Report 16-10
December 2016

Wisconsin Retirement System
Calendar Year 2015

State of Wisconsin

Legislative Audit Bureau

Report 16-10
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Wisconsin Retirement System
Calendar Year 2015

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Response

From the Department of Employee Trust Funds

OPINION PUBLISHED SEPARATELY

The WRS financial statements and our opinion on them are available on the Department of Employee Trust Funds' website

STATE OF WISCONSIN
Legislative Audit Bureau

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Joe Chrisman
State Auditor

December 2, 2016

Senator Robert Cowles and
Representative Samantha Kerkman, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Cowles and Representative Kerkman:

As required by s. 13.94 (1) (dd), Wis. Stats., we have completed an audit of the 2015 financial statements of the Wisconsin Retirement System (WRS), which is administered by the Department of Employee Trust Funds (ETF). These financial statements and our unmodified opinion on them may be found on ETF's website. The WRS fiduciary net position, which represents resources available to pay pension benefits, decreased from $92.2 billion as of December 31, 2014, to $88.5 billion as of December 31, 2015, or by 4.0 percent. This decline is primarily attributable to the decline in net investment income from $4.9 billion in 2014 to a loss of $675.0 million in 2015, or by 113.8 percent.

Accounting standards for pension funds, issued by the Governmental Accounting Standards Board, require the calculation of a net pension liability or net pension asset, which is represented by the difference between fiduciary net position reported in the financial statements and the total pension liability calculated by the actuary. ETF calculated a net pension liability for the WRS of $1.6 billion as of December 31, 2015. This is a $4.1 billion decrease from the net pension asset of $2.5 billion, calculated as of December 31, 2014.

Each of the almost 1,500 participating employer in the WRS is required to report its proportionate share of this net pension liability on its financial statements if prepared on the basis of generally accepted accounting principles. We have also audited the Schedule of Employer Allocations of the WRS, the Schedule of Pension Amounts by Employer of the WRS, and the related notes, as of December 31, 2015, and provide our unmodified opinion as described in report 16-11, which we also published today.

Although we noted some improvements in ETF's financial reporting process, we again identified errors made by ETF and, therefore, we again report a significant deficiency in ETF's internal controls over financial reporting. In addition, we identified a significant deficiency in the Department of Administration's (DOA's) centralized cash reconciliations, which are relied upon by ETF. Both significant deficiencies are reported in the Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is on page 25.

This report was completed later than anticipated due to delays in ETF's financial statement preparation, which was affected by the State's implementation of a new enterprise resource planning (ERP) system. The significant deficiency in DOA's centralized cash reconciliations caused additional delays.

Respectfully submitted,

Joe Chrisman
State Auditor

JC/CS/ss

Introduction ■

The WRS is a cost-sharing, multiple-employer, defined-benefit pension plan.

Created in January 1982, the Wisconsin Retirement System (WRS) is a cost-sharing, multiple-employer, defined-benefit pension plan that provides post-retirement financial benefits to participating employees, as well as disability and death benefits to participants and their beneficiaries.

Approximately 613,900 individuals participated in the WRS on December 31, 2015, including:

- 256,100 (41.7 percent) active participants who were making contributions;
- 191,800 (31.2 percent) retired participants who were receiving WRS benefits; and
- 166,000 (27.1 percent) inactive participants, such as former employees, who were not yet receiving benefits and who were not required to make contributions.

ETF and SWIB work together to manage the WRS.

The WRS is the ninth-largest public pension plan in the United States. As of December 31, 2015, the WRS had a fiduciary net position of $88.5 billion, which represents resources available to pay pension benefits. ETF is responsible for managing the operations of the WRS that interact with employers and participants, including collecting contributions from and paying retirement benefits to WRS participants, and the State of Wisconsin Investment Board (SWIB) is responsible for managing WRS investments. ETF and SWIB work closely together to ensure the solvency and long-term future of the WRS.

Organizational Structure

ETF was created to manage employee benefit programs for participating state and local government employees, including managing the WRS. Under s. 40.03, Wis. Stats., the 13-member ETF Board is responsible for the overall direction and supervision of ETF. Statutes specifically identify that, among other items, this Board is responsible for:

- appointing the Secretary of ETF;
- selecting and retaining an actuary to perform all necessary actuarial services for benefit programs administered by ETF; and
- approving the contribution rates and actuarial assumptions determined by the actuary.

Although the ETF Board is the overall governing body for ETF, the 13-member Teachers Retirement Board and the 9-member Wisconsin Retirement Board each serve in an advisory role on issues related to the WRS.

The ETF Board members include:

- the Governor, or the Governor's designee on the Group Insurance Board;
- the Administrator of the Division of Personnel Management in DOA, or designee;
- four members of the Teachers Retirement Board;
- four members of the Wisconsin Retirement Board;
- one member nominated by the Governor and appointed with the advice and consent of the Senate, as a public representative, who is not a member of the WRS but has at least five years of actuarial, insurance, or employee benefits plan experience;
- one annuitant elected by retired WRS participants; and
- one active WRS participant that must be either a technical college or school district educational support personnel employee, elected by participating employees who meet the same employment criteria.

