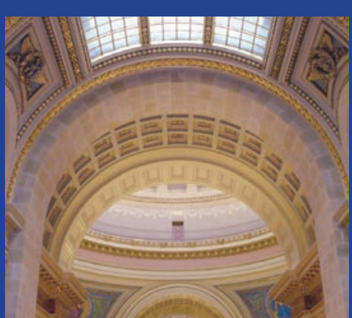
Report 18-10
October 2018

Department of Employee Trust Funds

Calendar Year 2017

State of Wisconsin



Legislative Audit Bureau

Report 18-10
October 2018

Department of Employee Trust Funds

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OPINIONS PUBLISHED SEPARATELY

The financial statements and our opinions on them are found in the Department of Employee Trust Funds' *2017 Comprehensive Annual Financial Report*

STATE OF WISCONSIN | Legislative Audit Bureau
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Joe Chrisman
State Auditor

October 5, 2018

Senator Robert Cowles and
Representative Samantha Kerkman, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Cowles and Representative Kerkman:

As required by s. 13.94 (1) (dd), Wis. Stats., and as requested by the Department of Employee Trust Funds (ETF), we have completed an audit of ETF's financial statements of 12 separate funds used to account for the financial position and activity of various benefit programs available to state and local government employees, including the Wisconsin Retirement System (WRS). ETF's *2017 Comprehensive Annual Financial Report*, which can be found on its website, includes the statements and our unmodified opinions on them.

The WRS is the largest program administered by ETF. The WRS fiduciary net position, which represents resources available to pay pension benefits, increased from $92.6 billion as of December 31, 2016, to $104.4 billion as of December 31, 2017, or by 12.8 percent. ETF calculated a net pension asset of $3.0 billion as of December 31, 2017. Under pension accounting standards, each employer participating in the WRS will be required to report its proportionate share of the net pension asset on its financial statements if prepared on the basis of generally accepted accounting principles. To assist employers with this reporting, ETF prepared employer schedules. We audited and provided an unmodified opinion on these schedules in report 18-11.

The Governmental Accounting Standards Board (GASB) has issued new accounting standards applicable to other postemployment benefit (OPEB) plans, which ETF adopted for its 2017 financial statements. OPEB refers to the benefits, other than pensions, that a state or local government employee may receive after they have left employment, generally upon retirement. ETF calculated a net OPEB liability of $493.5 million for the State Retiree Life Insurance program and $300.9 million for the Local Retiree Life Insurance program. Under the new OPEB accounting standards, each employer participating in the programs will be required to report its proportionate share of the net OPEB liability on its financial statements if prepared on the basis of generally accepted accounting principles. To assist employers with this reporting, ETF prepared employer schedules. We audited and provided unmodified opinions on these schedules in reports 18-12 and 18-13.

We report a significant deficiency related to user access to a critical ETF information technology system. The Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters begins on page 35.

We appreciate the courtesy and cooperation extended to us by ETF staff during the audit. A response from ETF follows the appendices.

Respectfully submitted,

Joe Chrisman
State Auditor

JC/CS/ss

Introduction ▪

ETF administers employee benefit programs for participating state and local government employees.

The Department of Employee Trust Funds (ETF) administers employee benefit programs for participating state and local government employees. These programs include the Wisconsin Retirement System (WRS) and health and life insurance programs for active and retired employees of the State and participating local governments. ETF reports the financial activity of programs it administers in financial statements that are included in its Comprehensive Annual Financial Report (CAFR). These financial statements are prepared by ETF using generally accepted accounting principles (GAAP) prescribed by the Governmental Accounting Standards Board (GASB).

ETF administers the following nine benefit programs:

- The WRS is the largest program administered by ETF. This program provides post-retirement financial benefits to participating employees, as well as disability and death benefits to participants and their beneficiaries. As of December 31, 2017, the WRS included 257,413 active members and 1,499 participating employers with a total membership of 632,802. Total membership includes annuitants and inactive members, who are participants who are not currently retired but are no longer employed by a participating employer and who have chosen to maintain their WRS account.

- The Duty Disability Insurance program offers special disability benefits to approximately 22,200 protective occupation members in the WRS, such as police officers, firefighters, and correctional officers. As of December 31, 2017, this program was providing benefits to approximately 1,000 disabled members or their beneficiaries.

- The Long-Term Disability Insurance program provides disability payments to members of the WRS. During 2017, approximately 2,700 members received benefits under this program. This program was closed to new members effective January 1, 2018, and benefit payments continue only for members who were either receiving benefits or had filed an application for benefits prior to January 1, 2018. The financial activity of the Long-Term Disability Insurance program is reported with the WRS beginning with the year ended December 31, 2017.

- The Accumulated Sick Leave Conversion Credits program provides for the conversion of the value of unused sick leave at the time of retirement into an account to be used to pay for post-retirement health insurance for retired employees of the State of Wisconsin, including state agencies and state authorities such as the University of Wisconsin (UW) Hospitals and Clinics Authority. As of December 31, 2017, approximately 16,800 retired employees and others were using these credits.

- The Group Life Insurance program offers group life insurance coverage for active and retired employees of the State of Wisconsin, including state agencies and state authorities such as the UW Hospitals and Clinics Authority, and 738 local governments participating as of December 31, 2017. The financial activity of this program is separated into three funds for financial reporting: Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance.

- The Employee Reimbursement Accounts and Commuter Benefits program offers employees of the State pre-tax payroll deductions that are credited to an account for the reimbursement of qualifying medical costs, dependent care costs, and transportation expenses, such as bus passes, parking, and other transit costs. In 2017, approximately 19,100 employees had a medical account, 3,300 employees had a dependent care account, and 2,800 employees had a commuter benefit account.

- The Group Health Insurance program offers health insurance coverage, including medical, pharmacy, and dental benefits, to active and retired employees of the State of Wisconsin, including state agencies and state authorities such as the UW Hospitals and Clinics Authority, and 354 local governments participating as of December 31, 2017. Approximately 80,700 active employees and 28,700 retired employees were participating in the program as of December 31, 2017. The financial activity of this program is separated into three funds for financial reporting: Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance.

- The Income Continuation Insurance program offers short-term and long-term disability benefits for employees of the State of Wisconsin, including state agencies and state authorities such as the UW Hospitals and Clinics Authority, and 219 local governments participating as of December 31, 2017. During 2017, approximately 59,700 employees participated in this program, and benefits were provided to approximately 2,500 participants.

- The Milwaukee Retirement Systems invests other retirement systems' funds with the WRS. Currently, the Milwaukee Retirement System invests funds from two Milwaukee Public Schools Supplemental Retirement Plans.

