

# **CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM**

Review Report

## **PENSION CONTROLS AND MECHANISMS**

*July 1, 2009, through June 30, 2011*



**JOHN CHIANG**  
California State Controller

September 2012



**JOHN CHIANG**  
*California State Controller*

September 5, 2012

Jack Ehnes, Chief Executive Officer  
California State Teachers' Retirement System  
100 Waterfront Place  
West Sacramento, CA 95605

Dear Mr. Ehnes:

The State Controller's Office (SCO) reviewed the California State Teachers' Retirement System (CalSTRS) for the period of July 1, 2009, through June 30, 2011. The purpose of the review was to determine whether controls are in place to detect and prevent pension payments based on unusually large or excessive final compensation amounts, commonly known as pension spiking. The SCO specifically reviewed the electronic methods used to identify pension spiking, the audit processes used by CalSTRS to oversee its member school districts, and the efforts conducted by its newly formed Compensation Review Unit.

The SCO also independently reviewed five school districts for the period of July 1, 2006, through June 30, 2011, to determine whether the districts had controls in place to provide reasonable assurance that pension spiking could be prevented or detected.

The SCO identified the following concerns:

- CalSTRS did not provide adequate oversight of the reporting entities it monitors. For example, at the rate at which audits currently are being performed, each district would be audited only once every 48 years. In addition, CalSTRS' audit process should have been more effective in detecting pension spiking at its member school districts.
- CalSTRS missed opportunities to increase school district accountability by reducing instances of suspicious or unjustified salary increases (i.e., pension spiking). Our independent review of the San Francisco Unified School District and the San Diego Unified School District concluded that these districts lacked the level of transparency and the necessary controls over management pay increases that a public entity should exercise on behalf of its constituents. As a result, pension spiking may be occurring at these districts.
- Our review disclosed that CalSTRS did not review or verify the results of electronic edits it put in place to specifically identify potential pension spiking, except when there was an occasional inquiry from other CalSTRS divisions. CalSTRS could better analyze and use electronic information and coordinate its auditing efforts with its newly formed Compensation Review Unit so that audits are focused on higher-risk school districts.

If you have any questions, please call Mr. Finlayson at (916) 324-6310, or e-mail him at [afinlayson@sco.ca.gov](mailto:afinlayson@sco.ca.gov).

Sincerely,

*Original signed by*

**JEFFREY V. BROWNFIELD**  
Chief, Division of Audits

JVB/mp

Enclosure

cc: Chris Ford, Chief of Staff  
California State Teachers' Retirement System  
MaryAnn Campbell-Smith, Chief Auditor  
California State Teachers' Retirement System

# Contents

## **Review Report**

<b>Executive Summary</b> .....	1
<b>Introduction</b> .....	1
<b>Background</b> .....	2
<b>Scope, Objectives, and Methodology</b> .....	2
<b>Conclusion</b> .....	3
<b>Views of Responsible Officials</b> .....	4
<b>Restricted Use</b> .....	4
<b>Findings and Recommendations</b> .....	5
<b>Attachment—CalSTRS' Responses to Draft Audit Report</b>	

# Review Report

## Executive Summary

The State Controller's Office (SCO) has completed a review of the California State Teachers' Retirement System (CalSTRS) to determine whether controls are in place to detect and prevent pension payments based on unusually large or excessive final compensation amounts, commonly known as pension spiking. The SCO specifically reviewed the electronic methods used to identify pension spiking, the audit processes used by CalSTRS to oversee its member school districts, and the efforts conducted by its newly formed Compensation Review Unit for the period of July 1, 2009, through June 30, 2011.

The SCO also independently reviewed five reporting entities: three school districts, one community college district, and one county office of education, to determine whether controls are in place to provide reasonable assurance that pension spiking could be prevented or detected.

The SCO's review was conducted pursuant to the State Controller's authority under Government Code section 12410.

The SCO identified the following concerns:

1. CalSTRS did not provide adequate oversight of the reporting entities it should be monitoring. For example, at the rate at which audits currently are being performed, each district would be audited only once every 48 years. In addition, CalSTRS' audit process should have been more effective in detecting pension spiking at its reporting entities (i.e., school districts).
2. CalSTRS missed opportunities to increase reporting entity accountability. Our independent review of the San Francisco Unified School District and the San Diego Unified School District concluded that these districts lacked the level of transparency and the necessary controls over management pay increases that a public entity should exercise on behalf of its constituents. As a result, pension spiking may be occurring at these districts.
3. Our review disclosed that CalSTRS did not review or verify the results of electronic "edits" it put in place to specifically identify potential pension spiking, except when there was an occasional inquiry from other CalSTRS divisions.

## Introduction

This report presents the results of the SCO's review of pension control mechanisms exercised by CalSTRS over its member entities. With a large number of retirements predicted to occur in the near future and the fiscal impact these retirements will have on CalSTRS' Teachers' Retirement Fund, the SCO reviewed the adequacy of CalSTRS' methods to prevent potential pension spiking.