The members of the Teachers Retirement Board and the Wisconsin Retirement Board represent a mix of state and local government employers and employees, annuitants, and the general public. The Secretary of ETF is charged with implementing the policies approved by the Board, and with managing the daily operations of ETF, including managing the WRS.

WRS Participating Employers

Section 40.21 (1), Wis. Stats., allows any Wisconsin public employer to participate in the WRS, but statutes require certain entities to participate, including state agencies and all counties except Milwaukee County, which maintains its own retirement system. In addition:

- second-, third-, and fourth-class cities must allow police officers and paid firefighters to participate if those employees were allowed to participate in Wisconsin's retirement system before March 31, 1978;

- villages with a population of 5,000 or more must allow police officers to participate and villages with a population of 5,500 or more must also allow paid firefighters to participate, if those employees were allowed to participate in Wisconsin's retirement system before March 31, 1978; and

- school districts must allow employees in teaching positions to participate.

There were 1,487 employers participating in the WRS as of December 31, 2015.

Table 1 shows the number and type of public employers that participated in the WRS as of December 31, 2015. Most of the 1,487 employers that participated in the WRS were local governments and school districts. The City of Milwaukee does not participate because it maintains its own retirement system.

Table 1

Types of Employers Participating in the WRS
As of December 31, 2015

Type	Number
School Districts	424
Villages	264
Towns	247
Special Districts[1]	207
Cities	152
Counties	71
State Agencies, UW System, and Public Authorities	58
Fourth-Class Cities[2]	36
Wisconsin Technical College System Districts	16
Cooperative Educational Service Agencies	12
Total Employers	**1,487**

[1] Includes employers such as the Madison Metropolitan Sewerage District, the Oshkosh City Housing Authority, and the South Central Library System.

[2] Defined as cities with populations of less than 10,000.

Statutes require employers participating in the WRS to enroll all eligible employees. Under current law, employees initially hired by a WRS employer on or after July 1, 2011, are eligible to participate in the WRS if the expected duration of employment is one year or more and they are expected to be employed for at least two-thirds of what is considered full-time. Current statutes require five years of service before such an employee is considered vested.

WRS Funding

The WRS is funded through a combination of employer and employee contributions and investment earnings.

The WRS is funded through annual employer and employee contributions and investment earnings. The ETF Board has established a WRS funding policy with three primary goals:

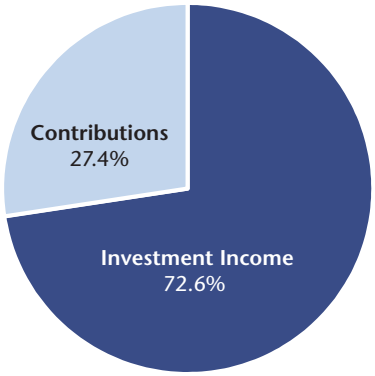
- ensure funds are adequate to pay benefits;
- maintain stable and predictable contribution rates for employers and employees; and

- maintain inter-generational equity to ensure the cost of the benefits is paid for by the generation that receives the benefits.

From 2006 through 2015, investment income represented 72.6 percent of total funding for the WRS and employer and employee contributions represented 27.4 percent of total funding for the WRS, as shown in Figure 1.

Figure 1

WRS Funding Sources
2006 through 2015



Contribution rates, which include both an employer and an employee share, are actuarially determined as a percentage of an employee's earnings and are approved annually by the ETF Board. As shown in Table 2, total contribution rates for "general employees," which includes teachers and most other employees, ranged from a low of 10.4 percent for calendar year (CY) 2009 to a high of 14.0 percent for CY 2014.

Table 2

Total Contribution Rates for General Employees in the WRS

Calendar Year	Total Contribution Rate[1]
2008	10.6
2009	10.4
2010	11.0
2011	11.6
2012	11.8
2013	13.3
2014	14.0
2015	13.6
2016	13.2
2017	13.6

[1] Includes both the employer share and the employee share of contributions and benefit adjustment contributions, but does not include employer specific prior service cost rates.

The assets of the WRS are invested by SWIB in two funds. The Core Retirement Investment Trust Fund (Core Fund) is a fully diversified or balanced fund, which provides less volatile investment returns and is invested for the long term in several types of investments. The Variable Retirement Investment Trust Fund (Variable Fund) is an equity fund, or stock fund, which provides returns that are typically more volatile than the Core Fund.

The basic objective of the WRS is to invest contributions so that investment income and the contributions will be sufficient to pay projected future pension benefits.

SWIB has a fiduciary responsibility to prudently invest the pension assets in a diversified manner to meet WRS funding needs while minimizing the risk of large losses. SWIB's investment strategy is to meet the long-term expected rate of return assumption, which is 7.2 percent. The basic objective of the WRS is to invest contributions paid by employers and employees so that the investment income and the contributions will be sufficient to pay projected future pension benefits. As of December 31, 2015, SWIB's 20-year return for the Core Fund was 7.2 percent, net of investment expense, which equals the long-term expected rate of return assumption of 7.2 percent.

