REPORT DIGEST

TEACHERS' RETIREMENT SYSTEM
COMPLIANCE AUDIT
FOR THE YEAR ENDED JUNE 30, 1995

SYNOPSIS

●The System's present practice does not prohibit Trustees and employees from accepting goodwill expenditures or any other items of value from individuals or entities under contract with the System.

●System management failed to follow generally accepted accounting principles (GAAP) in accounting for certain investments. Accordingly, adjustments totaling $115 million were proposed by the auditors and subsequently recorded by the System at year end to properly state investments in accordance with GAAP.

●Investment trust statements are not reconciled to the System's general ledger by a person independent of the accountant responsible for recording the monthly journal entries, and cash and investment reconciliations are not reviewed by an appropriate level of management.

●The System is not obtaining annual audited financial statements for real estate investments. The System's real estate portfolio totals approximately $2 billion .

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

INTRODUCTION

This digest covers our State compliance audit of the System for the year ended June 30, 1995. A financial audit covering the year ended June 30, 1995 was previously issued.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

NEED TO REVIEW PRACTICE OF ACCEPTING ITEMS OF VALUE FROM CONTRACTORS

The System's present practice does not prohibit Trustees and employees from accepting goodwill expenditures or any other items of value from individuals or entities under contract with the System.

System officials indicate prospective investment managers periodically offer goodwill items such as meals for System staff or Trustees while the manager is seeking their business. However, System officials prohibit investment managers who are seeking the System's business from paying for so much as a meal. In contrast, the System's practices do not prohibit investment managers who are already under contract from making goodwill expenditures or giving any other items of value to System officials.

For example, in fiscal year 1995 eight of the System's Trustees and some of their spouses, along with four System employees, traveled to Florida to visit certain hotel properties, shopping centers, apartments, and farms. According to System officials, the purpose of the trip was to allow the Trustees to see some of the properties firsthand and evaluate the possibility of future real estate transactions in the region.

The System paid for certain expenses associated with the trip, however, other expenses were picked up by investment managers currently under contract with the System. System officials estimate that $14,000 was spent by the investment managers for accommodations and meals at sites not owned by the System.

We recommended the System officials review their current practice of allowing individuals and entities under contract with the System to give, and pension officials to accept, goodwill expenditures or any other items of value. (Finding 1, page 10)

In response, System officials stated they have reviewed, twice during the past three years, standards of employee conduct and the standards to which vendors and potential vendors are held. System officials say that State law is absolutely silent on goodwill expenditures but these expenditures are common in the private and public sectors. In the absence of a statutory framework, TRS has established practices which they feel are appropriate and effective in preventing actual improprieties and abuses.

NECESSARY ADJUSTMENTS TO PRESENT FINANCIAL INFORMATION IN ACCORDANCE WITH GAAP

System management failed to follow generally accepted accounting principles (GAAP) in accounting for certain investments. Accordingly, adjustments totaling $115 million were proposed by the auditors and subsequently recorded by the System at year end to properly state investments in accordance with GAAP.

The System maintains a complex and diversified portfolio of investment consisting of real estate, mortgage loans, domestic and foreign bonds, domestic and foreign equities, and venture capital. The book value and market value of this portfolio at June 30, 1995 was $12,499,068,000 and $13,230,761,000, respectively. The System's accounting policy in preparing its financial statements is to report investments at cost, subject to adjustment for market declines judged to be other than temporary.

We recommended the System review complex investment transactions to ensure they are properly recorded in accordance with generally accepted accounting principles. (Finding 2, pages 12-13)

System officials agreed with the finding and recommendation and stated they will adjust internal procedures to ensure major investment transactions are properly recorded.

CASH AND INVESTMENT RECONCILIATIONS

Investment trust statements are not reconciled to the System's general ledger by a person independent of the accountant responsible for recording the monthly journal entries, and cash and investment reconciliations are not reviewed by an appropriate level of management.

Although cash and investment reconciliations are performed on a monthly basis, we noted that:

-investment reconciliations are prepared by an accountant who also has responsibility for recording the monthly journal entries for investments.

-cash and investment reconciliations are not reviewed by a person independent of the preparer.

The responsibility for both recording journal entries and reconciling investments does not provide for adequate segregation of duties. The adequate safeguarding of System assets, including cash and investment, is a critical element of the internal controls structure.

