



Audits & Risk Management Committee

Item Number 3 – Open Session

Subject: Progress Report on the 2020 Independent Auditor’s Report on Internal Control Over Financial Reporting and Management Letter

Presenter(s): Chairperson

Item Type: Consent Information

Date & Time: March 5, 2021 – 0 minutes

Attachment(s): Attachment 1 – Progress Report on Implementation of Recommendations

PowerPoint(s): None

PURPOSE

The purpose of this item is to provide a status report on management’s progress towards implementing the recommendations included in the Independent Auditor’s Report on Internal Control Over Financial Reporting and Management Letter, dated October 22, 2020.

DISCUSSION

As part of the audit of CalSTRS’ financial statement for the fiscal year ended June 30, 2020, Crowe LLP cited five deficiencies of internal control. One significant deficiency was within the Independent Auditor’s Report on Internal Control Over Financial Reporting, four deficiencies were in the Management Letter, and all included recommendations to improve controls over financial reporting. The Audits and Risk Management (ARM) Committee reviewed both the Basic Financial Statements including, the Independent Auditor’s Report on Internal Control Over Financial Reporting and the Management Letter at the November 2020 meeting.

During an audit, the auditor may become aware of deficiencies in internal controls while obtaining an understanding of the entity and its control environment. A deficiency in internal controls exists when the design or operation of a control does not allow for management or staff, in the normal course of performing their assigned functions, to prevent, detect and correct misstatements on a timely basis. Any material and significant deficiencies are included in the Report on Internal Control over Financial Reporting. Otherwise, deficiencies that are not considered significant or material are included in a Management Letter, which is not required to be reported to the board by

the auditor. However, to promote transparency, CalSTRS' management presents the management letter, and updates on progress, to this committee. Overall, management is responsible for the design and implementation of internal controls over financial reporting.

Audit Services provides a status report (Attachment 1) that summarizes the deficiency and management actions towards implementing the recommendations. The committee will receive another status report at the July 2021 meeting to monitor the status of the findings before the next financial statement audit. Annually, the independent financial statement auditor, Crowe LLP, validates implementation of management's corrective actions and report the status to the Committee at the November 2021 meeting.

Independent Auditor’s Report on Internal Control Over Financial Reporting – Progress Report as of January 2021

Recommendation	Original Management Response to Recommendation	Current Status of Implementation
<p>Finding 2020-001 Significant Deficiency – Internal Control over Reporting Fair Value and Fair Value Hierarchy (Level) of Certain Private Equity Co-Investments</p> <p>Crowe recommends management re-evaluate its policies over fair value measurements for private equity co-investments to ensure they are properly valued using appropriate valuation methods, considering materiality, including both quantitative and qualitative factors in its assessment. Management should reconsider the design and/or operating effectiveness of internal control over fair value measurements to appropriately evaluate each new alternative investment and the appropriate method to assess fair value in accordance with GAAP.</p> <p>Private equity co-investments grew from approximately \$2 billion at June 30, 2019 to approximately \$3 billion at June 30, 2020 and as the portfolio continues to grow and change, we recommend management re-review its policies and internal controls over fair value measurements to support the preparation and fair presentation of investments within the financial statements.</p>	<p>CalSTRS recognizes the importance of a strong internal control structure to ensure the fair value measurement of investments, and the related disclosure of the methods used for those measurements within the fair value leveling hierarchy, are presented in the financial statements in accordance with Generally Accepted Accounting Principles. Although management currently maintains a robust internal control structure over these measurements and the associated disclosures, we agree with this finding and acknowledge improvements can be made to the related internal control process.</p> <p>Management will re-evaluate and modify, where necessary, its policies and procedures over fair value measurement for private equity co-investments, to ensure they are properly valued using appropriate valuation methods when determining fair value and the associated leveling hierarchy in accordance with GAAP. In doing so, management will consider the various qualitative and quantitative factors including the cost and potential benefits of various valuation approaches.</p> <p>Also, it should be noted that this deficiency has no impact on the reported performance returns or performance calculations used in the determination of incentives for statutory positions for the 2019-20 plan year.</p>	<p>Management is evaluating the current policies and procedures for fair value measurement and reporting of all private asset investments (including private equity co-investments), to identify and mitigate gaps in internal controls. This effort will include enhancement of controls to ensure each private asset is evaluated before establishing its leveling in the fair value hierarchy disclosures. We expect to complete this internal effort by June 30, 2021.</p> <p>Additionally, the CalSTRS Private Equity team has engaged an independent valuation firm to review valuation information CalSTRS receives from its partners for certain private equity co-investments, provide an independent opinion on the valuation of the investments, and in certain instances perform an independent valuation of the investments. We expect to complete this effort by March 2021 for all investments identified and reviews will continue quarterly thereafter.</p> <p>Finally, to complete this effort, management will engage a third-party consultant to evaluate and document CalSTRS overarching framework and processes for fair valuing and reporting all private asset investment types and provide recommendations to CalSTRS for improvements to align with industry best practices. We expect to complete this effort by December 2021.</p>