WRS Benefits

The WRS is a defined-benefit plan that provides participants with lifelong monthly retirement benefits and, depending upon the annuity type selected, may also provide benefits to a beneficiary after

the participant's death. These benefits are initially determined by either a formula, which is based on the participant's years of service and final average salary, or a money purchase benefit, which is based on the participant's contributions, an employer's matching contributions, and investment income. The method that yields the largest benefit payment is used to calculate a participant's initial benefit. This initial benefit may be adjusted based on changes in the market value of retirement fund assets, but would generally not be adjusted below the initial benefit amount. A defined-benefit plan is in contrast to a defined-contribution plan, such as a 401(k) plan, in which benefits are based on the amounts contributed to a participant's account and investment gains or losses on those funds.

Financial Condition of the WRS

As required by statutes, we have completed an audit of the financial statements and related notes of the WRS as of and for the year ended December 31, 2015. Our audit of the financial statements and related notes of the other employee benefit programs administered by ETF is ongoing. The financial statements of the WRS and of the other employee benefit programs will be presented in ETF's Comprehensive Annual Financial Report (CAFR), as well as in the State's CAFR, published by DOA.

The WRS financial statements were prepared by ETF using generally accepted accounting principles (GAAP) prescribed by the Governmental Accounting Standards Board (GASB). To complete our audit of the financial statements of the WRS, we reviewed ETF's internal controls over financial reporting, tested financial transactions, and reviewed the financial statements, notes, and required supplementary information that were prepared by ETF management.

We provided an unmodified opinion on the financial statements of the WRS for the year ended December 31, 2015.

In addition to providing an unmodified opinion on the financial statements and related notes of the WRS for the year ended December 31, 2015, we have issued our Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is on page 25. In that report, we describe a significant deficiency in internal control related to ETF's financial reporting process. Although we noted some improvement in ETF's process for preparing the financial statements, we again identified errors made by ETF, and we again make a recommendation for further improvement in its processes. We also describe a significant deficiency in DOA's cash reconciliations, which are relied upon by ETF. Due to the pervasiveness of this deficiency and its effects on state agencies and programs, users of the WRS financial statements should be informed of this deficiency. No recommendations were made to ETF related to the concerns with the centralized controls at DOA.

The issuance of the WRS financial statements was later than anticipated due to delays in ETF's financial statement preparation process, which was affected by the State's implementation of a new

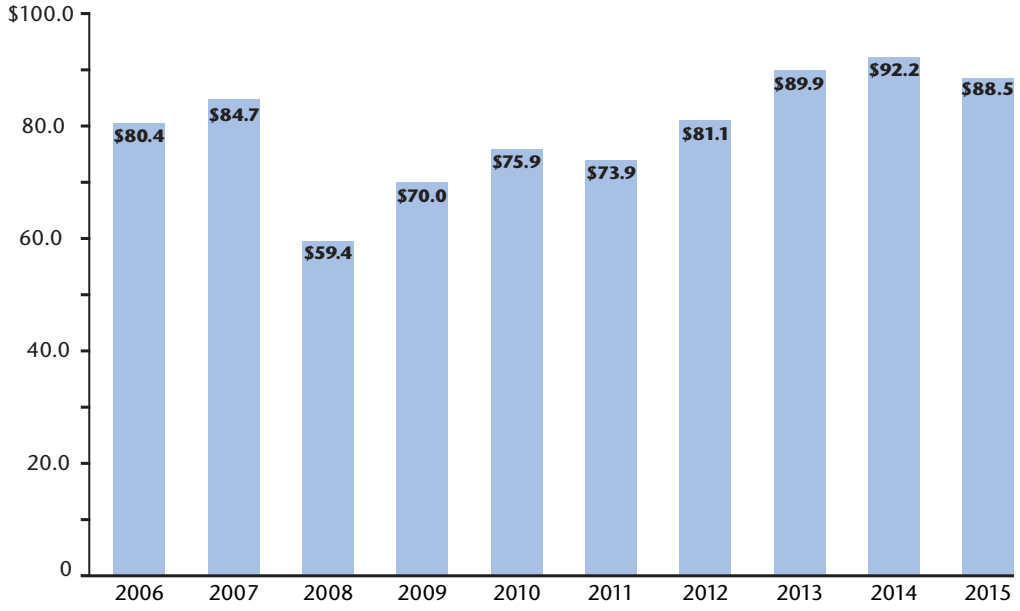
enterprise resource planning system. A significant deficiency in DOA's centralized cash reconciliations caused additional delays.

The fiduciary net position of the WRS as of December 31, 2015, was $88.5 billion.

The Net Position Restricted for Pensions (fiduciary net position) of the WRS represents the value of the plan's assets that are currently available to make benefit payments. As of December 31, 2015, the WRS had a fiduciary net position of $88.5 billion, which was a 4.0 percent decrease from the prior year. From December 31, 2006, through December 31, 2015, the fiduciary net position of the WRS increased by $8.1 billion (10.1 percent), as shown in Figure 2. The significant decline in fiduciary net position in 2008 reflects the effect of the economic recession that began in December 2007.

