015. GLO should strengthen controls over its incentive compensation plan by formally approving that plan prior to the start of the plan performance period. GLO also should retain documentation of management's review of plan calculations in accordance with its policies and procedures.

The Employees Retirement System (ERS) generally awarded and paid incentive compensation in accordance with its policies and procedures for plan year 2015. However, ERS overpaid an employee $176.77 because it did not calculate that employee's award in accordance with its policies and procedures. Additionally, ERS should strengthen controls over its incentive compensation calculation and review process by developing formal calculation and review procedures. The ERS executive director, who was appointed on June 1, 2015, did not receive any incentive compensation for the 2015 performance period.

Incentive Compensation for Plan Year 2015

The PSF, GLO, ERS, and TRS awarded a total of $15,311,127 in incentive compensation to 253 employees through their incentive compensation plans for plan year 2015. Specifically:

- The PSF awarded $1,639,513 to 47 employees.
- GLO awarded $299,655 to 5 employees.
- ERS awarded $4,764,067 to 63 employees.
- TRS awarded $8,607,892 to 138 employees.

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

The Teacher Retirement System (TRS) generally awarded and paid incentive compensation in accordance with its policies and procedures for plan year 2015. However, TRS overpaid a total of $2,236.00 to 9 employees because it input incorrect information into its calculation. TRS should strengthen controls over its incentive compensation calculation and review processes to prevent and detect errors and ensure that it records all incentive compensation payments correctly in its general ledger.

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

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Michael Clayton, Audit Manager, or Lisa Collier, First Assistant State Auditor, at (512) 936-9500.

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 and Related Issue Ratings		
Chapter	**Title**	**Issue Rating** [a]
1	The PSF Calculated and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures	Low
2	GLO Calculated and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures	Low
3	ERS Generally Awarded and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures	Low
4	TRS Generally Awarded and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures	Low

[a] A chapter 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 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 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 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 Chapters 2 through 4 in this report, auditors made recommendations to address the issues identified during this audit at GLO, ERS, and TRS; those agencies agreed with their respective recommendations.

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, 2015, at the PSF and ERS; June 30, 2015, at GLO; and September 30, 2015, at TRS.

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Detailed Results

Chapter 1

The PSF Calculated and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures

Chapter 1 Rating:

Low [1]

The Permanent School Fund (PSF) of the Texas Education Agency calculated and paid incentive compensation for its plan year ended August 31, 2015, in accordance with its policies and procedures. The commissioner of education formally approved the PSF incentive compensation plan before the beginning of the plan performance start date.

The PSF awarded a total of $1,639,513 in incentive compensation to 47 employees. The PSF awarded the most incentive compensation to its chief investment officer, who was awarded $143,551 payable during a three-year period. That $143,551 represented 9 percent of the $1,639,513 in total incentive compensation that the PSF awarded.

Gross of Fees and Net of Fees

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.

Source: CFA Institute Web site at http://www.cfapubs.org/doi/full/10.2469/ipmn.v2011.n1.1

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.

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). PSF awards incentive compensation if investment performance exceeds benchmarks. Total fund investment performance exceeded the target benchmark by 0.28 percent (28 basis points) for the three-year period from September 1, 2012, to August 31, 2015 (see text box for more information on basis points).

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

[1] Chapter 1 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.

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

Table 2 shows the positions eligible to earn incentive compensation in the PSF plan and the incentive compensation payment awards for each position for plan year 2015.

Table 2

PSF Incentive Compensation Awards for Plan Year 2015

Eligible Position	Incentive Compensation Award or Award Range
Chief Investment Officer	$143,551
Deputy Chief Investment Officer and Director of Fixed Income	$105,837
Deputy Executive Administrator	$80,551
Director of Equities	$110,851
Director of Global Risk Control Strategies	$94,897
Director of Private Markets	$106,295
Portfolio Manager I - IV	$27,922 to $80,777
Risk Manager	$27,165
Investment Analyst I - IV	$14,240 to $41,612
Risk Analyst	$6,421
Director of Finance	$25,366
Director of Investment Operations	$32,264
Director of Legal and Compliance	$25,859
Director of Operational Due Diligence	$19,422
Accountant I - VII	$10,564
Attorney I - VI	$7,914
Director of Investment Technology	$14,450
Financial Analyst I - IV	$1,873 to $9,382
Program Specialist I - VII	$1,125 to $4,276
Systems Analyst I - VI	$3,162 to $5,153
Executive Assistant I - III	Position was vacant
Staff Services Officer I - V	$651

Source: The PSF.