ETF Administration

The administration of the programs reported in ETF's CAFR is overseen by the ETF Secretary and the governing boards for the programs. The programs are administered by ETF using the services provided by multiple entities, including third-party administrators, actuaries, and the State of Wisconsin Investment Board (SWIB).

The ETF Board is responsible for the overall direction and oversight of ETF.

Under s. 40.03, Wis. Stats., the 13-member ETF Board is responsible for the overall direction and oversight of ETF. Statutes specifically identify that, among other items, the ETF Board is responsible for:

- appointing the Secretary of ETF;
- selecting and retaining an actuary to perform all necessary actuarial services for benefit programs administered by ETF; and
- approving the contribution rates and actuarial assumptions determined by the actuary.

The 2018 ETF Board members are shown in Appendix 1 and include:

- the Governor, or the Governor's designee on the Group Insurance Board;
- the Administrator of the Division of Personnel Management in the Department of Administration (DOA), or designee;
- four members of the Teachers Retirement Board;
- four members of the Wisconsin Retirement Board;
- one member nominated by the Governor and appointed with the advice and consent of the Senate, as a public representative, who is not a member of the WRS but has at least five years of actuarial, insurance, or employee benefits plan experience;
- one annuitant elected by retired WRS participants; and
- one active WRS participant who must be either a technical college or school district educational support personnel employee, elected by participating employees who meet the same employment criteria.

Although the ETF Board is the overall governing body for ETF, the 13-member Teachers Retirement Board and the 9-member Wisconsin Retirement Board each serve in an advisory role on issues related to the WRS. The members of the Teachers Retirement Board and the Wisconsin Retirement Board represent state and local government employers, employees, annuitants, and the general public.

The Group Insurance Board oversees certain benefit programs.

In addition to the ETF Board, the 11-member Group Insurance Board is responsible for setting policies and overseeing administration of the Group Health Insurance, Group Life Insurance, Employee Reimbursement Accounts and Commuter Benefits, and the Income Continuation Insurance programs. The 2018 Group Insurance Board members are shown in Appendix 2 and include:

- the Governor, or designee;
- the Administrator of the Division of Personnel Management in DOA, or designee;
- the Attorney General, or designee;
- the Secretary of DOA, or designee;
- the Commissioner of Insurance, or designee;
- a member appointed by the Governor;
- an insured participant in the WRS who is a teacher and is appointed by the Governor;
- an insured participant in the WRS who is not a teacher and is appointed by the Governor;
- an insured participant in the WRS who is a retired employee and is appointed by the Governor;
- an insured participant who is an employee of a local unit of government and is appointed by the Governor; and
- the chief executive or member of the governing body of a local unit of government that is a participating employer in the WRS and is appointed by the Governor.

Table 1 lists the programs that ETF administers and the board that has authority over the policies and administration of each program.

Table 1

ETF Board and Group Insurance Board Authority, by Program
As of December 31, 2017

Program	ETF Board	Group Insurance Board
Wisconsin Retirement System	✓	
Duty Disability Insurance	✓	
Long-Term Disability Insurance		✓[1]
Accumulated Sick Leave Conversion Credits	✓	
Group Life Insurance[2]		✓
Employee Reimbursement Accounts and Commuter Benefits		✓
Group Health Insurance[3]		✓
Income Continuation Insurance		✓[4]
Milwaukee Retirement Systems	✓	

[1] Effective January 1, 2018, oversight of this program was moved to the ETF Board and the program was closed to new members.

[2] Includes the Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance funds.

[3] Includes the Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance funds.

[4] At its February 8, 2017 meeting, the Group Insurance Board approved moving the authority of this program to the ETF Board. However, current statutes have not been modified to permit this change.

Third-party administrators are used to help administer several of the benefit programs.

The Secretary of ETF is charged with implementing the policies approved by each of the boards, and with managing the daily operations of ETF. Each program administered by ETF has its own unique requirements related to eligibility, contributions, benefit payment determination, and reporting. As of July 1, 2018, ETF was authorized 272.20 full-time equivalent positions. In addition, ETF uses third-party administrators to perform administrative functions for certain benefit programs, such as determining participant eligibility, processing participant claims, and making benefit payments to participants. For example, ETF uses a third-party administrator to determine eligibility for and pay benefits to participants in the Income Continuation Insurance program.

ETF uses actuaries to perform actuarial calculations for several benefit programs.

ETF also uses actuaries to perform actuarial calculations for several benefit programs it administers. Although the role of the actuary for each program varies due to the different program requirements, the duties generally include performing calculations to project future benefit payments, determining a liability for costs that have been incurred but not reported, and comparing these liabilities against the projected assets that will be available. In addition, the actuaries may recommend changes to contribution rates intended to increase or decrease contribution revenues that provide future assets to fund projected liabilities.

As shown in Table 2, ETF uses third-party administrators to manage five of the nine benefit programs and uses actuaries for seven of the programs.

Table 2

ETF's Use of Third-Party Administrators and Actuaries, by Program
As of December 31, 2017

Program	Third-Party Administrator	Actuary
Wisconsin Retirement System		✓
Duty Disability Insurance		✓
Long-Term Disability Insurance	✓[1]	✓
Accumulated Sick Leave Conversion Credits		✓
Group Life Insurance[2]	✓	✓
Employee Reimbursement Accounts and Commuter Benefits	✓	
Group Health Insurance[3]	✓	✓
Income Continuation Insurance	✓	✓
Milwaukee Retirement Systems		

[1] Effective January 1, 2018, this program was closed to new members, and ETF assumed responsibility for processing benefit payments for existing beneficiaries. The third-party administrator maintained responsibility for assessing eligibility for applications received prior to January 1, 2018.

[2] Includes the Life Insurance, State Retiree Life Insurance, and Local Retiree Life Insurance funds.

[3] Includes the Health Insurance, State Retiree Health Insurance, and Local Retiree Health Insurance funds.

With the exception of group life insurance assets, which are held by the third-party administrator, the assets of all of the programs are invested by SWIB in one or more of the following funds: Core Retirement Investment Trust Fund (Core Fund), Variable Retirement Investment Trust Fund (Variable Fund), or the State Investment Fund (SIF). The Core Fund is a fully diversified fund, or balanced fund, which provides less volatile investment returns and is invested for the long term in several types of investments. The Variable Fund is an equity fund, or stock fund, which provides returns that are typically more volatile than the Core Fund. The SIF invests the excess operating funds of the State and local governments with the objective of providing liquidity, safety of principal, and competitive rates of return. For more information about the investment performance and financial condition of the Core Fund and Variable Fund as of December 31, 2017, and the SIF as of June 30, 2017, please see reports 18-9 and 17-22, respectively.