Figure 2

Wisconsin Retirement System
Fiduciary Net Position[1]
As of December 31
(in billions)



[1] Shown as Net Position Restricted for Pensions on the financial statements.

Net investment income declined from $4.9 billion in 2014 to a loss of $675.0 million in 2015 due to declines in the investment returns of the Core and Variable Funds.

Contributions to the WRS from employers and employees remained relatively stable at $1.9 billion in 2014 and in 2015. Net investment income, which is the sum of realized and unrealized gains and losses less SWIB's investment expenses, declined from $4.9 billion in 2014 to a loss of $675.0 million in 2015, or by 113.8 percent. The decrease in net investment income reflects the declines in investment returns realized by the Core and Variable Funds. As reported by SWIB, the gross investment return of the Core Fund declined from 5.7 percent in 2014 to a loss of 0.4 percent in 2015, and

the investment return of the Variable Fund declined from 7.3 percent in 2014 to a loss of 1.2 percent in 2015.

Total WRS benefit payments provided to retired participants or their beneficiaries increased from $4.5 billion in 2014 to $4.8 billion in 2015, or by 6.3 percent. The number of retired participants increased from 185,600 as of December 31, 2014, to 191,800 as of December 31, 2015. The average annual annuity paid increased from $24,185 in 2014, to $24,780 in 2015, or by 2.5 percent.

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Pension Accounting Standards ■

In 2012, GASB issued standards for accounting and financial reporting for public pension plans and for the financial statements of participating employers. These GASB standards established accounting and financial reporting requirements for measuring the pension liability, as well as requirements for both the notes and required supplementary information to the WRS financial statements, and the GAAP-based financial statements of the almost 1,500 employers that participate in the plan.

The pension accounting standards require ETF to calculate the total pension liability and the net pension liability or asset for the WRS, and disclose them in the notes and in the required supplementary information to the WRS financial statements. Under these standards, ETF calculated a net pension liability of $1.6 billion for the WRS as of December 31, 2015, which will be reported by each participating employer based upon its proportionate share of this net pension liability, as well as pension expense and other amounts, in its own financial statements if prepared under GAAP.

Under the pension accounting standards, a pension liability is established based on the present value of projected pension benefits for service already provided.

Prior to the implementation of these standards, financial reporting was based on the pension plan's funding principles. Under these principles, a pension liability was reported only when a government did not make its annual required contributions to the pension plan for current or prior service costs, which represent the present value of projected pension benefits earned by employees in the current year or prior years. Under the pension accounting standards, a pension liability is established based on the present value of projected pension benefits that have not yet been funded for service

already provided, and a pension expense is recorded during the period in which the employee earned the pension benefit.

Calculating the Total Pension Liability

The total pension liability is the sum of the amounts needed to pay for the pension benefits earned by each participant.

The total pension liability for the WRS is the sum of the amounts needed to pay for the pension benefits earned by each participant based on service provided as of the date the actuarial valuation is performed. A total pension liability exists because the employers participating in the WRS have committed to provide benefits to their employees in the future when those employees retire. That commitment is part of employee compensation and constitutes a liability. The calculation of the total pension liability is complex and includes various actuarial assumptions and calculations, such as:

- a projection of future benefit payments for current and former participants and their beneficiaries based upon the current terms of the WRS;
- a discount of those payments to their present value, or the amount of funds currently needed to provide the projected payments in the future; and
- an allocation of the present value of benefit payments over past, present, and future periods of employee service.

The total pension liability for the WRS was $90.1 billion as of December 31, 2015.

To determine the total pension liability for the WRS as of December 31, 2015, ETF's actuary performed an actuarial valuation as of December 31, 2014, and adjusted for changes such as interest earned, contributions paid, benefits paid, and dividend adjustments during CY 2015. Based on this valuation and the adjustments, the total pension liability for the WRS was $90.1 billion as of December 31, 2015.

The discount rate is the rate used to calculate the present value of projected benefit payments.

The discount rate, or interest rate, used to calculate the present value of projected benefit payments, which is used to determine the total pension liability, is specifically defined under the pension accounting standards. ETF used the long-term expected rate of return assumption for the WRS, which is 7.2 percent, as the discount rate because current and projected future plan assets are expected to cover the projected benefit payments for the WRS. If the current and projected future plan assets of the WRS had not been sufficient to cover the projected benefit payments, the pension accounting standards would have required ETF to blend the index rate for 20-year municipal bonds (3.57 percent as of December 31, 2015) with its long-term expected rate of return assumption (7.2 percent as

of December 31, 2015). In such circumstances, the blended discount rate would have been lower and would have resulted in a larger total pension liability.

The discount rate used can have a significant effect on the amount of the total pension liability.