The SCO's review was conducted pursuant to the State Controller's authority under Government Code section 12410.

## **Background**

The responsibility of CalSTRS is to provide retirement-related benefits and services primarily to teachers in public schools, community colleges, and county offices of education.

CalSTRS is the largest teachers' retirement fund in the United States. As of October 31, 2011, it had more than 852,000 members and carried \$148.2 billion in assets.

CalSTRS is managed by the Teachers' Retirement Board (Board). The Board has control over the investment and administration of the Teachers' Retirement Fund. The Board comprises twelve members, including five members appointed by the Governor, four ex-officio members, and three members elected by CalSTRS members.

CalSTRS is responsible for the determination and payment of benefits to members, retirees, and beneficiaries. The retirement income amount is based on the member's age at retirement, the number of service credits at retirement, and the member's final compensation. In the case of the Defined Benefit program, final compensation is based either on the highest single year or an average of three consecutive years, depending on the number of years of service the member has at retirement.

Pension spiking is a situation in which an individual member's final compensation is increased to a level that does not reflect the compensation that the member has been earning on an ongoing basis for that position. This may reflect one-time increases in compensation or increases that became effective shortly before retirement that would not continue to be paid to the member's successor.

## **Scope, Objectives, and Methodology**

The State Controller's Office (SCO) reviewed the California State Teachers' Retirement System (CalSTRS) for the period of July 1, 2009, through June 30, 2011. The purpose of the review was to determine whether controls are in place to detect and prevent pension payments based on unusually large or excessive final compensation amounts, commonly known as pension spiking. The SCO specifically reviewed the electronic methods used to identify pension spiking, the audit processes used by CalSTRS to oversee its member school districts, and the efforts conducted by its newly formed Compensation Review Unit.

The SCO also independently reviewed five reporting entities for the period of July 1, 2006, through June 30, 2011, including three school districts, one community college district, and one county office of education, to determine whether the districts had controls in place to provide reasonable assurance that pension spiking could be prevented or detected.

The objectives of our review were to determine whether CalSTRS has made adequate efforts and put in place systems to detect and take action in a timely manner against potential pension spiking, and provides adequate oversight of these processes. Specifically, the objectives were as follows:

- Review automated programs designed to flag excessive salary bumps from one year to the next.
- Determine whether or not a particular compensation increase was appropriate and properly documented.
- Review five member entities to determine if CalSTRS is properly identifying inconsistent or accelerated pay increases during an employee's final compensation period.
- Conduct a review of CalSTRS' implementation of its Compensation Review Unit.

In order to accomplish our objectives, we performed the following procedures:

- Reviewed rules and regulations associated with the Teachers' Retirement Law and other pertinent documents related to school teachers' retirement.
- Reviewed audit working papers and reports prepared by CalSTRS auditors and its contractor, Mayer Hoffman McCann P.C., to determine the procedures performed, their results, and the follow-up of audit findings.
- Reviewed audit reports prepared by CalSTRS' independent auditors Macias, Gini, and O'Connell, LLP, pursuant to the annual financial and performance audit requirements.
- Reviewed internal reports, risk analyses, annual work plans, reports to management, internal audit reports, and contractor's memos and reports related to the oversight of the teachers' retirement system.
- Reviewed CalSTRS Board meeting minutes.
- Interviewed various officials and staff at CalSTRS and member entities that submit retirement information to CalSTRS (e.g., school districts), to gain an understanding of relevant policies, procedures, and processes.
- Conducted five independent reviews of member entities.

## Conclusion

Our review of CalSTRS disclosed that:

1. CalSTRS does not provide adequate oversight to detect pension spiking at its reporting entities.
  - With more than 1,900 reporting entities (e.g., school districts in California), CalSTRS' Audit Services would have a 48-year audit cycle given its current-year audit plan to perform 40 audits per year.
  - Given that 40% of past audits conducted by CalSTRS had findings related to pension spiking, conducting more audits could detect additional instances of pension spiking.

- As of October 2011, CalSTRS' did not renew the services of an audit contractor to assist in performing pension spiking reviews. This further has diminished CalSTRS' ability to complete audits. As of September 2011, CalSTRS had a backlog of 33 uncompleted audits.
2. Our review of the five reporting entities, three school districts, one community college district, and one county office of education, disclosed that two of the five reporting entities reviewed, or 40%, lacked transparent processes and sufficient internal controls over pay increases. Increases were granted without written board or executive approval, written performance evaluations, or similar justifications. The lack of sufficient internal controls and transparency made it impossible for us to conclude whether pension spiking existed at these entities.
  3. CalSTRS uses electronic intelligence methods to identify potential spiking, but needs to fully utilize and refine the information it is assessing. Our review disclosed that CalSTRS did not review or verify the results of electronic "edits" they put in place to specifically identify potential pension spiking except when there was an occasional inquiry from other CalSTRS divisions.