Audit Results

The financial statements included in ETF's separately issued CAFR include information related to the contributions, benefits paid, and investment income of each program. The contribution and benefit requirements differ among the programs and are established by statute, administrative code, and board decisions. In addition, various tax laws may impact the administration of a program and the amount of contributions that may be collected or the benefits that may be provided.

As required by statutes, we have completed an audit of the financial statements and related notes of the 12 funds reported in ETF's CAFR as of and for the year ended December 31, 2017. To complete our audit of the financial statements, we reviewed ETF's internal controls over financial reporting, tested financial transactions, and reviewed the financial statements, notes, and required supplementary information that were prepared by ETF management.

We provided unmodified opinions on the financial statements of programs administered by ETF for the year ended December 31, 2017.

In addition to providing unmodified opinions on the financial statements and related notes as of and for the year ended December 31, 2017, we have issued our Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which begins on page 35. As discussed in this report, we identified a significant deficiency related to controls over access to the Wisconsin Employee Benefit System (WEBS), which is used to track WRS member information, such as years of service and annual earnings.

■ ■ ■ ■

Wisconsin Retirement System ▪

The WRS is a cost-sharing, multiple-employer, defined-benefit pension plan.

Created in January 1982, the WRS is a cost-sharing, multiple-employer, defined-benefit pension plan that provides post-retirement financial benefits to participating employees, as well as disability and death benefits to participants and their beneficiaries.

As of December 31, 2017, 632,802 individuals participated in the WRS, including:

- 257,413 (40.7 percent) active participants who were making contributions;
- 203,300 (32.1 percent) retired participants who were receiving WRS benefits; and
- 172,089 (27.2 percent) inactive participants, such as former employees, who were not yet receiving benefits and who were not required to make contributions.

ETF and SWIB work together to manage the WRS.

The WRS is one of the ten largest public pension plans in the United States. As of December 31, 2017, the WRS had a fiduciary net position of $104.4 billion, which represents resources available to pay pension benefits. ETF is responsible for managing the operations of the WRS that interact with employers and participants, including collecting contributions from and paying retirement benefits to WRS participants. SWIB is responsible for managing WRS investments. ETF and SWIB work closely together to ensure the solvency and long-term future of the WRS.

WRS Participating Employers

Section 40.21 (1), Wis. Stats., allows any Wisconsin public employer to participate in the WRS, but statutes require certain entities to participate, including state agencies and all counties except Milwaukee County, which maintains its own retirement system. In addition:

- second-, third-, and fourth-class cities must allow police officers and paid firefighters to participate if those employees were allowed to participate in Wisconsin's retirement system before March 31, 1978;
- villages with a population of 5,000 or more must allow police officers to participate, and villages with a population of 5,500 or more must also allow paid firefighters to participate, if those employees were allowed to participate in Wisconsin's retirement system before March 31, 1978; and
- school districts must allow employees in teaching positions to participate.

As of December 31, 2017, 1,499 employers were participating in the WRS.

Table 3 shows the number and type of public employers that participated in the WRS as of December 31, 2017. Most of the 1,499 employers that participated in the WRS were local governments and school districts.

Table 3

Types of Employers Participating in the WRS
As of December 31, 2017

Type	Number
School Districts	422
Villages	268
Towns	257
Special Districts[1]	208
Cities	152
Counties	71
State Agencies, UW System, and Public Authorities	57
Fourth-Class Cities[2]	36
Wisconsin Technical College System Districts	16
Cooperative Educational Service Agencies	12
Total Employers	**1,499**

[1] Includes employers such as the Madison Metropolitan Sewerage District, the Oshkosh City Housing Authority, and the South Central Library System.

[2] Defined as cities with populations of less than 10,000.

Under current law, any employee of a participating WRS employer is eligible to participate in the WRS if the expected duration of employment is one year or more and the employee is expected to be employed for at least two-thirds of what is considered full-time. Current statutes require five years of service before such an employee is considered vested.

WRS Funding

The WRS is funded through a combination of employer and employee contributions and investment earnings.

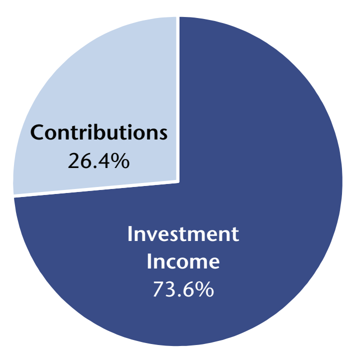
The WRS is funded through annual employer and employee contributions and investment earnings. The ETF Board has established a WRS funding policy with three primary goals:

- ensure funds are adequate to pay benefits;
- maintain stable and predictable contribution rates for employers and employees; and
- maintain inter-generational equity to ensure the cost of the benefits is paid for by the generation that receives the benefits.

From 2008 through 2017, investment income, net of SWIB's investment expenses and amounts distributed to other benefit programs, represented 73.6 percent of total funding for the WRS. Employer and employee contributions represented 26.4 percent of total funding for the WRS, as shown in Figure 1.

Figure 1

WRS Funding Sources
2008 through 2017



Contribution rates, which include both an employer and an employee share, are actuarially determined as a percentage of an employee's earnings and are approved annually by the ETF Board. As shown in Table 4, total contribution rates for "general employees," which include teachers and most other employees, ranged from a low of 11.0 percent for calendar year (CY) 2010 to a high of 14.0 percent for CY 2014.

Table 4

Total Contribution Rates for General Employees in the WRS

Calendar Year	Total Contribution Rate[1]
2010	11.0%
2011	11.6
2012	11.8
2013	13.3
2014	14.0
2015	13.6
2016	13.2
2017	13.6
2018	13.4
2019	13.1

[1] Includes both the employer share and the employee share of contributions and benefit adjustment contributions, but does not include employer-specific–prior-service cost rates.

The basic objective of the WRS is to invest contributions so that investment income and the contributions will be sufficient to pay projected future pension benefits.

WRS assets are invested by SWIB in the Core Fund and Variable Fund. SWIB has a fiduciary responsibility to prudently invest the pension assets in a diversified manner to meet WRS funding needs while minimizing the risk of large losses. SWIB's investment strategy is to meet the long-term expected rate of return assumption, which is 7.2 percent. The basic objective of the WRS is to invest contributions paid by employers and employees so that the investment income and the contributions will be sufficient to pay projected future pension benefits. As of December 31, 2017, SWIB's 20-year return for the Core Fund, net of management fees was 6.9 percent, which is less than the long-term expected rate of return assumption of 7.2 percent. As of December 31, 2017, SWIB's 30-year return for the Core Fund, net of management fees, was 8.9 percent.

