REPORT DIGEST

TEACHERS' RETIREMENT SYSTEM
COMPLIANCE AUDIT
FOR THE TWO YEARS ENDED JUNE 30, 1994

{Expenditures and Activity Measures are summarized on the reverse page.}

INTRODUCTION

This digest covers our State compliance audit of the System for the two years ended June 30, 1994. A financial audit covering the year ending June 30, 1994 was previously issued.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

NEED TO ADEQUATELY REVIEW TRANSACTIONS POSTED BY THE TRUSTEE

The System does not adequately review transactions posted daily by its Trustee. The Trustee provides a monthly trust report for the total fund as well as reports for the individually managed accounts. Two errors in the investments area were noted.

The first error pertains to the recording of cost values of certain investment accounts. The Trustee determined that the cumulative income recorded by an investment manager for fiscal years 1989 through 1993 was over $133 million greater than that recorded by the Trustee and the System. This was due to three factors. First, securities were transferred to an investment manager and sold, and the proceeds from the sale were reinvested. The transfer and sale should have resulted in a realized gain of $63 million. However, the investment manager and the Trustee valued the cost basis differently and the realized gain was never recognized. Second, nearly $25 million in reinvested income (primarily dividend income) was recorded by the investment manager but not reported to the Trustee. Lastly, nearly $45 million in realized gains were subsequently reinvested, but the Trustee did not receive the information. Therefore, the realized gain income was not recognized.

The second error relates to a large discrepancy noted in the Trustee's September, 1993 Cash Basis Settlement Report. The Trustee erroneously recorded interest expense of $65 million instead of recording the purchase of an investment. We noted that the correct amount of interest expense was slightly over $0.5 million, which was consistent with interest expense recorded in other months. The error was corrected by the Trustee at June 30, 1994, in its summary of fiscal year information report. However, System personnel did not identify the error resulting in a $65 million accounting reclassification entry in the June 30, 1994 supplemental schedules in the System's Comprehensive Annual Financial Report.

We recommended that System personnel compare the Trustee and investment manager's cost and market values each month to search for large discrepancies not corrected with the discrepancy report analysis. Further, reports such as the Cash Basis Settlement Report should be examined for reasonableness and potential large, unusual transactions. (Finding 1, pages 8 and 9)

System officials agreed with the recommendation and stated that a separate comparison between the Trustee and investment manager's cost and market values should be performed each month. System staff will monitor both Trustee reports and manager reports, reconciling discrepancies within the reports and will continue to closely monitor the discrepancy analysis completed by investment managers. Further, the System's Accounting Department will review the Cash Basis Settlement Report on a quarterly basis for reasonableness as accounts are reconciled.

NEED FOR ALL INVESTMENT HOLDINGS TO BE IN COMPLIANCE WITH THE SYSTEM'S "STATEMENT OF INVESTMENT OBJECTIVES AND POLICIES"

The System held certain investment holdings which were not in compliance with its "Statement of Investment Objectives and Policies", which was approved by the Board of Trustees. This Statement established guidelines for investments and investment managers to meet the System's objectives. **This finding has been repeated since 1992.**

We recommended that the System investigate the findings listed on the exception report on a timely basis and document the follow-up procedures taken. For investment holdings that are not detailed on the exception report, we recommended that the system actively monitor compliance with the Investment Guidelines. Further, when instances of noncompliance are noted, the System should ensure that the Board has approved any such departures from its established guidelines or take appropriate follow-up action with the investment manager. Also, the System should consider developing exception reports for international, real estate and venture capital investment managers. (Finding 2, pages 10 and 11)

The System agrees with the recommendation and is requiring staff to review new exceptions and document them within 30 days after the receipt of the report. System staff will also maintain a permanent file containing the documentation of exceptions and the resolutions of the exceptions. An exception report for international managers is being developed and should be available during fiscal year 1995. (For previous agency responses, see Digest Footnote 1.)

NEED TO IMPROVE TIMELINESS OF REAL ESTATE INVESTMENT ANALYSIS FOR FINANCIAL REPORTING PURPOSES

The System does not perform a timely year-end analysis of the cost and market values of its real estate accounts to determine if any adjustments are required.

In the 1993 and 1994 Financial audits, we discovered several differences between the preliminary and final real estate balances from the real estate managers. These differences required adjustments ($1.1 million and $2.3 million for fiscal years 1993 and 1994, respectively) to be made to the System's balances for each fiscal year's financial statements.

The System does not currently have procedures in place to reconcile preliminary real estate amounts to final June 30 balances. Such procedures would help ensure proper statement of real estate balances in the year-end financial statements.