We recommended the reconciliation of the investment trust statements to the general ledger be

prepared by a person independent of the accountant responsible for recording the
monthly journal entries and all cash and investment reconciliations be reviewed by an appropriate level of management. This review should clearly be documented on all reconciliations to ascertain that reconciliations are being properly reviewed and approved on a timely basis. (Finding 3, page 14)

System officials concurred with the finding and recommendation and stated that separation of duties and supervisory review are necessary elements of internal control and the recommended changes have been implemented.

REAL ESTATE INVESTMENT MANAGER POLICIES AND PROCEDURES

The System is not obtaining annual audited statements for real estate investments.

The System's $2 billion real estate portfolio is monitored by a staff of 5 individuals. In order to effectively monitor the portfolio with this number of staff, the System places substantial reliance on the real estate investment managers. We did note that generally the information provided by the real estate investment managers was very comprehensive and of good quality. However, no audit of the financial information is presently required by the System.

According to the System's "Real Estate Investment Manager Policies and Procedures", the System "reserves the right" to inspect the investment manager's books and records, but independent audits are not required. An effective internal control structure would include annual audits of significant real estate holdings.

The System's personnel stated that selected audits are performed, but only at the discretion of the real estate investment mangers. Additionally, these audits are not required to be submitted to the System.

We recommended the System revise its "Real Estate Investment Manager Policies and Procedures" to require annual audited financial statements for significant real estate investment holdings. Further, we recommended a coordinated annual audit process be established at the direction of the System. Such a coordinated audit process should strengthen internal controls over real estate investments and also expand the System's ability to conduct periodic reviews of its real estate investment managers in a cost-effective manner. (Finding 4, page 15)

System officials concurred with the recommendation and stated that a program of real estate investment audits would add value to their existing oversight activities. They indicate that a pilot program has been initiated and that the System is currently negotiating with audit firms for financial audits of investment managers and for audits of randomly chosen properties from the managers' portfolios. They expect this pilot project will allow TRS to assess the cost-effectiveness of the audits and to determine an appropriate scope for the long-term.

OTHER FINDINGS

The remaining findings are less significant and the System's responses indicate that they are addressing the conditions. We will review the System's progress in implementing our recommendations in our next audit.

Mr. Jon Bauman, Chief Operating Officer at the System, provided responses to our recommendations. All responses were received on March 15, 1996.

FUTURE REPORTING REQUIREMENTS

In November 1994, the Governmental Accounting Standard's Board (GASB) issued Statement No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans". This Statement requires that plan assets be reported at fair value, rather than at cost. In addition, this Statement establishes a new financial reporting framework that will result in significant changes to the financial statements as well as the required supplementary information. The requirements of this Statement are effective for periods beginning after June 15, 1996, with earlier implementation encouraged. If comparative financial statements are presented, restatement of the prior year financial statements is required.

The System intends to adopt this Statement beginning with the fiscal year ending June 30, 1997. The effect of this Statement will be to increase the net assets and decrease the unfunded actuarial accrued liability of the System by the difference between fair value and cost of the net assets on the date of adoption. If the implementation of Statement No. 25 had occurred in fiscal year 1995, the net assets available for benefits at June 30, 1995 would have been $13,373,558,000, resulting in a funding ratio of 55.8%.

At present, investments are valued at cost or book value as specified by State law. Thus, implementation of Statement No. 25 will require a change to existing State law to comply with generally accepted accounting principles. Net assets available for benefits at June 30, 1995 were $12,641,865,000 resulting in a funding ratio of 52.7%. (Pages 42 & 43)

RELATED TRANSACTIONS

During fiscal year 1995, the System entered into an Investment Management agreement (contract) with Zimmerman Investment Management Company (ZIMCO). The contract was effective September 1, 1994. The president of ZIMCO is the former Chief Investment Officer of the System who resigned his $106,653 position effective August 31, 1994. While employed by the System as Chief Investment Officer, he was responsible for overseeing the entire System investment program including development of currency hedging and risk management overlay programs which were managed "in-house". The contract authorizes ZIMCO to manage the currency hedging and risk management programs which were previously developed and managed "in-house" by the former Chief Investment Officer.