New Actuarial Standards

There has been increasing interest in understanding how public pension plans will fare in different market conditions and risk conditions. In September 2017, the Actuarial Standards Board adopted a new standard of practice for pension plan actuaries and administrators to disclose in their annual valuations the amount of risk to which the public pension plan is exposed. In addition, a research project conducted by employees of the PEW Charitable Trusts and published by Harvard University in May 2018 recommended that public pension plans complete "stress testing" in order to better understand the impact of large market fluctuations and various economic scenarios. The new actuarial standard will be effective in November 2018, but we note the actuary for the WRS has included risk measures in the valuation for 2017. We will continue to monitor the implementation of this new actuarial standard in future WRS valuation reports.

WRS Benefits

The WRS is a defined-benefit plan that provides participants with lifelong monthly retirement benefits and, depending upon the annuity type selected, may also provide benefits to a beneficiary after the participant's death. These benefits are initially determined by either a formula, which is based on the participant's years of service and final average salary, or a money purchase benefit, which is based on the participant's contributions, an employer's matching contributions, and investment income. The method that yields the largest benefit payment is used to calculate a participant's initial benefit. This initial benefit may be adjusted based on changes in the market value of retirement fund assets, but would generally not be adjusted below the initial benefit amount. A defined-benefit plan is in contrast to a defined-contribution plan, such as a 401(k) plan, in which benefits are based on the amounts contributed to a participant's account and investment gains or losses on those funds.

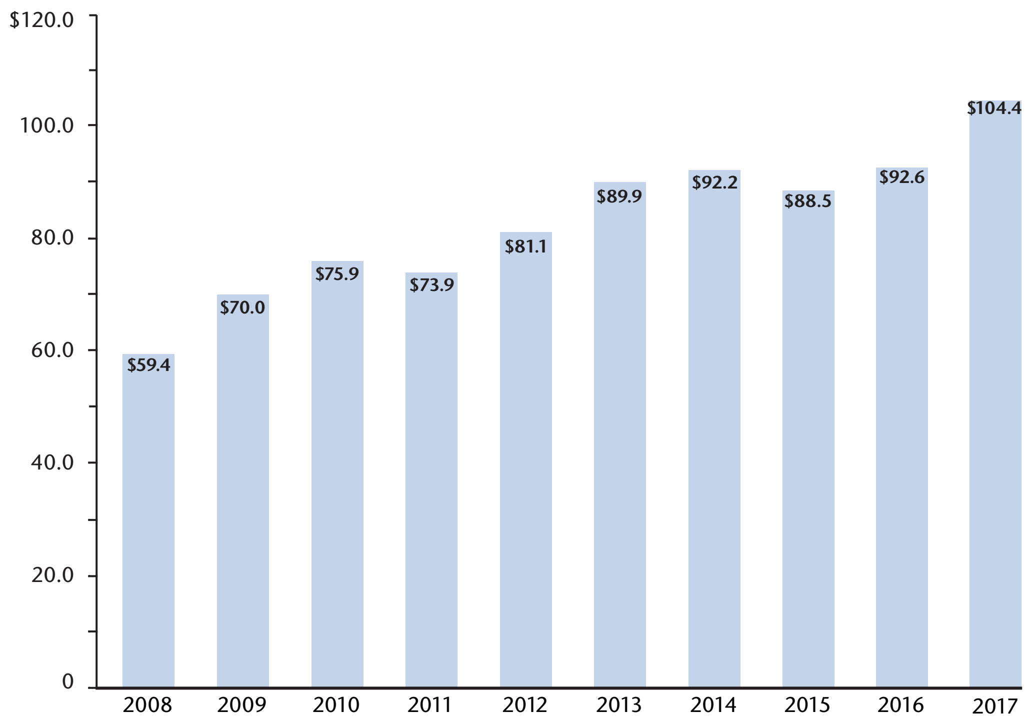
Financial Condition of the WRS

As of December 31, 2017, the fiduciary net position of the WRS was $104.4 billion.

The Net Position Restricted for Pensions (fiduciary net position) of the WRS represents the value of the plan's assets that are currently available to make benefit payments. As of December 31, 2017, the WRS had a fiduciary net position of $104.4 billion, which was a 12.8 percent increase from the prior year. From December 31, 2008, through December 31, 2017, the fiduciary net position of the WRS increased by $45.0 billion (75.7 percent), as shown in Figure 2.

Figure 2

Wisconsin Retirement System
Fiduciary Net Position[1, 2]
As of December 31
(in billions)



[1] Shown as Net Position Restricted for Pensions on the financial statements.

[2] The inclusion of the Long-Term Disability Insurance program increased the beginning fiduciary net position by $0.2 billion for 2017.

Net investment income increased from $7.3 billion in 2016 to $14.9 billion in 2017.

Contributions to the WRS from employers and employees increased from $1.9 billion in 2016 to $2.0 billion in 2017, or by 5.2 percent. Net investment income, which is the sum of realized and unrealized gains and losses less SWIB's investment expenses and amounts distributed to other benefit programs, increased from $7.3 billion in 2016 to $14.9 billion in 2017, or by 104.5 percent. The increase in net investment income reflects the increase in investment returns of the Core and Variable Funds. The gross investment return of the Core Fund increased from 8.6 percent in 2016 to 16.2 percent in 2017, and the gross investment return of the Variable Fund increased from 10.6 percent in 2016 to 23.2 percent in 2017.

The average annual annuity paid increased from $24,725 in 2016 to $25,181 in 2017, or by 1.8 percent.

Total WRS benefit payments provided to retired participants or their beneficiaries increased from $5.0 billion in 2016 to $5.2 billion in 2017, or by 5.2 percent. The number of retired participants increased from 197,647 as of December 31, 2016, to 203,300 as of December 31, 2017. The average annual annuity paid increased from $24,725 in 2016 to $25,181 in 2017, or by 1.8 percent.

Pension Accounting Standards

Accounting standards for public pension plans are promulgated by GASB. These standards establish accounting and financial reporting requirements for measuring the pension liability, as well as requirements for both the notes and required supplementary information to the WRS financial statements, and the GAAP-based financial statements of the 1,499 employers that participate in the plan. The pension accounting standards require ETF to calculate the total pension liability and the net pension liability or asset for the WRS, and disclose them in the notes and in the required supplementary information to the WRS financial statements. Each participating employer will report its proportionate share of this net pension liability or asset, as well as pension expense and other amounts, in its own financial statements if prepared under GAAP.