We recommended that the System prepare a schedule of real estate balances reported by the Trustee based on preliminary amounts when received in July. These amounts should be compared with the final manager's June 30 balances received in early September. The differences, if material, should be reported to the Accounting Department and recorded in the System's records. (Finding 3, page 12)

System officials concurred with the recommendation and stated that a reconciliation schedule between preliminary real estate balances and finalized balances should be prepared. Staff will implement a schedule that will be completed by the manager and submitted to the System with the finalized financial statements received in early September. Differences, if material, will be entered into the Annual Financial Report.

NEED FOR ALTERNATIVE INVESTMENTS POLICIES AND PROCEDURES

The System did not have a formal policy for "alternative investments" as part of the approved Board of Trustees Policies and Procedures during fiscal years 1993 and 1994. As a result, managers have no set guidelines as to which they must adhere.

Alternative investments are made up of venture capital accounts, miscellaneous farmland and managed futures. During the fiscal years 1993 and 1994 audits, it was noted that the System was not performing an analysis of its alternative investments portfolio. As a result, the need for accounting adjustments was not detected prior to the audit. These adjustments resulted from the Trustee and TRS using different accounting methods in the recording of alternative investments.

According to System officials, the Board approved an alternative investments policy in September, 1994. The System subsequently created an analyst position to focus on alternative investments.

We recommended that the System ensure investment manager compliance with the new alternative investments policy. All current holdings and pending purchases should be reviewed in accordance with the new policies. Furthermore, the financial statements of all managers should be obtained and analyzed for proper treatment. (Finding 4, page 13)

System officials concur that compliance of the Board approved Alternative Investments Guidelines and Policy should be monitored. The System has created a staff position to focus on the analysis of the alternative investment portfolio.

Mr. Tim Hayes, Investment Accounting Manager and Mr. Todd Kennedy, Controller, provided responses to our recommendations.

UNDERFUNDED PENSION BENEFIT OBLIGATION

Net assets available for benefits (at cost) totaled $11,992 million at June 30, 1994. The pension obligation was valued at $21,747 million at June 30, 1994. The difference between the pension obligation and the net assets available for benefits of $9,755 million reflects the unfunded liability of the system at June 30, 1994. The unfunded liability increased approximately $2,149 million during FY 94.

The annual increase in the unfunded liability in FY 94 of $2,149 million represents a significant growth when compared to prior year increases. Part of this rise is attributed to the fact that TRS adopted new assumptions for 1994 actuarial purposes. Specifically, additional actuarial assumptions regarding factors which had not previously been measured such as severance pay, unused sick leave and optional service were adopted. These new assumptions added $772.1 million to the FY 94 unfunded pension benefit obligation.

DECLINE IN HEALTH INSURANCE RESERVE ACCOUNT BALANCE

The System maintains a Health Insurance Reserve Account for the purpose of paying the System's share for enrolled annuitants. At the beginning of FY 93, the Health Insurance Reserve Account had a balance of $74.5 million. However, at June 30, 1994 the Reserve Account balance was $38.2 million. According to System officials, the significant decrease in the account balance was primarily due to increased enrollments resulting from the early retirement incentive and increased premiums. The System pays 75% of the cost of coverage on benefit recipients pursuant to 40 ILCS 5/15-153.2 which was revised effective January 14, 1991. This revision to the law increased the portion the System pays for health insurance coverage on benefit recipients from 50% to 75%. System officials believe that continuation of this decrease in the Reserve Account balance may force the System to reduce its subsidy payment and/or benefits. (Pages 34 and 35)

A summary of changes in the Health Insurance Reserve Account is as follows (in millions):

Health Insurance Reserve Account

	Fiscal Year		
	1994	**1993**	**1992**
Opening Balance	$63.0	$74.5	$75.7
TRS transfer	24.7	26.0	26.5
* TRS subsidy premium payments	(49.5)	(37.5)	(27.7)
Ending Balance	$38.2	$63.0	$74.5

(*Note: Health Insurance Premium Payments made by Annuitants and Dependents do not flow through the Health Insurance Reserve Account. They are not reflected in the above balances.)

USE OF DERIVATIVES BY THE SYSTEM

The term "derivative" is often used to categorize a wide variety of financial instruments whose value "depends on" or is "derived from" the value of an underlying asset, reference rate or index. These instruments include, but are not limited to, futures and option contracts.

System officials state that their use of derivatives is limited; less than one tenth of 1% of their assets were placed in these instruments as of June 30, 1994. Further, System officials state that these instruments are used in a conservative manner that reflects accepted industry practice and are specifically authorized under the Board of Trustees' Investment Guidelines. Also, System representatives state they have not, and will not, utilize the riskier derivative products that have been proven to be problematic to other funds and companies.