### **Views of Responsible Officials**

We issued a draft report on July 17, 2012. Jack Ehnes, Chief Executive Officer, responded by letter dated July 26, 2012 (Attachment), not disagreeing with the findings and agreeing with the recommendations. The final report includes CalSTRS' response.

### **Restricted Use**

This report is intended for the information and use of CalSTRS and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

*Original signed by*

JEFFREY V. BROWNFIELD  
Chief, Division of Audits

September 5, 2012



# Findings and Recommendations

**FINDING 1—**  
***CalSTRS did not provide adequate oversight of reporting entities it should be monitoring and its audit process should have been more effective in detecting pension spiking at its member entities***

Our review determined that CalSTRS' Audit Services does not provide adequate oversight of reporting entities (e.g., school districts) it should be monitoring. In addition, even though we noted that Audit Services' audit objectives when conducting audits of its reporting entities contains a pension spiking objective, that is not the primary focus of its audits.

Several factors contributed to the lack of adequate oversight, including:

- The loss of a significant CalSTRS audit management employee
- The failure of Audit Services to effectively use its own auditors
- Use of an audit contractor to do fieldwork rather than using CalSTRS audit staff
- Disincentives within its contract arrangement with its most recent audit contractor
- A large number of unfinished audits

Furthermore, the current CalSTRS audit cycle only provides for an audit of a reporting entity on an average of once every 48 years.

During the review period, the previous Audit Chief left her position in early February 2011. Her exit left Audit Services with only interim management until October 2011, when CalSTRS appointed a new Audit Chief. Thus, from February 2011 until October 2011, CalSTRS audit staff had little guidance. Examples of the lack of guidance include:

- The audit plan for fiscal year (FY) 2010-11 did not appear to be fully implemented. During FY 2010-11, CalSTRS conducted 30 audits when, in previous years, CalSTRS was performing 45 audits per year.
- The audit plan for FY 2011-12 was not developed and adopted until September 2011, shortly before the new Audit Chief was hired in October 2011.

Audit Services does not appear to use its audit employees effectively or have duty statements that are commensurate with employees' actual functions. Currently, Audit Services has nine lead auditors. An analysis of their job duty statements disclosed that their time is spent as follows:

- 50% Conducting audits
- 40% Acting as a team leader or directing other subordinate auditors
- 5% Performing other duties as requested by supervisor
- 5% Attending external/internal training conferences to enhance knowledge and competencies

The scope of our review did not include a review of the auditors' actual job duties (i.e., how much time was actually spent on each of the above functions). However, because there is only one subordinate auditor, we can only conclude that the nine lead auditors are performing other activities, or that their job duty statements are incorrect, because 40% of their time is to be spent on acting as a team leader or directing subordinate auditors. In either case, this situation indicates poor oversight over the auditors' daily activities. Based on our review, we noted that there were inefficiencies occurring during our review period in Audit Services.

Our review disclosed that during the review period, Audit Services contracted with an outside audit firm, Mayer Hoffman McCann P.C. (MHM), to perform audit services, including fieldwork, for CalSTRS. CalSTRS relied heavily upon the firm as the firm performed the field work for 92 of 120, or 77%, of the pension spiking CALSTRS audits during the three-year period of our review, July 1, 2008, through June 30, 2011.

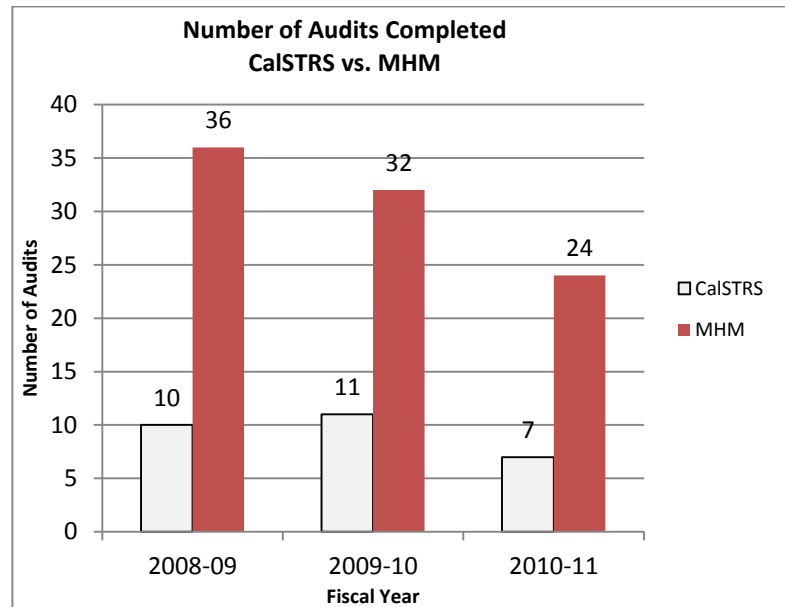
Our review of the audit contract between CalSTRS and MHM disclosed that the contract arrangement created a disincentive for MHM to fully identify problems, such as pension spiking.