Calculating the Total Pension Liability

The total pension liability is the sum of the amounts needed to pay for the pension benefits earned by each participant.

The total pension liability for the WRS is the sum of the amounts needed to pay for the pension benefits earned by each participant based on service provided as of the date the actuarial valuation is performed. A total pension liability exists because the employers participating in the WRS have committed to provide benefits to their employees in the future when those employees retire. That commitment is part of employee compensation and constitutes a liability. The calculation of the total pension liability is complex and includes various actuarial assumptions and calculations, such as:

- a projection of future benefit payments for current and former participants and their beneficiaries based upon the current terms of the WRS;
- a discount of those payments to their present value, or the amount of funds currently needed to provide the projected payments in the future; and
- an allocation of the present value of benefit payments over past, present, and future periods of employee service.

The total pension liability for the WRS was $101.4 billion as of December 31, 2017.

To determine the total pension liability for the WRS as of December 31, 2017, ETF's actuary performed an actuarial valuation as of December 31, 2016, and adjusted for changes such as interest earned, contributions paid, benefits paid, and dividend adjustments during CY 2017. Based on this valuation and the adjustments, the total pension liability for the WRS was $101.4 billion as of December 31, 2017.

The discount rate is the rate used to calculate the present value of projected benefit payments.

The discount rate is a critical factor in calculating a pension plan liability, and it can have a significant effect on the amount of the total pension liability. The discount rate, or interest rate, is used to calculate the present value of projected benefit payments and is specifically defined under the pension accounting standards. ETF used the long-term expected rate of return assumption for the WRS, which is 7.2 percent, as the discount rate because current and projected future plan assets are expected to cover the projected benefit payments for the WRS. If the current and projected future plan assets of the WRS had been determined to be insufficient to cover the projected benefit payments, the pension accounting standards would have required ETF to blend the long-term rate of return of 7.2 percent with the 20-year, tax exempt general obligation municipal bond index rate with an average rating of AA/Aa (3.31 percent as of December 29, 2017, using Fidelity's Index's 20-year Municipal GO AA Index). In such circumstances, the blended discount rate would have been lower and would have resulted in a larger total pension liability.

A change in the discount rate can have a significant effect on the amount of the total pension liability.

Under the pension accounting standards, ETF is required to calculate the sensitivity of the total pension liability to a one percentage point decrease or increase in the discount rate. At 7.2 percent, the total pension liability for the WRS was $101.4 billion as of December 31, 2017. However, a one percentage point decrease in the discount rate (6.2 percent) increases the total pension liability as of December 31, 2017, to $112.1 billion, and a one percentage point increase in the discount rate (8.2 percent) decreases the total pension liability to $93.3 billion.

Calculating a Net Pension Liability or Asset

To determine the net pension liability or asset, the pension accounting standards require the total pension liability to be subtracted from the pension plan's fiduciary net position. When the total pension liability is greater than the fiduciary net position, the pension plan will disclose a net pension liability in its notes. When the fiduciary net position is greater than the total pension liability, the pension plan will disclose a net pension asset in its notes.

ETF reported a net pension asset of $3.0 billion for the WRS as of December 31, 2017.

As of December 31, 2017, the WRS had a fiduciary net position of $104.4 billion and a total pension liability of $101.4 billion, which resulted in a net pension asset of $3.0 billion. As shown in Table 5, this represents an improvement from the net pension liability of $0.8 billion, reported as of December 31, 2016.

Table 5

WRS Net Pension Asset (Liability)[1]
As of December 31
(in billions)

	2016	2017	Increase (Decrease)
Fiduciary Net Position	$92.6	$104.4	$11.8
Total Pension Liability	(93.4)	(101.4)	(8.0)
Net Pension Asset (Liability)	**$(0.8)**	**$ 3.0**	**$ 3.8**

[1] The financial activity of the Long-Term Disability Insurance program was reported with the WRS beginning with the year ended December 31, 2017. This change increased both the fiduciary net position and total pension liability of the WRS for 2017. The 2016 amounts reported in the table do not include the financial activity of the Long-Term Disability Insurance program.

An increase in the value of the investments of the Core and Variable Funds from December 31, 2016, to December 31, 2017, was the primary cause of the $11.8 billion increase in the fiduciary net position and resulted in the reporting of a net pension asset as of December 31, 2017.

Calculating Other Collective Amounts

In addition to the calculation of the total pension liability and the calculation of the net pension liability or asset, the pension accounting standards require public pension plans to calculate pension expense, as well as amounts that are considered deferred for the plan. Pension expense is the net increase or decrease in the net pension liability or asset, with certain adjustments, and is recorded in the period during which the employee earned the pension benefit. For the year ended December 31, 2017, pension expense for the WRS was $1.3 billion. Deferred outflows of resources, which primarily represents the difference between projected and actual experience, was $4.4 billion. Deferred inflows of resources, which primarily represents the difference between projected and actual investment earnings on pension plan investments, was $5.8 billion.

Employer Reporting

Employers participating in the WRS have made a commitment to provide pension benefits and have an obligation to make contributions to fund those benefits.

As noted, the WRS is a cost-sharing, multiple-employer, defined-benefit pension plan with 1,499 participating employers. In this type of pension plan, the contributions are combined and the benefits are paid out of a common pool of assets. By participating in the WRS, employers have made a commitment to provide pension benefits to employees, and they are obligated to make contributions into the future to ensure that sufficient resources are available to make the benefit payments. Therefore, because the employers participating in the WRS have ultimate responsibility for the resulting pension obligations, each participating employer is required to report its proportionate share of the net pension liability or asset, as well as other collective amounts presented in the employer schedules in its GAAP-based financial statements.

Each employer participating in the WRS must report its proportionate share of the net pension asset in its GAAP-based financial statements.

To assist employers participating in the WRS in determining the employer's proportionate share of these amounts, ETF has prepared a Schedule of Employer Allocations and a Schedule of Collective Pension Amounts for the year ended December 31, 2017. We audited and provided unmodified opinions on these schedules in report 18-11. Because the WRS has calculated a net pension asset for the year ended December 31, 2017, each employer participating in the WRS must report its proportionate share of the net pension asset, as well as other collective amounts, on its GAAP-based financial statements. A net pension asset indicates that, as of December 31, 2017, the assets of the WRS were sufficient to cover the projected liability for benefit payments to employees under the financial reporting standards.

The proportionate share of the net pension asset for State of Wisconsin agencies as of December 31, 2017, was $829.7 million, of which $398.8 million related to UW System. The net pension asset for the state agencies will be included in the State's GAAP-based financial statements, which will be published in the State of Wisconsin's CAFR for the year ended June 30, 2018.