According to System officials, upon receipt of the former Chief Investment Officer's resignation it was concluded that following his separation from TRS' employment, the System would not have available "in-house" capabilities to manage its "in-house" risk management program. Accordingly, the Board determined it was "in the System's best interest" to negotiate a contract pursuant to which he would assume (following his resignation) the responsibility of managing the risk management program. System officials indicated that in June 1994 they retained a law firm to negotiate on their behalf to maintain an "arms length" transaction with the Chief Investment Officer who was still employed with the System. System officials stated that this contract was entered into on a temporary basis, at which time the Board also authorized a consultant to conduct a search for qualified hedging and risk overlay managers.

For the ten month period ended June 30, 1995, Zimmerman Investment Management Company was paid a total of $2,469,999. (Page 44)

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WILLIAM G. HOLLAND, Auditor General

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SUMMARY OF AUDIT FINDINGS

Number of	This Audit	Prior Audit
Audit Findings	6	4
Repeated Audit Findings	0	1
Recommendations Implemented or not repeated	4	7

SPECIAL ASSISTANT AUDITORS

KPMG Peat Marwick, LLP were our Special Assistant Auditors for this audit.

TEACHERS' RETIREMENT SYSTEM OF ILLINOIS
INFORMATION FROM FINANCIAL AND COMPLIANCE AUDITS
YEAR ENDED JUNE 30, 1995

OPERATING STATEMENT ANALYSIS	**FY 1995**	**FY 1994**
Revenues:		
Contributions - Members	$ 430,761,000	$ 413,395,000
Contributions - State of Illinois	267,146,000	266,077,000
Contributions - School Districts	331,023,000	217,388,000
Total Contributions	$1,028,930,000	$ 896,860,000
Total Investment Income	513,927,000	558,692,000
Gain on Sale of Investments	257,560,000	430,229,000
Total Revenues	$1,800,417,000	$1,885,781,000
Expenses:		
Total Benefits	$1,111,676,000	$873,874,000
Other Expenses	39,100,000	32,739,000
Total Expenses	$1,150,776,000	$906,613,000
Revenues in Excess of Expenses	$649,641,000	$979,168,000
INVESTMENT PORTFOLIO ANALYSIS - Book Value	**JUNE 30, 1995**	**JUNE 30, 1994**
Total Government Obligations	$ 1,896,415,889	$ 1,642,772,274
Total Corporate Obligations	1,518,434,985	2,077,940,720
International Notes	1,360,522,989	1,452,907,887
Preferred Stock (U.S. & International Combined)	18,714,329	40,867,957
Common Stock - U.S.	2,988,476,249	2,653,306,322
Common Stock - International	1,382,321,554	1,200,633,386
Short Term Investments	776,901,583	816,622,742
Real Estate Equity	2,223,887,753	2,186,714,141
Venture Capital	246,049,077	193,983,106
Currency Investment	87,343,764	21,611,021
Total Investment Portfolio at Book Value	$12,499,068,172	$12,287,359,556
Total Investment Portfolio at Market Value	$13,230,761,238	$12,333,822,871
ADMINISTRATIVE EXPENSES	**FY 1995**	**FY 1994**
Personal Services	$ 7,150,000	$ 6,854,000
Professional Services	615,000	791,000
Postage	345,000	426,000
Machine Repair and Rental	320,000	275,000
Other Contractual Services	518,000	470,000
Commodities	290,000	204,000
Occupancy Expense	370,000	374,000
Provision for Depreciation	731,000	659,000
Loss on Trade-in of Equipment	6,000	35,000
Total Administrative Expenses	$10,345,000	$10,088,000
SELECTED ACCOUNT BALANCES	**JUNE 30, 1995**	**JUNE 30, 1994**
Cash	$ 1,055,000	$ -
Total Receivables	444,120,000	222,468,000
Investments, at cost	12,499,068,000	12,287,359,000
Property and Equipment	3,513,000	4,007,000
Total Assets	$12,947,756,000	$12,513,834,000
Total Liabilities	305,891,000	521,610,000
Net Assets Available for Benefits	$12,641,865,000	$11,992,224,000
Total Pension Benefit Obligation	23,980,566,000	21,746,875,000
Unfunded Pension Benefit Obligation	$(11,338,701,000)	$ (9,754,651,000)
SUPPLEMENTARY INFORMATION	**FY 1995**	**FY 1994**
Total investment manager fees	$51,309,039	$55,200,400
Return on Investments		

Total market time weighted return	13.4%	4.7%
Average Number of System Employees	161	160
Number of Retirement Annuitants	52,740	48,207
Number of Survivor Benefit Annuitants	6,014	5,806
Number of Disability Benefit Recipients	880	965

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