- CalSTRS used an “agreed-upon procedures” type of audit services contract, that does not allow flexibility in audit testing, and the contractor’s budget was for a fixed fee of \$14,000 per engagement.
- When the contractor identified problems within each engagement, specifically, the existence of pension spiking, the contractor was required to request approval from CalSTRS before expanding their testing to possibly identify more spiking. However, the contract did not provide for any additional funding to the contractor. Consequently, the contractor had no fiscal incentive to incur additional time and expense without an associated increase in their budget.

CalSTRS and the contractor performed and completed 120 audits during the review period. Of the 120 audits, 48 audits, or 40%, had findings related to pension spiking. This illustrates that CalSTRS was relying on the firm to detect pension spiking while, at the same time, limiting the contractor’s ability to detect such spiking with a fixed fee “agreed-upon procedures” audit approach. We could not ascertain if additional pension spiking would have been disclosed if the contract was not for a fixed fee.

During our analysis of the audits completed in recent years, we noted that CalSTRS issued 40 audits on average per year under its letterhead. Of these 40 audits, 30 were based on fieldwork conducted by the firm and the other 10 audits were based on fieldwork performed exclusively by CalSTRS auditors.

The table below depicts the number of audits completed by CalSTRS and MHM by fiscal year for the review period:



We question CalSTRS' ability to continue to maintain the 40 audits per year average, based on the following:

- CalSTRS no longer engages a contractor to perform the majority of the fieldwork.
- Each Audit Services auditor did sufficient fieldwork to issue, on average, only one audit per year. The audit services for the FY 2011-12 work plan includes 33 audits carried over from prior years in addition to 20 or more new audits, for a total of at least 53 audits. This work plan commits Audit Services to complete 45 audit reports in FY 2011-12. Assuming Audit Services is able to complete these 45 audit reports in the fiscal year, at least 8 reports would be carried over to the subsequent fiscal year. Without additional staffing or hiring another contractor, and in light of prior history, we question Audit Services' ability to meet its current audit work plan commitment to complete 45 audits. As discussed in Finding 2, at this rate, each school district would be audited only once every 48 years.

The SCO wants to recognize that, during the review, CalSTRS was implementing a new stand-alone Compensation Review Unit that is charged specifically with detecting pension spiking activity. This unit will allow audit resources to be used on more audits or other tasks. However, this unit's implementation will not fully alleviate the necessity for additional staffing to provide adequate oversight of the entities reporting to CalSTRS.

### Recommendation

Our review disclosed that, since the inception of our review, CalSTRS has taken positive steps to improve its audit processes; however, further improvements should be implemented to identify additional potential pension spiking.

The SCO recommends that CalSTRS:

- Increase the frequency with which its reporting entities are audited by increasing the number of audits Audit Services completes each year.
- Continue to use a risk-based analysis and other evidence-based criteria to identify which reporting entities to audit. This analysis should be used to determine the number of entities that should be audited each year as well as the resources needed to properly provide program oversight.
- Perform an analysis to determine if additional audit resources are needed in order to provide adequate oversight of the entities reporting to CalSTRS.
- Review and analyze the Teachers' Retirement Law for any necessary clarifications or enhancements to allow CalSTRS to provide better oversight over its member entities.

### CalSTRS's Response

CalSTRS concurs with the State Controller's Office (SCO) recommendations that employer audit efforts should be strengthened. CalSTRS agrees that the agreed upon procedures required of the prior contractor were limited. However, CalSTRS auditors retained lead responsibility for audit planning and sample selection, expanded audit testing, audit report issuance, and appeal defense for the 120 completed audits. As of April 2011, employer audits are performed solely by Audit Services. CalSTRS further agrees that 48 of the 120 completed audits reported non-compliance findings; however, only 26 of the 120 audits (22%), had findings related to 'pension spiking' as defined in the SCO report.

### SCO's Comment

CalSTRS did not disagree with our findings and agreed with our recommendation.

While we agree that 48 of the 120 completed audits reported non-compliance findings, all 48 had findings related to pension spiking. Our analysis of the 48 reports disclosed that 26 reports had findings related to pension spiking and 22 had findings related to potential pension spiking. Had the potential pension spiking issues not been corrected that they would fall into our definition of pension spiking. Therefore, our report remains unchanged.

**FINDING 2—  
CalSTRS missed  
opportunities to increase  
member entities'  
accountability by  
reducing instances of  
suspicious or unjustified  
salary increases (i.e.,  
pension spiking)**

We selected the five reporting entities to review after evaluating an internal risk analysis document prepared by Audit Services. That analysis ranked the reporting entities by level of risk for pension spiking. For each of the five entities tested, we obtained a list of all CalSTRS member retirements during the five-year period reviewed and then judgmentally selected samples from different types of employees: executives, administrators, teachers, and non-certificated employees.

