



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: July 9, 2021 – 0 minutes

Attachment: Attachment 1 – Progress Report on Implementation of Recommendations

PowerPoint: 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/SUMMARY

In connection with 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 minor deficiencies were in the Management Letter, and all included recommendations to improve controls over financial reporting.

Management is responsible for the design and implementation of internal controls over financial reporting. During the course of 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. 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 for the Audits and Risk Management (ARM) Committee review.

The ARM Committee reviewed the Independent Auditor’s Report on Internal Control Over Financial Reporting and Management Letter at the November 2020 meeting and management’s first progress report at the March 2021 meeting. Audit Services is presenting a second status report that summarizes management actions towards implementing those recommendations. This is the final report of management’s progress (Attachment 1). The independent financial statement auditor, Crowe LLP, will validate implementation of management’s corrective actions and report the status to the committee at the November 2021 ARM Committee meeting.

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

Recommendation	January 2021 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>Management is evaluating the current policies and procedures for fair value measurement and reporting of all private assets 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 CalSTRS with industry best practices. We expect to complete this effort by December 2021.</p>	<p>Management continues to evaluate the current policies and procedures for fair value measurement and reporting of all private asset investments. As part of this evaluation, management has put in place a new internal control over fair value measurements to appropriately evaluate each new private asset investment and the appropriate method to assess fair value in accordance with GAAP. This control is designed to provide more precision to the process of assessing the fair value and fair value hierarchy level of private investment assets using an internally developed fair value measurement assessment tool. We plan to fully implement this new control for the current year financial statements ending June 30, 2021.</p> <p>The independent valuation firm engaged by CalSTRS to review the valuation information received for certain private equity co-investments has completed its review and provided a detailed report for each investment. The Private Equity asset class management has reviewed the consultant’s final valuation report and concluded that the fair value of the private equity co-investments reported as of June 30, 2020 falls within the range determined by the consultant. Co-investment valuation reviews will continue to be performed on a semi-annual basis as of March 31 and September 30.</p> <p>In addition to these efforts, CalSTRS management also has selected and is finalizing the procurement process for a consultant to evaluate and document CalSTRS fair value accounting and reporting framework for private assets. We expect to complete this engagement effort by December 2021.</p>

Independent Auditor’s Management Letter – Progress Report as of April 2021

Recommendation	January 2021 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 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 the agency. 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>	<p>The Employer Help teams held more than 30 conference calls with employers during April and May to share training offerings and present employer onboarding practices and documents. These calls build on our employer relationships using a structured agenda to cover current topics and address any outstanding reporting issues. Employer Help coordinated responses to employer questions including other business area subject matter experts when needed.</p> <p>Management is focused on employer engagement and a new concept of Employer Stories, a repository of employer behaviors and projects to better engage with them on reporting questions and improve data accuracy.</p> <p>The Employer Readiness team engaged and informed all 92 reporting entities regarding the upcoming BenefitConnect system implementation. These visits included file format review, demonstrations of new system functionality and introduction to the Learning Management System (LMS) for online training for the new system. The team continues support by hosting follow up visits with employers to respond to inquiries.</p> <p>There are now 42 Pension Solution CBTs available in the LMS for employers in preparation for new SEW implementation. By the end of Quarter 3 in March 2021, 206 employers took the computer-based training on fundamental reporting topics. Employers completed an additional 18 webinars reaching 237 participants.</p>

Independent Auditor’s Management Letter – Progress Report as of April 2021		
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<p>Active Member Data – Completeness and Accuracy (continued)</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.</p> <p>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. 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>	<p>In March 2021, Employer Services Training developed 10 job aids located on the Employer Support Portal. These job aids provide information about related statutes for the most common employer reporting topics as well as how the information translates to reporting in the new Secure Employer Website for both old file format and new file format users. The job aid topics are: Annualized Pay Rates, Benefit Structures, Cash Balance Benefit Program Participation, Class of Employees, Community College Comparison Calculation, Creditable Compensation, Creditable Service, Defined Benefit Program Membership, Working after Retirement, and the Reduced Workload Program.</p>

Independent Auditor’s Management Letter – Progress Report as of April 2021		
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<p>Active Member Data – Completeness and Accuracy (continued)</p>	<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>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>	<p>Management continues to review its procedures and planning for the next actuarial experience study that will consider Crowe’s comments on the MPP Program.</p>

Independent Auditor’s Management Letter – Progress Report as of April 2021		
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<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 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>	<p>We have implemented additional steps to ensure a layered review process between staff and managers in our preparation of the financial statements for the period ending March 31, 2021. Staff ensured all tables agreed to the supporting documentation when preparing the financial statement and managers also agreed the supporting documentation to the financial statement tables, ensuring all changes in the underlying support documents were properly reflected in the final versions of the financial statements. This layered review process is documented and will be performed for the financial statements for the year ended June 30, 2021, and for all subsequent financial statement reporting periods.</p>