The discount rate is a critical factor in calculating a pension plan liability, and it can have a significant impact on the amount of the total pension liability. Under the pension accounting standards, ETF is required to calculate the sensitivity of the total pension liability to a one percentage point decrease or increase in the discount rate. At 7.2 percent, the total pension liability for the WRS was $90.1 billion as of December 31, 2015. However, a one-percent decrease in the discount rate (6.2 percent) increases the total pension liability to $99.9 billion, which would result in a net pension liability of $11.4 billion, and a one-percent increase in the discount rate (8.2 percent) decreases the total pension liability to $82.5 billion, which would result in a net pension asset of $6.0 billion.

Calculating a Net Pension Liability or Asset

To determine the net pension liability or asset, the pension accounting standards require the total pension liability to be subtracted from the pension plan's fiduciary net position. When the total pension liability is greater than the fiduciary net position, the pension plan will disclose a net pension liability in its notes. When the fiduciary net position is greater than the total pension liability, the pension plan will disclose a net pension asset in its notes.

ETF reported a net pension liability of $1.6 billion for the WRS as of December 31, 2015.

As of December 31, 2015, the WRS has a fiduciary net position of $88.5 billion. When the total pension liability of $90.1 billion is subtracted from the fiduciary net position of the WRS, a net pension liability of $1.6 billion results as of December 31, 2015. As shown in Table 3, this is a decrease of $4.1 billion from the net pension asset of $2.5 billion reported as of December 31, 2014.

Table 3

WRS Net Pension Asset/(Liability)
As of December 31 (in billions)

	2014	2015	Increase (Decrease)
Fiduciary Net Position	$92.2	$88.5	$(3.7)
Total Pension Liability	(89.7)	(90.1)	(0.4)
Net Pension Asset (Liability)	**$ 2.5**	**$(1.6)**	**$(4.1)**

A decline in the value of the investments of the Core and Variable Funds from December 31, 2014, to December 31, 2015, was the primary cause of the $3.7 billion decrease in the fiduciary net position and resulted in the reporting of a net pension liability as of December 31, 2015.

Calculating Other Collective Amounts

In addition to the calculation of the total pension liability and the calculation of the net pension liability or asset, the pension accounting standards require public pension plans to calculate pension expense, as well as amounts that are considered deferred for the plan. Pension expense is the net increase or decrease in the net pension liability or asset, with certain adjustments. Reporting of pension expense under the pension accounting standards more closely aligns the pension expense with the periods during which the pension benefits are earned by the employees. For the year ended December 31, 2015, pension expense for the WRS was $2.0 billion. Deferred outflows of resources, which primarily represents the difference between projected and actual investment earnings, was $8.1 billion. Deferred inflows of resources, which primarily represents the difference between expected and actual experience, was $3.4 billion.

Employer Reporting

Employers participating in the WRS have made a commitment to provide pension benefits and have an obligation to make contributions to fund those benefits.

As noted, the WRS is a cost-sharing, multiple-employer, defined-benefit pension plan with almost 1,500 participating employers. In this type of pension plan, the contributions are combined and the benefits are paid out of a common pool of assets. By participating in the WRS, employers have made a commitment to provide pension benefits to employees, and they are obligated to make contributions into the future to ensure that sufficient resources are available to make the benefit payments. Therefore, because the employers participating in the WRS have ultimate responsibility for the resulting pension obligations, each participating employer is required to report its proportionate share of the net pension liability or asset, as well as other collective amounts including pension expense, on its GAAP-based financial statements.

For the year ended December 31, 2015, each WRS participating employer was allocated its proportionate share of the net pension liability.

To assist employers participating in the WRS in determining the employer's proportionate share of these amounts, ETF has prepared a Schedule of Employer Allocations and a Schedule of Pension Amounts by Employer for the year ended December 31, 2015. We audited and provided an unmodified opinion on these schedules in report 16-11. Because the WRS has calculated a net pension liability for the year ended December 31, 2015, each employer participating in the WRS must report its proportionate share of this net pension liability on its GAAP-based financial statements. A net pension liability indicates that, at that point in time, the assets of the WRS were not sufficient to cover the projected liability for benefit payments to employees.

As shown in Table 4, the ten largest WRS participating employers were allocated a total of $669.9 million, or 41.2 percent of the $1.6 billion net pension liability as of December 31, 2015. In comparison, these same participating employers were allocated $1.0 billion, or 41.0 percent of the $2.5 billion net pension asset as of December 31, 2014. The proportionate share of the net pension liability for State of Wisconsin agencies as of December 31, 2015, was $456.1 million, of which $220.8 million related to the University of Wisconsin (UW) System. The net pension liability for the state agencies will be included in the State's GAAP-based financial statements, which will be published in the State's CAFR for the year ended June 30, 2016.