The SCO conducted its own independent review of the five reporting entities with the primary objective of determining whether the entities reported accurate and complete contribution data for all qualified CalSTRS members based on each eligible member's creditable service and creditable compensation.

We evaluated pay increases granted prior to retirement and assessed whether the increases were adequately approved, justified, and documented. The five entities were:

- Pajaro Valley Unified School District
- San Francisco Unified School District
- Foothill-De Anza Community College District
- Los Angeles County Office of Education
- San Diego Unified School District

Our procedures included:

- A cursory review of certificated employees' salaries. These employees' compensation is governed by bargaining unit agreements. Therefore, we considered the risk of pension spiking to be low.
- For each retired employee reviewed, we calculated the percentage of salary increase between the salary of the last year worked prior to retirement and the salary of the second-to-last year worked.
- We reviewed each selected employee's personnel file, if available, and other source documents, such as board approvals, salary schedules, performance evaluations, and employment contract provisions, to verify whether the salary increase was justified, supported, and properly documented.

If the increases were not approved nor justified, we concluded that the increases were indicative of pension spiking and that the entity lacked sufficient internal controls to deter spiking.

Our review disclosed that, for two of the five entities we reviewed, or 40%, instances existed in which the pay increases lacked documentation, such as board or executive approval, written performance evaluations, or similar justifications. The two districts were the San Francisco Unified School District and the San Diego Unified School District. Overall, we concluded that both districts lacked the level of transparency over pay increases that a public entity should exercise on behalf of its constituents.

The SCO's 40% exception rate is consistent with the exception rate determined by CalSTRS' Audit Services and its contractor; yet, CalSTRS and its contractor conducted only 120 audits in the past three years, a very small number, considering that there are 1,938 reporting entities in California. Again, at that rate, a school district would be audited only once every 48 years.

Our review disclosed that, at the San Francisco Unified School District and the San Diego Unified School District, large salary increases occurred and were not approved or justified by the school district.

In some cases, increased salaries were approved without transparency in an open forum, lacked proper documentation, and were not properly justified.

In many instances, the salary increases at both districts appear to have been granted in closed-session board meetings with no subsequent minutes or other explanation for the increases. While we understand that personnel matters often are conducted in closed-session board meetings, we would expect a salary increase to be justified with a performance evaluation, assessment, or other type of written documentation, especially when the increase occurs shortly prior to retirement.

For instance, at the San Diego Unified School District, we repeatedly requested supporting documents so that we could make determinations regarding whether the employees were properly appointed to their positions or whether they were placed at the appropriate pay levels. The district indicated that the supporting documents we requested were missing from the files. Subsequently, we requested alternative methods to support the requested documents. The district indicated that it did not have any other support documentation available.

We noted that the district did not maintain point-of-origination documentation to substantiate a Personnel Action Request in personnel files such as:

- Board of Education appointment notifications
- Superintendent approval of salary placement
- Salary protection approvals
- Complete personnel agreements
- Employee salary placement notification letters

At the San Francisco Unified School District, we identified 15 executives or managers who received pay increases that collectively averaged 6% in the year proceeding their retirements. Although that rate may not seem excessive, we noted that rank-and-file employees were experiencing furloughs and pay cuts at this same time. One executive received a 26% increase six months prior to retirement, and another executive received a 20% increase one year prior to retirement. In each of these examples, the district did not use or maintain employment agreements or contracts delineating positions, compensation amounts, or terms of service prior to 2009. Without proper supporting documentation, we were not able to confirm the accuracy of the compensation due employees or if the compensation was justified.

At the San Diego Unified School District, we could not assess \$3.2 million in salaries granted to 29 managers. We originally requested to review 56 employee management files representing \$6.4 million in salaries for the period of July 1, 2006, through June 30, 2011.

After our repeated requests and the district's attempts to locate the documentation and/or personnel files to support these salaries, the district indicated that the files could not be located. In addition, the district indicated that it could not provide any alternative method to determine if the salaries for these 29 of 56 employee files, or 52%, which represented \$3.2 million in salaries, were properly approved and justified.

Therefore, we were unable to confirm the accuracy and validity of these salaries. As the district lacked transparency, we could not determine if these salaries were an attempt to conceal any pension spiking issue.

This lack of transparency in justifying pay increases and the failure to maintain adequate supporting documents, coupled with the small number of audits that CalSTRS completes each year, creates an environment where pension spiking may easily go undetected. These missed opportunities show that CalSTRS needs to improve its oversight and monitoring of its reporting entities.

#### Recommendation

CalSTRS needs to increase the number of audits it performs to minimize missed opportunities in identifying pension spiking issues. To accomplish this increase, CalSTRS should conduct a comprehensive analysis of its entities and maximize its use of all electronic tools and data available, along with the results from its newly formed Compensation Review Unit.

This process will facilitate identifying additional efficiencies in performing its audits and determine any additional resources that may be required. CalSTRS should then be in a better position to perform its audit function.