GLO Calculated and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures

Chapter 2 Rating:

Low [2]

The General Land Office (GLO) calculated and paid incentive compensation for its plan year ended June 30, 2015, in accordance with its policies and procedures. However:

- The land commissioner and the chief clerk did not formally approve the incentive compensation plan until July 9, 2014, which was after the performance period began. Obtaining formal approval of the incentive compensation plan prior to the beginning of the performance period could help ensure that the plan aligns with the intent of executive management.

- GLO did not retain documentation of one manager’s review and approval of the incentive award calculation spreadsheet in accordance with its policies and procedures. Management review provides additional assurance that the incentive awards are calculated and paid in accordance with plan policies and procedures.

GLO awarded a total of $299,655 in incentive compensation to 5 employees. GLO awarded the most incentive compensation to its chief investment officer, who was awarded $211,815 payable during a two-year period. That $211,815 represented 71 percent of the $299,655 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 goals in investment performance (60 percent) and a qualitative 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. GLO awards incentive compensation for exceeding one-year, three-year, or five-year investment performance benchmarks. If the one-year total fund return is negative but outperforms the benchmark, the payment of incentive compensation awarded for the current performance period is deferred and payable on December 1 of the following year, regardless of performance results. Total fund investment performance:

[2] 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.

- Exceeded the target benchmark by 5.99 percent (599 basis points) for the five-year period from July 1, 2010, to June 30, 2015.

- Exceeded the target benchmark by 4.63 percent (463 basis points) for the three-year period from July 1, 2012, to June 30, 2015.

- Exceeded the target benchmark by 2.37 percent (237 basis points) for the one-year period from July 1, 2014, to June 30, 2015.

GLO pays incentive compensation awards in installments over time. Specifically, it pays 50 percent of the award on December 1 following the end 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 plan and the incentive compensation payment awards for each position for plan year 2015.

Table 3

GLO Incentive Compensation Awards for Plan Year 2015	
Eligible Position	Incentive Compensation Award or Award Range
Deputy Commissioner of Funds Management	$211,815
Real Assets Portfolio Manager	$56,040
Senior Financial Analyst	$645 to $20,002
Program Specialist	$11,153

[a] GLO changed the Deputy Commissioner of Funds Management title to Chief Investment Officer after the adoption of the plan

Source: GLO.

Recommendations

GLO should:

- Formally approve the incentive compensation plan prior to the start of the plan performance period.

- Retain documentation of management's review of plan calculations in accordance with its policies and procedures.

Management's Response

Recommendation: Formally approve the incentive compensation plan prior to the start of the plan performance period.

Management's Response: We agree with the finding. The FY2016 plan was approved prior to the start of the plan performance period.

Recommendation: Retain documentation of management's review of plan calculations in accordance with its policies and procedures.

Management's Response: We agree with the finding. The documentation will be retained per the policies and procedures.

Title of Responsible Person: Director of Budget and Planning

Chapter 3

ERS Generally Awarded and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures

Chapter 3 Rating:

Low [3]

The Employees Retirement System (ERS) generally calculated and paid incentive compensation for its plan year ended August 31, 2015, in accordance with its policies and procedures. However:

- ERS incorrectly calculated the proration for one employee, which resulted in an overpayment of $176.77. For incentive calculations, ERS employee promotions are prorated effective as of the date of the promotion. The overpayment occurred because ERS used the wrong promotion date for the proration calculation, and subsequent reviews did not identify the error.
- ERS does not have written policies and procedures regarding the incentive compensation calculation and review process. That increases the risk of inaccurate award payouts due to mistakes in the calculation and review process.

ERS awarded a total of $4,764,067 in incentive compensation to 63 employees. ERS awarded the most incentive compensation to its chief investment officer, who was awarded $382,777 payable over a three-year period. That $382,777 represented 8 percent of the $4,764,067 in total incentive compensation that ERS awarded. The ERS executive director, who was appointed on June 1, 2015, did not receive any incentive compensation for the 2015 performance period.