Independent Auditor’s Management Letter - Progress Report as of January 2021

Recommendation	Original Management Response to Recommendation	Current Status of Implementation
<p>Active Member Data – Completeness and Accuracy (Repeat Finding)</p> <p>Due to the reliance on the contributing entities for the completeness and accuracy of active member data, it is probable that there will continue to be errors in reported data.</p> <p>Crowe recommends that management continue to enhance its internal controls through development and/or improvement of data analytics to identify data anomalies and potential systemic errors based on historical experience, modify employer training strategies to improve effectiveness of training resulting in fewer reporting errors and continue to focus on employer readiness for the implementation of Benefit Connect, which includes functionality and file format regulations intended to reduce errors in reporting and provide immediate feedback to employers regarding potential errors upon submitting their contribution data. Management’s evaluation of potential improvements should always consider the cost/benefit of any new enhancements related to the risk of incorrect member data.</p>	<p>Management continues to improve in the areas mentioned in the recommendation. In FY19-20, CalSTRS developed a new online curriculum of computer-based training modules that focus on core employer reporting concepts and include information about common reporting errors and feedback we receive from the just-in-time education provided to the employer, post-audit. Employer staff can take the computer-based training on-demand, allowing them more access to education in parallel with our legacy in-person or webinar training curriculum that we continue to deliver. Each training method CalSTRS offers involves a post-training assessment to gauge the effectiveness of the training.</p> <p>CalSTRS also developed and delivered an online curriculum for new system training in preparation for BenefitConnect implementation. CalSTRS will meet with all 90+ report sources (56 completed to date covering employers that submit 90% of annual member contribution data) to introduce them to the new system, demonstrate the available computer-based training, and allow them access to the Employer Readiness Environment where they can apply the knowledge they gain from the training modules to practice reporting against the test environment with converted production data. In the first half of 2021, CalSTRS will determine if these reporting entities need additional training specific to their needs after they complete the online curriculum.</p>	<p>Management continues to maintain regular contact with employers to identify educational opportunities that increase knowledge of reporting solutions to common reporting errors.</p> <p>We conduct regular and consistent communications with report sources and individual report units to clarify reporting questions, establish training opportunities for new and existing payroll staff, and strengthen CalSTRS’ relationships with our employer partners.</p> <p>The identification of unexpected reporting continues to be a focus across CalSTRS. Management continues to review and refine strategies to improve member data accuracy. Regular interaction with employers ensures that employers have appropriate and timely information.</p> <p>In July 2020, Member Account Services (MAS) Training Services developed a series of computer-based trainings (CBT) for employers on the most important reporting topics so they can self-serve. These CBTs include the following fundamental topics: Creditable Service, Defined Benefit Membership, Creditable Compensation, Defined Benefit Reporting Requirements, Unused Sick Leave, Working after Retirement, and the Reduced Workload Program. By December 2020, 50 employers took the CBTs. Each CBT offers a post-training assessment to gauge the effectiveness of training. The assessments show that employers have a good understanding of the concept of each CBT topic.</p>

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	<p>With the introduction of BenefitConnect in FY21-22, we will explore its new functionality and reporting capabilities to continue to increase our ability to analyze the data that employers submit and will explore other technology that allows for analysis of large data sets, such as the millions of contribution data lines we receive each year.</p> <p>CalSTRS also maintains regular contact with our employer partners and conducts periodic conferences with report sources to discuss any outstanding reporting questions, assess potential training opportunities and continue to strengthen the relationships with the employer staff responsible for reporting member data.</p> <p>Finally, management continues to explore and improve our regression models to enhance the trending capabilities within our systems to identify systemic errors and improve the accuracy of member data. The identification of unexpected results and improving the quality of active member data will be ongoing and the results will continue to be communicated to all impacted parties. With the partnership between Member Accounts Services and the Financial Services Branch, these unexpected results are discussed and ideas for improvements are explored and implemented, if feasible.</p>	<p>These CBTs supplement “in-person” training (which continues to occur during this period of working remotely and will likely continue to occur when we reduce remote work as the virtual training sessions have been well-received) and are not meant to replace it. CalSTRS is focused on exploring and providing new methods and vehicles for delivering this training.</p> <p>Specifically, in FY 20-21, MAS Training Services also increased employer training quarterly while working remotely. Staff delivered 4 webinars quarterly to educate employers on reporting laws and their reporting responsibilities to CalSTRS. The topics include Creditable Service, Defined Benefit Membership, Creditable Compensation, Defined Benefit Reporting Requirements, Unused Sick Leave, Working after Retirement, and the Reduced Workload Program.</p> <p>The CBTs are available in a learning management system (LMS) currently in use for Pension Solution training materials. There are also 24 Pension Solution CBTs available in the LMS for employers in preparation for new SEW implementation. Through Pension Solution project activities, the LMS has been marketed and advertised well to employers, increasing the future rate of employer adoption as CalSTRS publishes more non-project training on the LMS.</p> <p>As the Agency approaches the release of Benefit Connect and the new Secure Employer Website, Management has increased outreach efforts with employers to increase their preparedness to utilize the new system and its additional analytical capabilities and to provide additional training.</p>