WILLIAM G. HOLLAND, Auditor General
WGH:BLB:pp

SUMMARY OF AUDIT FINDINGS

Number of	This Audit	Prior Audit
Audit Findings	4	8
Repeated audit findings	1	0
Recommendations implemented or not repeated	7	5

SPECIAL ASSISTANT AUDITORS

Arthur Andersen LLP were our special assistant auditors for this audit.

DIGEST FOOTNOTES

#1: NONCOMPLIANCE WITH "STATEMENT OF INVESTMENT OBJECTIVES AND POLICIES" - Previous Agency Responses.

1992:"We partially agree with the recommendation. The management of an $11.0 billion fund is not as finite and precise as one might think. While we are working at having the fund within guidelines, in all asset classes, these are guidelines and will occasionally be missed. All investment activity is accomplished with the full knowledge of the Board of Trustees and we will consider implementation of the recommendation as soon as possible.

TEACHERS' RETIREMENT SYSTEM OF ILLINOIS
INFORMATION FROM FINANCIAL AND COMPLIANCE AUDITS
TWO YEARS ENDED JUNE 30, 1994

OPERATING STATEMENT ANALYSIS	**FY 1994**	**FY 1993**
Revenues:		
Contributions - Members	$ 413,395,000	$ 363,334,000
Contributions - State of Illinois	266,077,000	269,896,000
Contributions - School Districts	217,388,000	36,078,000
Total Contributions	$ 896,860,000	$ 669,308,000
Total Investment Income	558,692,000	520,148,000
Gain on Sale of Investments	430,229,000	622,488,000
Total Revenues	$1,885,781,000	$1,811,944,000
Expenses:		
Total Benefits	$873,874,000	$715,368,000
Other Expenses	32,739,000	28,948,000
Total Expenses	$906,613,000	$744,316,000
Revenues in Excess of Expenses	$979,168,000	$1,067,628,000
INVESTMENT PORTFOLIO ANALYSIS - Book Value	**JUNE 30, 1994**	**JUNE 30, 1993**
Total Government Obligations	$ 1,642,772,274	$ 1,105,832,469
Total Corporate Obligations	2,077,940,720	1,934,796,118
International Bonds	1,452,907,887	1,419,986,838
Preferred Stock (U.S. & International Combined)	40,867,957	32,614,982
Common Stock - U.S.	2,653,306,322	2,820,077,357
Common Stock - International	1,200,633,386	967,320,192
Short Term Investments	816,622,742	568,174,167
Real Estate Equity	2,186,714,141	1,944,597,601
Venture Capital	193,983,106	203,164,193
Currency Investment	21,611,021	52,761,112
Total Investment Portfolio at Book Value	$12,287,359,556	$11,049,325,029
Total Investment Portfolio at Market Value	$12,333,823,000	$11,714,339,000
ADMINISTRATIVE EXPENSES	**FY 1994**	**FY 1993**
Personal Services	$ 6,854,000	$ 5,455,000
Professional Services	791,000	1,274,000
Postage	426,000	312,000
Machine Repair and Rental	275,000	273,000
Other Contractual Services	470,000	444,000
Commodities	204,000	300,000
Occupancy Expense	374,000	399,000
Provision for Depreciation	659,000	742,000
Loss on Trade-in of Equipment	35,000	22,000
Total Administrative Expenses	$10,088,000	$9,221,000
SELECTED ACCOUNT BALANCES	**JUNE 30, 1994**	**JUNE 30, 1993**
Cash	$ -	$ 2,246,000
Total Receivables	222,468,000	29,115,000
Investments, at cost	12,287,359,000	11,049,325,000
Property and Equipment	4,007,000	4,262,000
Total Assets	$12,513,834,000	$11,084,948,000
Total Liabilities	521,610,000	205,358,000
Net Assets Available for Benefits	$11,992,224,000	$10,879,590,000
Total Pension Benefit Obligation	21,746,875,000	18,485,890,000
Unfunded Pension Benefit Obligation	$ (9,754,651,000)	$ (7,606,300,000)
SUPPLEMENTARY INFORMATION	**FY 1994**	**FY 1993**
Total investment manager fees	$65,371,996	$37,341,742
Return on Investments		

Total time-weighted return TRS managers combined	4.7%	11.6%
Average Number of System Employees	160	140
Number of Retirement Annuitants	48,207	43,195
Number of Survivor Benefit Annuitants	5,806	5,642
Number of Disability Benefit Recipients	965	1,017

EXECUTIVE DIRECTOR
During Audit Period: Robert Daniels Currently: Robert Daniels