Funding and GASB Financial Reporting Methodologies

ETF uses a funding methodology to establish required contribution rates for employers and employees and to measure the pension plan's unfunded liabilities. For financial reporting purposes, ETF is required to use the GASB pension accounting standards. GASB did not establish the financial reporting methodology to be used for funding purposes. Instead, GASB created the financial reporting methodology to enhance transparency of pension-related information in financial reports and to be a tool to allow for comparisons across public pension systems. These two methodologies result in different measures of the funded status of the WRS. Under the funding methodology, the WRS is nearly 100.0 percent funded as of December 31, 2017, and under the GASB financial reporting methodology, the WRS is 102.9 percent funded.

There are similarities in the actuarial assumptions used in calculating the projected future benefit payments under the funding and financial reporting methodologies for the WRS, including assumptions related to mortality rates, salary increases, and disability rates. However, there are several differences in how the liability is calculated under each methodology, which creates a differing determination of the financial status of the pension plan.

One of the key differences in the calculations is how investment income or loss is considered. Under the funding methodology, ETF's actuary uses a smoothing mechanism for investment income or loss, known as the market recognition account (MRA) for the Core Fund investment activity. The MRA accumulates the difference between actual investment income or loss and expected investment income calculated at the long-term expected rate of return assumption of 7.2 percent. The difference is then distributed into the calculated plan net assets over a five-year period so that the expected investment income is affected by portions of the previous five years' amounts included in the MRA. This results in less volatility in the plan net assets under the funding methodology and, thus, less volatility in the calculation of the contribution rates for employers and employees.

Under the GASB financial reporting methodology, WRS investments are valued at fair value.

Under the financial reporting methodology, pension plan assets are valued at fair value as of the reporting period end date, which is December 31 for the WRS. The use of the fair value of the plan assets in the calculation will cause a large degree of volatility in the reported net pension liability or asset, depending upon investment performance and fluctuations in the investment market.

Relationship to Contribution Rates

ETF seeks to set contribution rates that allow employers to better plan and meet contribution requirements.

The WRS is an irrevocable trust and all funds remain in the trust and can only be used to fund pension benefits. ETF's funding policy for the WRS has the goal of establishing steady contribution rates that allow employers to better plan and meet contribution requirements.

Contribution rates are set to fund the benefits earned by employees during the year. In setting these rates, one of the most significant factors considered is investment performance. However, while the investment performance of the Core and Variable Funds affects the setting of contribution rates, the full effect of a particular year's investment gain or loss is smoothed through the use of the MRA, so that contribution rates are gradually increased or decreased over time.

Although the net pension liability or asset calculated under the GASB pension standards for financial reporting is an indication of the financial health of the system, it should not be used as a mechanism to determine if contribution rates should be increased or decreased. Under the pension accounting standards, GASB separated the funding and financial reporting methodologies. If ETF were to adjust contribution rates based on the financial reporting methodology, more pronounced fluctuations in the rates could result, primarily because the fair value of investments at a point in time would be used. The volatility of using the fair value of investments to adjust contribution rates could be difficult for employers and employees to anticipate and manage.

Comparison to Other Pension Plans

GASB anticipated that the pension accounting standards would allow for comparability across public pension plans since plans are required to use the same GASB financial reporting methodology and are required to value plan investments at fair value when calculating the net pension liability or net pension asset.

Differences in the structure of pension plans and timing of pension plan reporting will affect the comparability across pension plans.

Although pension plans will follow the same accounting standards in reporting the pension liability, differences such as plan structures, planned asset allocations, and investment strategies will continue to affect the comparability of pension plans. In addition, because pension plans have varying fiscal-year ends, changes in the condition of investment markets at different points in time during a year will also affect comparability.

We collected information from other cost-sharing, multiple-employer, defined-benefit plans that were part of the WRS peer group defined by an annual study performed by CEM Benchmarking Inc. In comparison to these plans, the WRS had the highest funded ratio of 102.9 percent, as shown in Table 6.

Table 6

Comparison of Selected Pension Plans Based on Financial Reporting Methodology[1, 2]
(in billions)

Pension Plan	Total Pension Liability	Fiduciary Net Position	Net Pension Asset	Net Pension Liability	Funded Ratio
Wisconsin Retirement System (WRS)[3]	$101.4	$104.4	$3.0	n/a	102.9%
New York State and Local Employees' Retirement System[4]	209.1	197.6	n/a	11.5	94.5
Ohio Public Employees Retirement System[3]	102.7	87.1	n/a	15.6	84.9
Oregon Public Employees Retirement System	79.9	66.4	n/a	13.5	83.1
Iowa Public Employees Retirement System	37.4	30.8	n/a	6.7	82.2
State Teachers Retirement System of Ohio	96.1	72.4	n/a	23.8	75.3
Virginia Retirement System—Teachers Retirement System	45.4	33.1	n/a	12.3	72.9
Arizona State Retirement System	51.8	36.2	n/a	15.6	69.9
California State Teachers' Retirement System	302.8	210.3	n/a	92.5	69.5
Pennsylvania Public School Employees' Retirement System	102.5	53.2	n/a	49.4	51.8

[1] Based on information from other cost-sharing, multiple-employer, defined-benefit pension plans that were part of the WRS peer group as defined by an annual study performed by CEM Benchmarking Inc.

[2] Unless otherwise noted, for the plan year ended June 30, 2017.

[3] For the plan year ended December 31, 2017.

[4] For the plan year ended March 31, 2017.

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Other Postemployment Benefits (OPEB) ▪

OPEB refers to the benefits, other than pensions, that a state or local government employee may receive after they have left employment, generally upon retirement. An OPEB plan can include medical, prescription drug, dental, vision, and other health-related benefits, whether provided separately or through a pension plan, as well as death benefits, life insurance, and long-term care coverage, when provided separately from a pension plan.

In 2015, GASB issued two new OPEB standards: GASB Statement Number 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* for accounting and financial reporting for OPEB plans that are administered through trusts or equivalent arrangements; and GASB Statement Number 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* for the financial reporting by participating employers. These OPEB accounting standards first became effective for the OPEB plans administered by ETF for CY 2017, and for participating employers for reporting periods beginning after June 15, 2017.

The new GASB standards change accounting and financial reporting requirements for measuring the OPEB liability for OPEB plans, as well as requirements for both the notes and required supplementary information to the OPEB plan financial statements, and the GAAP-based financial statements for the employers that participate in OPEB plans. GASB's overall goal with the issuance of new OPEB accounting standards was to improve the usefulness of OPEB information for making financial decisions and assessing accountability.