ERS awards incentive compensation based on a combination of investment performance and qualitative performance. All investment performance goals are measured against benchmarks, except for securities lending, which requires fixed income staff to have positive earnings for one-year and three-year periods to earn incentive compensation. The qualitative performance component assesses if ERS employees exceeded the applicable job performance standards. The ERS incentive compensation plan allows the ERS executive director to exercise discretion in plan-related matters. The following is an excerpt of plan section 7.1.

[3] 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.

> 7.1 The Plan shall be administered by the Board, as it relates to participation of the Executive Director, and by the Executive Director, as it relates to participation of other ERS employees, in accordance with the terms hereof, as amended from time to time. In administering the Plan, the Board or Executive Director, with input from ERS senior management, shall have discretionary authority to interpret the Plan document and to administer the Plan in accordance with its terms.

For plan year 2015, the executive director used his discretion to reduce the qualitative performance assessments for all but one employee that participated in the plan.

ERS calculates the investment performance component of incentive compensation based on total trust fund performance and individual assigned goals. ERS awards incentive compensation for exceeding one-year, three-year, or five-year investment performance benchmarks, depending on an employee’s length of service. ERS employees earn awards if the fund performance is negative for the year but exceeds the benchmark performance; however, award payment is deferred until the next plan year in which the one-year total trust performance is positive. ERS calculates total trust fund performance returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis. The total fund investment performance:

- Exceeded the target benchmark by 0.38 percent (38 basis points) for the five-year period from September 1, 2010, to August 31, 2015.
- Exceeded the target benchmark by 0.49 percent (49 basis points) for the three-year period from September 1, 2012, to August 31, 2015.
- Exceeded the target benchmark by 1.32 percent (132 basis points) for the one-year period from September 1, 2014, to August 31, 2015.

In conducting the audit at ERS, State Auditor’s Office auditors relied on ERS internal audit report number 2016-01, *Incentive Compensation Plan*, released on December 7, 2015. The State Auditor’s Office conducted procedures to confirm that the ERS internal audit department was qualified and that the internal audit work on which the State Auditor’s Office relied was sufficient.

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 two installments of 50 percent each, as directed by the previous executive director.

Table 4 shows the positions eligible to earn incentive compensation in the ERS plan and the incentive compensation payment awards for each position for plan year 2015.

Table 4

ERS Incentive Compensation Awards for Plan Year 2015	
Eligible Position	**Incentive Compensation Award or Award Range**
Investment Analyst I – II	$2,193 to $17,564
Investment Analyst III – IV	$2,948 to $60,783
Portfolio Manager I – V	$14,083 to $199,435
Supervising Portfolio Manager	$111,390 to $122,224
Trader I – II	$40,660
Chief Trader I – II	$82,169 to $107,665
Asset Class Portfolio Managers/Directors	$134,650 to $202,005
Risk Management and Applied Research	$121,133
Financial Analyst I-IV	$1,781 to $23,998
Investment Administrative Support	Opted out of incentive compensation for plan year 2015
Director of Investment Services	$130,044
Chief of Staff	Position was vacant
Deputy Chief Investment Officer	$172,010
Investments and Securities, Paralegal	Position was vacant
Investments and Securities, Attorney	$73,552 to $102,479
General Counsel and Chief Compliance Officer	$127,598
Chief Investment Officer	$382,777
Executive Director	Did not receive incentive compensation for plan year 2015

Source: ERS.

Recommendations

ERS should:

- Strengthen its payment review process to ensure that it identifies calculation errors.

- Develop written policies and procedures for its incentive compensation calculation and review process.

Management's Response

ERS management agrees with both recommendations. An initial draft of the Incentive Compensation Plan's process procedures has been completed. ERS staff will continue the review and improvement process of the plan procedures and expect to have a finalized document by August 31, 2016. The Director of Human Resources is the responsible staff for implementation.