Table 4

Net Pension Asset (Liability) by Employer

Participating Employers	December 31, 2014 Net Pension Asset[1]	December 31, 2015 Net Pension Liability	December 31, 2015 Proportionate Share
State Agencies, excluding the UW System	$ 356,608,704	$ (235,338,780)	14.5%
UW System	330,075,883	(220,794,780)	13.6
University Hospitals and Clinics	76,054,915	(52,786,677)	3.2
Milwaukee Teachers Retirement System	67,105,872	(43,792,878)	2.7
City of Madison	38,955,262	(25,970,173)	1.6
Madison Metropolitan School District	37,319,808	(24,882,909)	1.5
Dane County	27,669,464	(18,480,702)	1.1
Kenosha Unified School District	24,732,203	(16,281,444)	1.0
Green Bay Area Public Schools	23,562,897	(15,839,964)	1.0
Racine Unified School District	23,523,022	(15,779,061)	1.0
Subtotal	1,005,608,030	(669,947,368)	41.2
Total for Other Participating Employers	1,449,990,110	(955,033,227)	58.8
Total	$2,455,598,140	**$(1,624,980,595)**	**100.0%**

[1] These amounts have been adjusted from those reported in reports 15-11 and 15-12. The difference is immaterial.

■ ■ ■ ■

Funding and GASB Financial Reporting Methodologies ■

ETF uses a funding methodology to establish required contribution rates for employers and employees and to measure the plan's unfunded liabilities. For financial reporting purposes, ETF is required to use the GASB pension accounting standards. GASB did not intend for the financial reporting methodology to be used for funding purposes. Instead, GASB intended the financial reporting methodology to enhance transparency of pension-related information in financial reports and to be a tool to allow for comparisons across public pension systems. Each methodology results in a different measure of the funded status of the WRS. Under the funding methodology, the WRS is nearly 100.0 percent funded as of December 31, 2015, and under the GASB financial reporting methodology, the WRS is 98.2 percent funded.

Comparing Methodologies

There are similarities in the actuarial assumptions used in calculating the projected future benefit payments under the funding and financial reporting methodologies, including assumptions related to mortality rates, salary increases, and disability rates. However, there are several differences in how the liability is calculated under each methodology, which creates a differing determination of the financial status of the pension plan. One of the key differences in the calculations is the consideration of investment income or loss.

Under the GASB financial reporting methodology, WRS investments are valued at fair value, which will result in volatility in the calculation of the net pension liability or asset.

Under the funding methodology, ETF's actuary uses a smoothing mechanism for investment income or loss, known as the market recognition account (MRA) for the Core Fund investment activity. This account accumulates the difference between actual investment income or loss and expected investment income calculated at the long-term expected rate of return assumption of 7.2 percent. The difference is then distributed into the calculated plan net assets over a five-year period so that the expected investment income is affected by portions of the previous five years' amounts included in the MRA to determine the plan net assets. This results in less volatility in the plan net assets under the funding methodology, and thus, less volatility in the calculation of the contribution rates for employers and employees.

Under the financial reporting methodology, pension plan assets are valued at fair value as of the reporting period end date, which is December 31 for the WRS. The use of the fair value of the plan assets in the calculation will cause a large degree of volatility in the reported net pension liability or asset, depending upon investment performance and fluctuations in the investment market.

Relationship to Contribution Rates

ETF seeks to set contribution rates that allow employers to better plan and meet contribution requirements.

The WRS is an irrevocable trust and all funds remain in the trust and can only be used to fund pension benefits. ETF's funding policy for the WRS has the goal of establishing steady contribution rates that allow employers to better plan and meet contribution requirements. Contribution rates are set to provide for the benefits earned by employees during the year. In setting these rates, one of the most significant factors considered is investment performance. However, while the investment performance of the Core and Variable Funds affects the setting of contribution rates, the full effect of a particular year's investment gain or loss is smoothed through the use of the MRA, so that contribution rates are gradually increased or decreased over time.

Although the net pension liability or asset calculated under the GASB pension standards is an indication of the financial health of the system, it should not be used as a mechanism to determine if contribution rates should be increased or decreased. Under the pension accounting standards, GASB separated the funding and financial reporting methodologies. If ETF were to adjust contribution rates based on the financial reporting methodology, more pronounced fluctuations in the rates could result, primarily because the fair value of investments at a point in time would be used. For instance, if the $2.5 billion net pension asset reported as of December 31, 2014, had been considered in adjusting prior year

rates, we would anticipate that the contribution rates would have decreased. However, for the year ended December 31, 2015, there was a net pension liability of $1.6 billion. This is a 4.0 percent decrease, which was primarily as a result of a decrease in the fair value of investment. If this change from a net pension asset to a net pension liability was considered in setting the contribution rates, we would have expected an increase in the rates. The volatility of using the fair value of investments to adjust contribution rates could be difficult for employers and employees to anticipate and manage.

Comparison to Other Pension Plans

Differences in the structure of pension plans and timing of pension plan reporting will affect the comparability across pension plans.

GASB anticipated that the pension accounting standards would allow for comparability across public pension plans since plans are required to use the same GASB financial reporting methodology and are required to value plan investments at fair value when calculating the net pension liability or net pension asset. Although pension plans will follow the same accounting standards in reporting the pension liability, differences such as plan structures, planned asset allocations, and investment strategies will make comparisons across pension plans imperfect. In addition, because pension plans have varying fiscal-year ends, changes in the condition of investment markets at different points in time during a year will affect comparability.