#### CalSTRS's Response

CalSTRS concurs with the SCO's recommendations that employer audit efforts should be strengthened and would refer to the Finding 1 listing of actions taken by CalSTRS since June 30, 2011. CalSTRS would note that the San Francisco Unified School District and the San Diego Unified School District are 2 of the 60 employers ranked as 'high risk' in Audit Services Fiscal Year 2012-13 employer audit risk assessment. As outlined in Audit Services FY 2012-14 Employer Audit Plan, employers are selected for audit utilizing the risk assessment, with a focus on high-risk employers.

#### SCO's Comment

CalSTRS did not disagree with our findings and agreed with our recommendation.

CalSTRS agrees that both the San Francisco Unified School District and the San Diego School District posed a high risk for pension spiking. The fact the SCO was able to review these two entities in a short amount of time, were found to have considerable potential spiking issues, and were not previously audited by CalSTRS, exemplifies that CalSTRS has not provided adequate oversight of its reporting entities, as noted in Finding 1.

We acknowledge CalSTRS' current efforts intent to address their oversight; however, we strongly recommend a full audit to further develop and quantify our findings at these two school districts.

**FINDING 3—  
CalSTRS has electronic  
intelligence that  
indicates potential  
pension spiking but only  
recently began using this  
information**

Our review disclosed that CalSTRS did not review or verify the results of electronic edits they put in place to specifically identify potential pension spiking, except when there was an occasional inquiry from other CalSTRS divisions.

CalSTRS has had in place electronic “edits” that specifically are related to the detection of pension spiking. These edits identify instances in which employees’ monthly pay increases exceeded a certain percentage or where employees’ “special compensation” exceeds a set dollar amount in one year.

Our review of these electronic edits determined that they are valuable tools with which CalSTRS can identify potential spiking and increase the accountability of the reporting entities, particularly if used in conjunction with existing audits and its newly formed Compensation Review Unit. The edit tools went unused for years and, as a result, CalSTRS likely left undetected numerous instances of pension spiking overpayments.

In December 2011, we recommended to CalSTRS Member Services that these edits warranted ongoing and more thorough reviews and verifications. Member Services agreed with our assessment and subsequently began to review 100% of the exceptions identified by these edits, and to seek explanatory information from the responsible reporting entities.

In many instances, the reporting entities either corrected the exception or provided CalSTRS with supporting information that justified the exception. If the entities could not provide an adequate explanation, the exceptions were referred to CalSTRS’ Compensation Review Unit for further review.

As discussed in Finding 2, CalSTRS uses a risk-based analysis to identify entities to be audited, but has resources to conduct only about 40 audits each year. We believe that the profile of pension abuses identified during these audits, along with the information CalSTRS learns from using the electronic edits, will prove valuable in refining and focusing



both the audits and the edits. It is too early to assess whether the percentage of monthly pay increases or the amount of "special compensation" deemed excessive are thresholds that are too high or too low, but we encourage CalSTRS to periodically evaluate these to maximize the edit's effectiveness.

#### Recommendation

CalSTRS should continue with our recommendation to review and verify the result of their existing pension spiking edits. In addition, they should refine and focus both audits and edits by using the information gathered during its audits, electronic edit information, and information collected by its Compensation Review Unit.

#### CalSTRS's Response

CalSTRS concurs with the recommendation that edits identifying potential pension spiking warrant a 100% review. CalSTRS has taken the following actions to ensure the review. Prior to these enhancements, CalSTRS agrees that staff's review was not well documented and 100% review could not be assured. . . .

CalSTRS also concurs that the compensation thresholds should be routinely reviewed and adjusted based upon economic conditions and employer practices. In May 2012, thresholds were changed reflecting lower salary growth. Future review will coincide with the results of actuarial valuations. . . .

The CRU, in collaboration with Audits Services and Member Account Services, is providing valuable resources to help identify and deter pensions spiking. The ongoing collaborative effort aided by referral processes has strengthened our ability to address pension spiking concerns.

#### SCO's Comment

CalSTRS did not disagree with our findings and agreed with our recommendation. We acknowledge CalSTRS' current efforts to address our recommendations.

**Attachment—  
CalSTRS's Response to  
Draft Audit Report**

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Jack Ehnes  
Chief Executive Officer

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July 26, 2012

Jeffrey V. Brownfield  
Chief, Division of Audits  
State Controller's Office  
P.O. Box 942850  
Sacramento, CA 94250-5874

Dear Mr. Brownfield:

Thank you for the opportunity to provide comments on your July 17, 2012, draft report concerning "Pension Controls and Mechanisms." As fiduciaries, we are responsible for protecting the financial integrity of the Teachers' Retirement Fund and welcome any suggestions to improve controls to achieve full compliance by our reporting employers with the pension law. I believe you will find our detailed actions fully responsive and underscore our organizational commitment to addressing the issues you have identified.