Chapter 4

TRS Generally Awarded and Paid Plan Year 2015 Incentive Compensation in Accordance with Its Policies and Procedures

Chapter 4 Rating:

Low [4]

The Teacher Retirement System (TRS) generally calculated and paid incentive compensation for its plan year ended September 30, 2015, in accordance with its policies and procedures. However, TRS overpaid a total of $2,236 to 9 employees because it input incorrect information into its calculation. Specifically, to calculate the performance of one portfolio, TRS used a performance target that differed from the performance target documented in its incentive compensation plan. That overstated the performance of the employees assigned to that portfolio and resulted in the overpayments. TRS did not detect the error during its reviews.

TRS awarded a total of $8,607,892 in incentive compensation to 138 employees. TRS awarded the most incentive compensation to its chief investment officer, who was awarded $329,708 payable over a 2-year period. That $329,708 represented 4 percent of the $8,607,892 in total incentive compensation that TRS awarded.

Auditors relied on the work of the TRS internal audit department as part of this audit. Specifically, auditors reviewed the TRS internal audit report *Quarterly Investment Testing of compliance with the requirements of the Investment Policy Statement (IPS), Securities Lending Policy (SLP), Employee Ethics Policy, Code of Ethics for Contractors, Performance Incentive Pay Plan, and Procedures for Wire Transfers for the Quarter ended September 30, 2015*, released on November 10, 2015. The State Auditor's Office conducted procedures to confirm that the TRS internal audit department was qualified and that the internal audit work on which the State Auditor's Office relied was sufficient.

TRS changed one incentive compensation award amount for plan year 2014. (TRS made that change after the State Auditor's Office had audited incentive compensation for plan year 2014.). That change resulted in TRS paying an additional $22,453 to one employee, and TRS incorrectly recorded $5,613 of that amount as a one-time merit payment (rather than incentive compensation) in its general ledger. TRS paid the additional compensation to an employee who retired during the 2015 plan performance period.

The employee who received the award discussed above was the only individual affected by a change that TRS made to its incentive compensation

[4] Chapter 4 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.

plan prior to the start of the 2015 plan performance period. That change allowed qualified employees who retire to receive incentive compensation that they have earned but that has not been paid by their retirement date. As discussed above, TRS paid $5,613 to the employee as a one-time merit payment in February 2015, and it paid the remaining $16,840 in February 2016 as incentive compensation.

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 interpersonal relationship skills, accountability, and effective teamwork.

The TRS incentive compensation plan measures investment performance of the total fund and of an employee's individual assigned asset classes on both a one-year (33 percent) and three-year (67 percent) basis. If investment performance exceeds the benchmarks or the performance of other large public funds, 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. TRS employees may earn incentive compensation in years in which the total fund return is negative if that return exceeds the benchmark return. However, TRS defers the payment of those awards until the total fund has a positive return in a subsequent year. The total fund investment performance:

- Exceeded the benchmark by 62 basis points for the three-year period from October 1, 2012, to September 30, 2015.
- Exceeded the benchmark by 46 basis points for the one-year period from October 1, 2014, to September 30, 2015.

TRS pays incentive compensation awards in installments over time. Specifically, it pays 50 percent of an award on February 1 following the end 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 5 shows the positions eligible to earn incentive compensation in the TRS plan and the incentive compensation payment awards for each position for plan year 2015.

Table 5

TRS Incentive Compensation Awards for Plan Year 2015	
Eligible Positions	Incentive Compensation Award or Award Range
Chief Investment Officer	$329,708
Deputy Chief Investment Officer	$210,174
Senior Managing Director	$164,655 to $256,806
Managing Director	$159,109 to $160,669
Senior Director	$120,405 to $176,000
Director	$45,740 to $151,319
Senior Investment Manager	$64,545 to $122,763
Investment Manager	$14,750 to $89,850
Senior Associate	$31,159 to $51,807
Associate	$3,119 to $36,721
Senior Analyst	$4,029 to $20,775
Analyst	$1,460 to $10,978
Junior Analyst	Position was vacant
Administrative Assistants	$1,067 to $1,891

Source: TRS.

Recommendations

TRS should:

- Strengthen controls over the incentive compensation calculation and review processes to prevent and detect calculation input errors.
- Record all incentive compensation payments correctly in its general ledger.