We collected information from other cost-sharing, multiple-employer, defined-benefit plans that were part of a WRS peer group defined by a study performed by CEM Benchmarking Inc. In comparison to these plans, the WRS had the highest funded ratio of 98.2 percent, as shown in Table 5.

Table 5

Comparison of Selected Pension Plans Based on Financial Reporting Methodology[1, 2]
(in billions)

Pension Plan	Total Pension Liability	Fiduciary Net Position	Net Pension Asset	Net Pension Liability	Funded Ratio
Wisconsin Retirement System (WRS)[3]	$ 90.1	$ 88.5	n/a	$1.6	98.2%
New York State and Local Employees' Retirement System[4]	164.6	161.2	n/a	3.4	97.9
Oregon Public Employees Retirement System	70.7	64.9	n/a	5.8	91.8
Iowa Public Employees Retirement System	33.4	28.4	n/a	5.0	85.0
Ohio Public Employees Retirement System[3]	91.5	74.2	n/a	17.3	81.1
California State Teachers' Retirement System	259.1	191.8	n/a	67.3	74.0
State Teachers Retirement System of Ohio	99.0	71.4	n/a	27.6	72.1
Arizona State Retirement System	49.2	33.6	n/a	15.6	68.3
Virginia Retirement System – Teachers Retirement System	42.9	30.3	n/a	12.6	70.6
Pennsylvania Public School Employees' Retirement System	94.9	51.6	n/a	43.3	54.4

[1] Based on information from other cost-sharing, multiple-employer, defined-benefit pension plans that were part of the WRS peer group as defined by a study performed by CEM Benchmarking Inc.

[2] For the plan year ended June 30, 2015, unless otherwise noted.

[3] For the plan year ended December 31, 2015.

[4] For the plan year ended March 31, 2015.

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Auditor's Report ■

STATE OF WISCONSIN
Legislative Audit Bureau
Celebrating 50 Years of Service 1966-2016
22 East Mifflin Street, Suite 500 ▪ Madison, WI 53703 ▪ (608) 266-2818 ▪ Hotline: 1-877-FRAUD-17 ▪ www.legis.wisconsin.gov/lab
Joe Chrisman
State Auditor

Report 16-10

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters

Senator Robert Cowles and
Representative Samantha Kerkman, Co-Chairpersons
Joint Legislative Audit Committee

Members of the Employee Trust Funds Board and
Mr. Robert J. Conlin, Secretary
Department of Employee Trust Funds

We have audited the financial statements and related notes of the Wisconsin Retirement System as of and for the year ended December 31, 2015, and have issued our report thereon dated December 1, 2016. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, which is issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

Management of the Department of Employee Trust Funds (ETF) is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audit of the Wisconsin Retirement System financial statements, we considered ETF's internal control to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ETF's internal control. Accordingly, we do not express an opinion on the effectiveness of ETF's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent misstatements, or to detect and correct misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement of the Wisconsin Retirement System's financial statements will not be prevented, or that a material misstatement will not be detected and corrected on a timely basis. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, we identified certain deficiencies in internal control that we consider to be a significant deficiency related to financial reporting. In addition, we identified a significant deficiency with controls over the reconciliation of cash at the Department of Administration (DOA), which we believe should be reported to the users of the financial statements of the WRS.

Financial Reporting at the Department of Employee Trust Funds:

ETF is responsible for maintaining effective internal controls to ensure the financial statements and related notes for the WRS are fairly presented and that misstatements are prevented, or detected and corrected in a timely manner. ETF has implemented procedures for preparing the financial statements, including oversight and review by management.

In response to our findings from the calendar year (CY) 2014 audit, ETF hired an outside firm to review its financial reporting process. The firm made several recommendations in a report issued in spring 2016 detailing improvements ETF could make in its processes. Although efforts to implement these recommendations is ongoing, ETF indicated it has made some of the recommended improvements during 2016, such as providing additional training to staff, cross-training staff, developing a template to use in preparing spreadsheets, and developing a more formal communication process with the auditors.

During our CY 2015 audit, we noted some improvements to ETF's financial reporting process, particularly in the review process. However, we continued to identify errors that required adjustment to the financial statements and notes, which indicates that deficiencies continue to exist in the financial reporting process. For example:

- The Cash and Cash Equivalents account on the Statement of Fiduciary Net Position was understated by $90.9 million due to a receipt that was received by the bank as of December 31, 2015, but was not considered a cash receipt in the financial statements since it was not recorded in the accounting system until January 4, 2016. Although the recording of the receipt in the accounting system is the responsibility of DOA, ETF is responsible for ensuring accurate financial reporting. ETF staff reconciled contribution revenue and documented the mismatch in the date of the receipt of the contributions revenue and the date it was posted in the general ledger. However, this information was not used to adjust the recorded cash receipts in the financial statements. This error did not impact the reported fiduciary net position.

- The employer reserve balance was reported at $19.3 billion in the notes to the financial statements, when the correct amount was $20.5 billion, resulting in an understatement of $1.2 billion in the notes.