This report focused on "pension spiking" which is an abusive practice that has become a cornerstone of reform in the Governor's 12-point pension reform proposal. Spiking can take different forms across pension plans in the public and private sectors depending upon the plan's rules for crediting compensation; but in any form, it unduly drains resources that were not legitimately earned through career contributions.

Specific to CalSTRS, readers of this report should also understand that our benefit structure has some significant differences from other public pension systems that minimize, but do not entirely eliminate, the opportunity for pension spiking. First and foremost, the vast majority of CalSTRS 429,600 active members work under structured salary schedules and contracts that simply do not lend themselves to discretionary raises. Secondly, in an effort to proactively mitigate the potential for pension spiking, CalSTRS restructured its plan design in 2002 to incorporate a hybrid retirement structure consisting of defined benefit, cash balance, and defined contribution plans. The cash balance component of the CalSTRS hybrid plan, also known as defined benefit supplement, captures "overtime" or other earnings that would tend to spike a pension and places these earnings in an account separate from the primary defined benefit plan. This very important safeguard ensures that the underlying defined benefit pension is not inflated by additional assignments or unusual compensation. And finally, CalSTRS plan design does not allow for unused accumulated leave and other one-time payments to factor into the final compensation figure which is used to calculate our members' defined pension benefit.

**Our Mission:** *Securing the Financial Future and Sustaining the Trust of California's Educators*

Jeffrey V. Brownfield  
July 26, 2012  
Page 2

CalSTRS is reliant on the accurate reporting of compensation and service data from nearly 1,600 employers throughout the state. It was long ago recognized that there were far too many reporting errors coming into CalSTRS which impacted the accuracy of pension calculations. As a result, CalSTRS began work on the Employer Reporting Project (ERP), a significant effort that began in 2007 and is now in full production. The Employer Reporting Project has led to a sharp reduction in employer reporting errors and is referenced in our response to the findings. Following the conclusion of that project, CalSTRS formed a special internal task force in 2011 which identified a number of actions that could be taken to reduce spiking. Many of those process changes have been identified in your report, and our resulting actions are detailed in our response.

In late 2011, CalSTRS formed a dedicated Compensation Review Unit (CRU) with seven full-time staff to closely monitor individual cases to determine if compensation changes resulted in pension spiking. In addition, a toll-free Pension Abuse Reporting Hotline and online reporting form were created as a resource for parties to report potential pension spiking incidents. Since its inception, the CRU has identified nearly 270 cases which indicated additional investigation would be necessary; to date, 175 cases have been completed. Of those 175, 28 cases have been determined to be instances of pension spiking and are now in the adjudication and appeals process afforded under the law to members. Relative to the employer audits program, you will see substantial changes documented in the attachment including the strengthening of the program's leadership team and strong efforts to document processes. One of the key findings of the review questioned the value of contracted audit services as well as the relative number and timeliness of completed audits. Employer audits are now performed solely by Audit Services and a second employer auditing unit has been established. In addition, we will be requesting additional audit resources in the next budget cycle.

Apart from making these various changes over the past 18 months, we strongly believe in reassessing our progress going forward. Our board's Audit and Risk Management Committee will receive recurring progress reports on our compliance.

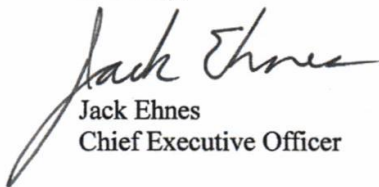
In closing, it's important to reiterate that the current processes of using electronic edits, follow-up on hotline tips, and employer audits are all important and worthwhile actions that can reduce spiking. However, although those actions are undertaken with the laudable intention of reducing waste, they do involve the expenditure of extensive resources. Spiking has been tackled successfully in many states through forceful legislation that imposes strict limits on compensation. We have provided our input over the past several years regarding improvements that can be made in public policy and law that would provide even greater certitude that this behavior is curtailed. We are committed to continuing our administrative approaches to combat spiking, but we also recognize that a more cost effective approach could be realized by legislation that sets hard and fast limits on compensation that can be treated as pension eligible.

Jeffrey V. Brownfield  
July 26, 2012  
Page 3

CalSTRS takes pension spiking very seriously. We are focused upon ensuring our members receive secure retirement incomes that appropriately reflect the service they provide to the state's students. The CalSTRS CRU and Audits Services teams are dedicated to thoroughly and deliberately reviewing any suspected instances of spiking before changing a member's pension benefit. Most importantly, in cases where spiking has been determined, CalSTRS responds by reducing benefits to the appropriate level and collecting overpayments in a manner consistent with the law.

We are moving forward with the actions detailed in our attached comments as well as encouraging legislative actions within the pension reform proposals that can provide a stronger compliance environment.