Trusted and Non-Trusted OPEB Plans

One of the primary factors that determines how an OPEB plan is reported is the determination of whether a plan is administered through a trust. To be considered a trusted plan, all of the following requirements must be met:

- contributions from employers and employees and earnings on those contributions must be considered irrevocable;
- plan assets must be dedicated to providing benefits to plan members according to the benefit terms; and
- plan assets must be legally protected from creditors of the employer, employees, and ETF.

If any of these requirements is not met, the OPEB plan is considered a non-trusted plan and the employers participating in the plan are solely responsible for determining the effect of participation in these programs on their GAAP-based financial statements, including the calculation of the OPEB liability.

The State Retiree Life Insurance program and the Local Retiree Life Insurance program are considered trusted OPEB plans.

ETF administers four separate OPEB plans for retired individuals: the State Retiree Life Insurance program and the Local Retiree Life Insurance program, both of which are considered trusted OPEB plans; and the State Retiree Health Insurance program and the Local Retiree Health Insurance program. The assets accumulated for the State Retiree Life Insurance program and the Local Retiree Life Insurance program, represented by the fiduciary net position, are reported by ETF in the Statement of Fiduciary Net Position for each program. In addition, ETF is responsible for disclosing information in the notes and in the required supplementary information related to the programs and the calculation of the OPEB liability. The State Retiree Health Insurance program and the Local Retiree Health Insurance program are considered non-trusted plans because the programs do not accumulate assets dedicated to providing benefits to plan members.

Retiree Life Insurance

Administered under the provisions of s. 40.70, Wis. Stats., the State Retiree Life Insurance program and the Local Retiree Life Insurance program provide postemployment life insurance coverage to all eligible employees of participating employers. The State of Wisconsin, including state agencies such as UW System and state authorities such as the UW Hospitals and Clinics Authority, participates in the State Retiree Life Insurance program. As noted, there were 738 local government employers participating in the Local Retiree Life Insurance program as of December 31, 2017. Under the OPEB accounting standards, the State Retiree Life Insurance program is a defined-benefit, single-employer OPEB plan and the Local Retiree Life Insurance program is a defined-benefit, multiple-employer OPEB plan.

As the third-party administrator for both the State Retiree Life Insurance program and the Local Retiree Life Insurance program, Securian Financial Group is responsible for the premium collection, benefit payment, and investment of assets accumulated for the payment of benefits. Employers pay stated contribution amounts to the program that are based upon the active employee premium amounts.

Calculating the Total OPEB Liability

The total OPEB liability is the sum of amounts needed to pay for the OPEB benefits earned by each participant as of the date of the actuarial valuation. A liability exists because the employers participating in the OPEB program have committed to providing the benefit at some point in the future. The calculation of the total OPEB liability is complex and includes various actuarial assumptions and calculations, such as:

- a projection of future benefit payments for active and retired participants and their beneficiaries based upon the current terms of the plan;

- a discount of those payments to their present value, which is the amount of funds needed currently to provide the projected payments in the future; and

- an allocation of the present value of benefit payments over past, present, and future periods of employee service.

As of December 31, 2017, the total OPEB liability was $845.5 million for the State Retiree Life Insurance program and $545.1 million for the Local Retiree Life Insurance program.

To determine the total OPEB liability for the State Retiree Life Insurance program and for the Local Retiree Life Insurance program as of December 31, 2017, ETF's actuaries performed actuarial valuations as of January 1, 2017, and adjusted for changes such as interest earned, contributions paid, and benefits paid during CY 2017. Based on these valuations and the adjustments, the total OPEB liability for the State Retiree Life Insurance program was $845.5 million as of December 31, 2017, and the total OPEB liability for the Local Retiree Life Insurance program was $545.1 million as of December 31, 2017.

The discount rate is a critical factor in calculating the total OPEB liability, and it can have a significant effect on the amount of the total OPEB liability. The discount rate, or interest rate, used to calculate the present value of projected benefit payments is specifically defined under the new OPEB accounting standards. For OPEB plans that are projected to have sufficient assets to make all projected future benefit payments, the long-term expected rate of return assumption is used to calculate the present value of projected benefit payments. However, when the assets are projected to be insufficient to make all projected future benefit payments of current active and retired employees eligible for benefits, a discount rate that blends the long-term expected rate of return with the 20-year, tax exempt general obligation municipal bond index rate with an average rating of AA/Aa is required. ETF was required to use a blended discount rate for both the State Retiree Life Insurance program and the Local Retiree Life Insurance program. The long-term expected rate of return of 5.0 percent was blended with the municipal bond rate of 3.44 percent as of December 31, 2017, using the Bond Buyer GO 20-Bond Municipal Bond Index. The blended discount rate for the State Retiree Life Insurance program was 3.60 percent and the blended discount rate for the Local Retiree Life Insurance program was 3.63 percent.

A change in the discount rate can have a significant effect on the amount of the total OPEB liability.

Because the State Retiree Life Insurance program and the Local Retiree Life Insurance program are required to use a blended discount rate, the OPEB liability calculated is larger than if the long-term expected rate of return of 5.0 percent was used. Under the OPEB accounting standards, ETF is required to calculate the sensitivity of the total OPEB liability to a one percentage point increase or decrease in the discount rate. For the State Retiree Life Insurance program, the total OPEB liability is $845.5 million as of December 31, 2017, using the discount rate of 3.60 percent. The sensitivity of the total OPEB liability to a one percentage point increase or decrease in the discount rate ranges from $707.0 million (at 4.60 percent) to $1,023.9 million (at 2.60 percent). For the Local Retiree Life Insurance program, using the discount rate of 3.63 percent, the total OPEB liability is $545.1 million, as of

December 31, 2017. The sensitivity of the total OPEB liability to a one percentage point increase or decrease in the discount rate ranges from $449.6 million (at 4.63 percent) to $669.5 million (at 2.63 percent).

Calculating the Net OPEB Liability

To determine the net OPEB liability or asset, the OPEB accounting standards require the total OPEB liability be subtracted from the OPEB plan's fiduciary net position. When the total OPEB liability is greater than the fiduciary net position, the OPEB plan will disclose a net OPEB liability in its notes. When the fiduciary net position is greater than the total OPEB liability, the OPEB plan will disclose a net OPEB asset in its notes.

As of December 31, 2017, the net OPEB liability was $493.5 million for the State Retiree Life Insurance program and $300.9 million for the Local Retiree Life Insurance program.