- Net Investment Income was understated by $6.5 million on the Statement of Changes in Fiduciary Net Position due to errors made in the calculations and entries that allocate earnings from the Core Retirement Investment Fund. Although these errors are not material to the WRS, our CY 2014 audit identified similar errors that were more significant.

After we brought these concerns to its attention, ETF corrected the financial statements and notes for all identified errors. In October 2015, the State implemented a new enterprise resource planning (ERP) system called STAR, which included both an accounting and payroll system. The staff time devoted to resolution of various implementation issues with STAR placed additional demands on ETF staff, which increased the risk of financial reporting errors.

We recommend ETF:

- continue with efforts to improve its financial reporting process, including effective review of entries and balances;
- implement additional procedures, such as receiving additional information from the bank or DOA related to receipts at the end of the year to ensure they are properly reported; and
- assess the issues that arose during preparation of the CY 2015 financial statements and the implementation of STAR and determine what other changes should be made to improve the financial reporting process.

Department of Employee Trust Funds Response:

ETF agrees that it has made improvements to the financial reporting process. ETF believes the results of the audit support this statement as the errors cited are either immaterial to or did not affect the WRS fiduciary net position.

As noted, the $90.9 million adjustment did not impact the reported fiduciary net position. A check with DOA at year-end regarding bank deposits has already been incorporated into ETF's procedures and should mitigate the risk of this situation occurring in the future.

The adjustment related to the employer reserve balance was a disclosure note only and did not impact the financial statements. As noted, the implementation of the State's new ERP system proved to be challenging. This included the ability to generate reports. An error in a report layout was the cause of this issue. Staff have since corrected the layout and also incorporated a check against the actuarial report which will be performed each year going forward.

The correction of $6.5 million to net investment income is .007% or .7 basis points of the WRS Trust fund, and as noted is not a material finding. The allocation of earnings is a complex process and the use of spreadsheets has its risks. This past year, staff implemented controls to mitigate the risk of errors, including documentation of the process and spreadsheet, an automated way to pull in data to allow for updating of calculations when data changes, and better reviews of the calculations. ETF believes these are good controls but will continue to look for opportunities to further mitigate the risk of errors in this process.

With the recent hire of a Financial Reporting Director, staff will continue efforts to improve the financial reporting process. This will include an assessment of issues that arose during the preparation of the CY 2015 financial statements. This assessment will be completed prior to the beginning of the audit for the year ending December 31, 2016.

Cash Reconciliation at the Department of Administration:

DOA is responsible for performing certain centralized internal control functions related to cash. State agencies, including ETF, rely on these controls. As part of our separate audit of DOA, we identified a significant deficiency in the centralized controls related to cash. This weakness relates to the lack of complete and timely reconciliations of cash reported by the bank with cash balances reported in the State's central accounting system, STAR. This control is important to ensure cash balances are accurate and to ensure all receipts and disbursements have been properly recorded. Due to the pervasiveness of the deficiency and its effects on state agencies and programs, this deficiency is reported to the users of the financial statements of the WRS. We communicated this weakness to DOA, who agreed with the finding. DOA's response will be included in our separate report related to the State's Comprehensive Annual Financial Report. We did not request a response from the management of ETF since DOA is responsible for corrective action.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Wisconsin Retirement System's financial statements are free from material misstatement, we performed tests of compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

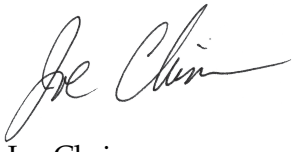
Department of Employee Trust Funds Response to Findings

ETF's written response to the finding identified in our audit is described in the preceding paragraphs. ETF's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of This Report

This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be used when considering ETF's internal control and compliance. The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of ETF's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU



Joe Chrisman
State Auditor

December 1, 2016

Response ■

State of Wisconsin
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

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December 1, 2016

JOE CHRISMAN, STATE AUDITOR
LEGISLATIVE AUDIT BUREAU
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MADISON WI 53703

Re: Audit of the 2015 Financial Statements of the Wisconsin Retirement System

Dear Mr. Chrisman:

Thank you for the opportunity to review and comment on the audit of the 2015 financial statements of the Wisconsin Retirement System (WRS). The WRS continues to be in a strong financial position due to its unique design and fiscal discipline. The funding ratio of nearly 100% under the funding methodology and 98.2% under the Governmental Accounting Standards Board (GASB) financial reporting methodology demonstrates this. As noted in your report, the funding ratio calculated under GASB standards will fluctuate year to year due to the use of fair market value of WRS assets in the calculation.

ETF staff acknowledge challenges encountered with the implementation of the State's new Enterprise Resource Planning (ERP) system, which resulted in more time required to prepare various reports and schedules. Despite these challenges, ETF has made improvements to the financial reporting process and will continue its efforts to do so. We believe the results of the audit support this statement as the errors noted are either immaterial to or did not affect the WRS fiduciary net position.

We value the completion of the audit and are pleased to now provide employers information for their financial reporting requirements.

Sincerely,

Robert J. Conlin
Secretary