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**An Audit of the Financial Statements of
the Teacher Retirement System of Texas for
the Fiscal Year Ended August 31, 1998**

December 9, 1998

Members of the Legislative Audit Committee:

The Teacher Retirement System of Texas' (System) fiscal year 1998 financial statements covered by our audit opinion dated November 18, 1998, are materially correct in accordance with generally accepted accounting principles. In addition, during fiscal year 1998 and as of August 31, 1998:

- Pension trust fund net assets increased by \$4.3 billion to \$66.5 billion.
- The System's pension plan became fully funded. The plan's actuarial assets exceed its actuarial liabilities by \$2.46 billion. As a result, the plan presently has enough assets to pay benefits to retirees and to current active members when they retire.
- Expenditures of the group insurance plans for active and retired participants exceeded revenues by \$32 million. The ending fund balance for the combined plans was \$194 million. System management estimates the retiree insurance plan has sufficient funding to continue operating through fiscal year 2000. Continuation of the retiree insurance plan will require legislative action to address long-term funding needs.

Portfolio and Accounting Management for Securities System (PAM)

The System achieved an important goal in fiscal year 1998 by implementing Portfolio and Accounting Management for Securities System (PAM), a new investment accounting software package. PAM tracks approximately \$65 billion in investments. Before PAM, the System had to use multiple investment accounting systems to track these assets. PAM can more effectively anticipate what the System's investments will earn, and it can more accurately calculate the historical cost of stocks. PAM provides improved multi-currency capabilities for handling international investments. A subsequent software release, not yet implemented, includes enhancements to handle the Euro (the common currency to be introduced on January 1, 1999, by the European Economic and Monetary Union).

The System used an appropriate process to evaluate software alternatives and, upon selecting PAM, implemented it for less than the budgeted amount. The System successfully converted data from its old systems to PAM. As of November 18, 1998, the System had adequate ongoing processes in place to ensure that market prices in PAM were materially correct and that PAM was protected from fire, water damage, and unauthorized use.

PAM was not Year 2000 compliant at the time of our audit, but the System was testing the vendor's subsequent software release, certified to be Year 2000 compliant. Because PAM is a third-party software package, the System must rely on the vendor to provide a Year 2000 compliant version.

An Internal Audit report dated May 14, 1998, identified deficiencies in controls over access to PAM. Subsequent to that date we noted that the System had substantially improved these controls.

SAO Report No. 99-018

Internal Controls and Compliance

We reported no weaknesses in the System's internal controls or noncompliance with laws and regulations that would significantly affect the financial statements. However, we tested controls and compliance to support our opinion on the financial statements, not to provide an opinion on controls and compliance. Accordingly, we do not express such an opinion.

We have provided to the System the following two reports required by *Government Auditing Standards*: (1) *Auditor's Report on Internal Controls* and (2) *Auditor's Report on Compliance with Laws and Regulations Material to the General Purpose Financial Statements*.

Status of Previous Audit Recommendations

The System resolved the two previous audit recommendations:

- The System improved controls over the accuracy of member data used by the Actuary. Formerly the System performed intermediate processing on this data before it was sent to the Actuary. Now, this function has been transferred entirely to the Actuary, who fully processes active and retired member data used in the actuarial valuation.
- The System's implementation of PAM improved its ability to accurately anticipate dividend income for international stocks.

We would like to thank the management and staff of the Teacher Retirement System for their cooperation during this audit. If you have any questions, please contact Carol A. Smith, Audit Manager, at 479-4700.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Objectives, Scope, and Methodology

Our objectives were to express an opinion on the System's financial statements for the fiscal year ended August 31, 1998, and to review selected controls over the PAM investment management software.

The scope of this audit included expressing an opinion on the System's financial statements and complying with applicable generally accepted auditing standards and *Government Auditing Standards*. With the implementation of PAM, we expanded our scope to evaluate in more detail selected controls over the conversion to and daily operations of the PAM system.

We gained an understanding of the System's overall control environment and controls to the extent necessary to plan the audit. We tested controls and material accounts as deemed necessary to support our opinion. Tests of accounts primarily included tests of details supporting entries, confirmations, and analytical review. In addition, we tested compliance with laws and regulations, primarily related to investments, pension fund reserve account balances, and benefit payments, that may have a material effect on the System's financial statements. We also conducted interviews, administered questionnaires, reviewed documents, and recalculated amounts related to the acquisition and operation of PAM.

cc: Board Members of the Teacher Retirement System of Texas
Mr. Charles L. Dunlap, Executive Director, Teacher Retirement System
Mr. David MacCabe, Internal Audit Director, Teacher Retirement System
Mr. Ronnie Jung, Chief Financial Officer, Teacher Retirement System