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		<p>In September 2020, MAS Training Services also developed the Employer Onboarding Resources Checklist. The checklist outlines the most critical and relevant information and resources for new employers to increase their confidence to submit accurate data. The checklist includes, among other topics, resources such as the Teachers’ Retirement Law, CalSTRS Directives and Publications, the Employer Support Portal and online trainings available in the LMS.</p> <p>Staff have refined the process for the periodic review and examination of Employer Approved Edits, the contribution data values that are flagged in the system and then approved by the employer prior to submission. MAS will be reviewing these more frequently in preparation for more timely analysis of these contribution data values that trigger similar employer action (Employer Suppressed Warnings) in the new Secure Employer Website.</p>
<p>Medicare Premium Payment (MPP) Program Census Data (Repeat Finding)</p> <p>Crowe recommends CalSTRS develop a system of internal control over the completeness and accuracy of the census data of all “eligible” participants of the MPP Program consistent with the program’s eligibility requirements, including the process by which CalSTRS external actuary determines the population of potentially “eligible” participants.</p>	<p>The determination of member eligibility for the MPP Program is complex and can be challenging to assess for a variety of reasons. However, even if the MPP Program is closed to new entrants for members whose retirement date is on or after July 1, 2012, it is possible for members to enroll into the program today due to the fact current law allows members, in some situations, to back-date their retirement to a date prior to July 1, 2012. In some other instances, some members have also been enrolled as a result of a member filing a successful</p>	<p>Management is reviewing its procedures and is planning for the next actuarial experience study that will consider Crowe’s comments on the MPP Program.</p>

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	<p>legal appeal that subsequently granted them eligibility to the MPP Program. CalSTRS is aware of these situations. To account for this possibility, the MPP program actuarial assumptions that were adopted by the CalSTRS board include a margin for such situations. The inclusion of this margin was discussed on page 62 of the 2020 experience study report.</p> <p>CalSTRS has a robust system of internal controls over the completeness and accuracy of the census data for the MPP Program that we believe factors in the nuances of the eligibility requirements necessary to compute the Total and Net OPEB Liability of the MPP Program at a precision level suitable for a separate stand-alone report. It should be noted that the liability for the “eligible participants” that are not currently enrolled is determined based on the assumptions calculated in the experience study and not on actual current census data. These assumptions are derived using methods and data that are consistent with the ones used in the actuarial valuation. CalSTRS believes that this consistency ensures that the computation of the Total and Net OPEB Liability of the MPP Program is done at a precision level suitable for a separate stand-alone report. Modifying the population on which the assumptions are applied for valuation purposes would first require a review and reassessment of the actuarial assumptions. CalSTRS recognizes that due to the complexities of this program, there are always opportunities to enhance controls. CalSTRS will consider the comments and recommendations made by Crowe in the next scheduled review of actuarial assumptions and methods.</p>	

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<p>START Administrator Account Monitoring</p> <p>Crowe recommends prior to performing the review of RACF and databases administrators, for the START application, the ISO perform procedures to confirm the report used in the control activity is complete and accurate (e.g. observe report generation by the SSA team to determine if all users are included in the reports provided). The ISO should document this procedure as part of the control activity.</p>	<p>The ISO has established a procedure to independently run reports that provide a listing of RACF and database administrators. The reports will be run by ISO monthly beginning November 2020 and will be used to monitor any additions or deletions for both groups. Additionally, the reports will be used as part of the annual review to ensure all administrator account profiles are reviewed.</p>	<p>Management implemented the new monthly report generation and review process in November 2020. The new process will also be used for the annual review. This finding has been fully remediated.</p>
<p>Precision of Financial Statement Review</p> <p>Crowe recommends management perform a review over the completeness and accuracy of revisions made to the draft financial statements to a level of precision that includes agreeing the financial statement changes to management’s supporting documentation/schedules to ensure the financial statements and related disclosures are not materially misstated.</p>	<p>Management recognizes the importance of ensuring the financial statements reflect accurate information and are properly supported and reviewed. As such, there are numerous controls currently in place to ensure information is accurately presented when compiling the basic financial statements, including information from revisions. However, we recognize improvements can be made and we will enhance the existing procedures and control structure to ensure revisions are properly supported, reviewed, and incorporated in the financial statements.</p>	<p>Management has completed an assessment of the conditions that resulted in the audit finding. Starting with the March 31, 2021 financial statements, we will implement additional steps to ensure a layered review process occurs between staff and managers to ensure the financial statements are properly supported and any changes in the underlying support documents is reflected in the financial statements.</p>