Sincerely,



Jack Ehnes  
Chief Executive Officer

cc: Teachers' Retirement Board

Attachment



**Response to State Controller's Office Draft Report dated July 17, 2012**

**Finding 1 – CalSTRS response:**

CalSTRS concurs with the State Controller's Office (SCO) recommendations that employer audit efforts should be strengthened. CalSTRS agrees that the agreed upon procedures required of the prior contractor were limited. However, CalSTRS auditors retained lead responsibility for audit planning and sample selection, expanded audit testing, audit report issuance, and appeal defense for the 120 completed audits. As of April 2011, employer audits are performed solely by Audit Services. CalSTRS further agrees that 48 of the 120 completed audits reported non-compliance findings; however, only 26 of the 120 audits (22%), had findings related to 'pension spiking' as defined in the SCO report.

Since June 30, 2011, the end of the SCO's review period, CalSTRS has taken the following actions:

- Audit Services issued a total of 32 final employer audit reports, which included Los Angeles Unified School District, and 6 draft audit reports for the Fiscal Year 2011-12.
- Audit Services completed its FY 2012-13 employer audit risk assessment, which identified 60, 510, and 789 high, medium, and low-risk employers, respectively. As outlined in Audit Services FY 2012-14 Employer Audit Plan, employers will be selected for audit utilizing a risk assessment model, with a focus on high-risk employers.
- A reorganization of Audit Services was completed, which resulted in the creation of a second employer audit unit. CalSTRS will continue to assess the need for additional audit resources to mitigate the risk of non-compliance by reporting employers.
- An Audit Manual was prepared and issued to Audit Services staff. Training on the Audit Manual and electronic audit working paper software was provided to all staff. In addition, Audit Services is in the process of updating employer audit programs and tools to increase the effectiveness and efficiency of employer audits.
- With the staffing of the Compensation Review Unit (CRU) in December 2011, the CRU and Audit Services teams developed internal processes that have resulted in the sharing of employer information and regular analyses on an ongoing basis.
- CalSTRS will continue its efforts to educate stakeholders and policymakers and seek legislative opportunities to ensure a financially sound retirement system.

**Finding 2 – CalSTRS Response:**

CalSTRS concurs with the SCO's recommendations that employer audit efforts should be strengthened and would refer to the Finding 1 listing of actions taken by CalSTRS since June 30, 2011. CalSTRS would note that the San Francisco Unified School District and the San Diego Unified School District are 2 of the 60 employers ranked as 'high risk' in Audit Services Fiscal

**Response to State Controller's Office Draft Report dated July 17, 2012**

Year 2012-13 employer audit risk assessment. As outlined in Audit Services FY 2012-14 Employer Audit Plan, employers are selected for audit utilizing the risk assessment, with a focus on high-risk employers.

**Finding 3 – CalSTRS Response:**

CalSTRS concurs with the recommendation that edits identifying potential pension spiking warrant a 100% review. CalSTRS has taken the following actions to ensure the review. Prior to these enhancements, CalSTRS agrees that staff's review was not well documented and 100% review could not be assured.

- Changes were made to the employer reporting process beginning in December 2008 with the Secure Employer Website to improve the accuracy of employers' contribution reporting. As a result, the edit exception rate has been reduced from 6.03% to 0.17%, a 97% reduction, greatly improving the reliability of employer reported contribution data.
- In April 2012, additional enhancements were made that aid staff in reviewing these edits including required annotations by the employer indicating the nature of the compensation.
- With these enhancements, staff are now reviewing 100% of the edits that assist in identifying potential pension abuse.
- CalSTRS promulgated regulations enforcing penalties and interest charges for late contributions and reporting to improve the timeliness of employer reporting that became effective July 1, 2012.

CalSTRS also concurs that the compensation thresholds should be routinely reviewed and adjusted based upon economic conditions and employer practices. In May 2012, thresholds were changed reflecting lower salary growth. Future review will coincide with the results of actuarial valuations.

CalSTRS took several actions prior to this report to address pension abuse. Among those actions are the following:

- In December 2010, CalSTRS convened an internal, cross functional task force of business experts to explore options in addressing pension abuse.
- CalSTRS initiated discussion with the Teachers Retirement Board in February 2011 regarding CalSTRS efforts to curb potential pension abuse.
- Three subsequent presentations were made to the Benefits and Services Committee and Board with a final presentation in September 2011 sharing the pension abuse task force recommendations and acknowledging the establishment of the Compensation Review Unit.
- Pension Abuse Hotline and Online Referral processes prominently displayed in our 'Contact Us' page on CalSTRS.com in September 2011.
- Automated tools were developed to query the corporate database for potential pension abuse cases.

**Response to State Controller's Office Draft Report dated July 17, 2012**

- Compensation Review Unit (CRU) was formed in September 2011 and fully staffed by December 2011. In addition, the Pension Abuse Reporting Hotline and online referral form were created in September 2011 to provide resources for employees and the general public to confidentially and securely report suspected instances of pension spiking.

The CRU, in collaboration with Audits Services and Member Account Services, is providing valuable resources to help identify and deter pension spiking. The ongoing collaborative effort aided by referral processes has strengthened our ability to address pension spiking concerns.



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