Management's Response

TRS is in agreement with the findings of the State Auditor's Office. We are constantly striving to improve processes, procedures, and internal controls related to incentive compensation payments. In fact, the changes made in plan year 2015 were the most comprehensive undertaken by the agency to date and provided additional checks and balances that had not been in place before. However, there are still several manual spreadsheet processes being used that increase the potential for human error. To that end, TRS is currently *seeking a technology solution that will minimize manual processes and we expect to have the necessary software implemented this year so that it can be used to calculate the results of the 2016 incentive compensation plan year.*

Title of Responsible Person: Chief Financial Officer

Appendices

Appendix 1

Objective, Scope, and Methodology

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, 2015, at the PSF and ERS; June 30, 2015, at GLO; and September 30, 2015, at TRS.

Methodology

The audit methodology included collecting information and documentation from the audited agencies; 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 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 matched amounts calculated for each recipient.

Auditors reviewed calculations, personnel files, payroll data, and externally reported 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.

Auditors tested access controls for key calculation data inputs and conducted procedures to determine whether auditors could rely on the work that ERS and TRS internal auditors conducted.

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 reviewing access to the data. Auditors verified the completeness of the incentive compensation award data by comparing information in the incentive compensation award calculation spreadsheets the audited agencies used to the data in Uniform Statewide Payroll/Personnel System. Auditors determined that the incentive compensation award data was sufficiently reliable for the purposes of this audit.

Auditors also determined that the investment performance data obtained from custodians was sufficiently reliable for the purposes of this audit.

Sampling Methodology

Auditors selected samples of incentive compensation awards for testing using professional judgment at the PSF, ERS, and TRS. Auditors tested the entire population of incentive compensation awards at GLO.

<u>Information collected and reviewed</u> included the following:

- Incentive compensation plan documentation at the PSF, GLO, ERS, and TRS.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending August 31, 2015, at the PSF and ERS; June 30, 2015, at GLO; and September 30, 2015, at TRS.
- Incentive compensation recipients' personnel files.
- Payroll data related to incentive compensation recipients.
- Investment performance reports from custodian banks.
- Agency internal audit documents.

<u>Procedures and tests conducted</u> 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, 2015, at the PSF and ERS; June 30, 2015, at GLO; and September 30, 2015 at TRS.

- Verified that incentive compensation award payments matched award calculations.
- Reviewed and tested compliance with the audited agencies' policies and procedures.
- Reviewed ERS and TRS internal auditors' education, professional certification, and continuing education to determine whether they complied with *Government Auditing Standards,* Sections 6.40 and 6.41.
- Examined, on a test basis, ERS and TRS internal auditors' work to determine whether it could be used as audit evidence.

<u>Criteria used</u> included the following:

- *Texas Education Agency Permanent School Fund Division Performance Incentive Pay Plan*, effective September 1, 2014.
- *General Land Office Performance Incentive Pay Plan*, effective July 1, 2014.
- *Employees Retirement System of Texas Incentive Compensation Plan for Key Investment Professionals and Leadership Employees*, effective September 1, 2014.
- *Teacher Retirement System of Texas Performance Incentive Pay Plan*, effective October 1, 2014.
- TRS and ERS board of trustees meeting minutes.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 13, page III-34, and Rider 22, pages III-9 and III-10, General Appropriations Act (83rd Legislature).
- Texas attorney general opinions related to incentive compensation.
- *Government Auditing Standards*, 2011 Revision, Section 6.41.
- *Teacher Retirement System of Texas Performance Incentive Calculation and Verification* procedures document, revised April 23, 2015.

Project Information

Audit fieldwork was conducted from February 2016 through April 2016. 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:

- Benjamin Nathanial Keyfitz, CPA (Project Manager)
- Yue Zhang, MPA (Assistant Project Manager)
- Doug Stearns
- Dennis Ray Bushnell, 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(s).

In determining the ratings of audit findings, auditors considered factors such as financial impact; potential failure to meet program/function objectives; violation of 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.

Appendix 3

Related State Auditor's Office Work

Related State Auditor's Office Work		
Number	**Product Name**	**Release Date**
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

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Dan Patrick, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Jane Nelson, Senate Finance Committee
The Honorable Robert Nichols, Member, Texas Senate
The Honorable John Otto, House Appropriations Committee
The Honorable Dennis Bonnen, House Ways and Means Committee

Office of the Governor

The Honorable Greg Abbott, Governor

Employees Retirement System

Members of the Employees Retirement System Board of Trustees
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