As shown in Table 7, both the State Retiree Life Insurance program and the Local Retiree Life Insurance program had a net OPEB liability as of December 31, 2017. The State Retiree Life Insurance program had a fiduciary net position of $352.0 million and a total OPEB liability of $845.5 million, which resulted in a net OPEB liability of $493.5 million. The Local Retiree Life Insurance program had a fiduciary net position of $244.2 million and a total OPEB liability of $545.1 million, which resulted in a net OPEB liability of $300.9 million.

Table 7

Net OPEB Liability for the State Retiree Life Insurance Program and the Local Retiree Life Insurance Program
As of December 31, 2017
(in millions)

	State Retiree Life Insurance	Local Retiree Life Insurance
Fiduciary Net Position	$ 352.0	$ 244.2
Total OPEB Liability	(845.5)	(545.1)
Net OPEB Liability	**$(493.5)**	**$(300.9)**

A net OPEB liability indicates that, at that point in time, the projected liability for benefit payments to employees exceeded the assets of the fund.

A net OPEB liability indicates that, at that point in time, the projected liability for benefit payments to employees exceeded the assets of the fund. Based upon the calculation of the total OPEB liability and the fiduciary net position of the fund under GASB requirements, the State Retiree Life Insurance program had a funded ratio of 41.6 percent and the Local Retiree Life Insurance program had a funded ratio of 44.8 percent as of December 31, 2017. Because GASB did not create the financial reporting methodology to be used for funding purposes, the existence of a net OPEB liability for the State Retiree Life Insurance program and the Local Retiree Life Insurance program should not be used to support a change in contribution rates for the programs. We note that the Group Insurance Board plans to review program funding policies at its November 2018 board meeting.

Calculating Other Collective Amounts

In addition to the calculation of the total OPEB liability and the calculation of the net OPEB liability, the OPEB accounting standards require OPEB plans to calculate OPEB expense, as well as amounts that are considered deferred for the plan. OPEB expense is the net increase or decrease in the net OPEB liability, with certain adjustments, and is recorded in the period during which the employee earned the OPEB. For the year ended December 31, 2017, OPEB expense for the State Retiree Life Insurance program was $47.5 million and OPEB expense for the Local Retiree Life Insurance program was $31.8 million. The amounts that are considered deferred for the plan represent inflows and outflows that result due to differences between expected and actual experience, changes of actuarial assumptions, and differences between projected and actual investment earnings. These are recognized in future OPEB expenses.

Deferred outflows of resources, which primarily represent changes in assumptions and the difference between projected and actual investment earnings was $46.8 million for the State Retiree Life Insurance program and $32.5 million for the Local Retiree Life Insurance program. Deferred inflows of resources, which primarily represent the difference between expected and actual experience was $4.5 million for the State Retiree Life Insurance program and $4.2 million for the Local Retiree Life Insurance program.

Employer Reporting

Employers have made a commitment to provide postemployment life insurance benefits to employees and have an obligation to make contributions to fund these benefits.

For the State Retiree Life Insurance program and the Local Retiree Life Insurance program, contributions from employers are combined, by program, and the benefits are paid out of the common pool of assets established for each program. By participating in the State Retiree Life Insurance program or the Local Retiree Life Insurance program, each employer has made a commitment to provide postemployment life insurance benefits to employees and is obligated to make contributions into the future to ensure that sufficient resources are available to make the benefit payments. Therefore, because the employer for the State Retiree Life Insurance program and the employers participating in the Local Retiree Life Insurance program have responsibility for the resulting OPEB obligations, each employer will be required to report its share of the net OPEB liability, as well as other collective amounts including OPEB expense, on its GAAP-based financial statements.

Each participating employer must report its share of the net OPEB liability in its GAAP-based financial statements.

The State Retiree Life Insurance program includes state agencies, including UW System, and the various authorities that participate in the program, such as the UW Hospitals and Clinics Authority. To assist the State of Wisconsin and those agencies and authorities that are part of the State's financial reporting entity but that prepare separately issued financial statements, ETF has prepared a Schedule of Employer Allocations and a Schedule of Collective OPEB Amounts for the year ended December 31, 2017. We audited and provided unmodified opinions on these schedules in report 18-13. The net OPEB liability of $493.5 million for the State Retiree Life Insurance program, as well as the other collective amounts, will be included in the State's GAAP-based financial statements, which will be published in the State of Wisconsin's CAFR for the year ended June 30, 2018.

To assist employers participating in the Local Retiree Life Insurance program in determining the employer proportionate share of the net OPEB liability and other amounts, ETF also prepared a Schedule of Employer Allocations and a Schedule of Collective OPEB Amounts for the year ended December 31, 2017, for the Local Retiree Life Insurance program. We audited and provided unmodified opinions on these schedules in report 18-12. Each local government that participates in the Local Retiree Life Insurance program must report its proportionate share of the net OPEB liability of $300.9 million for the Local Retiree Life Insurance program, as well as the other collective amounts in its GAAP-based financial statements for reporting periods beginning after June 15, 2017.

Retiree Health Insurance

The State Retiree Health Insurance program and the Local Retiree Health Insurance program are considered non-trusted OPEB plans.

The State Retiree Health Insurance program and the Local Retiree Health Insurance program are non-trusted OPEB plans that provide postemployment health insurance coverage to employees of the State of Wisconsin and employees of local governments that participate in the Wisconsin Public Employers Insurance Plan. Local government employers are responsible for ensuring the reporting requirements of the OPEB standards are met for the Local Retiree Health Insurance program. DOA, as the entity responsible for preparing the GAAP-based financial statements of the State of Wisconsin, is responsible for ensuring that the reporting requirements of the OPEB standards are met for the State Retiree Health Insurance program. The OPEB liability for the State Retiree Health Insurance program will be reported in the State of Wisconsin's CAFR for the year ended June 30, 2018. Information regarding the calculation of the OPEB liability for this program is included in report 18-14.

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Auditor's Report ■

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Joe Chrisman
State Auditor

Report 18-10

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters

Senator Robert Cowles and
Representative Samantha Kerkman, Co-Chairpersons
Joint Legislative Audit Committee

Members of the Employee Trust Funds Board and
Mr. Robert J. Conlin, Secretary
Department of Employee Trust Funds

We have audited the financial statements and related notes of the following fiduciary funds administered by the State of Wisconsin Department of Employee Trust Funds (ETF) as of and for the year ended December 31, 2017: the Wisconsin Retirement System, Accumulated Sick Leave Conversion Credits, Employee Reimbursement Accounts and Commuter Benefits, State Retiree Life Insurance, Local Retiree Life Insurance, Milwaukee Retirement Systems, State Retiree Health Insurance, and Local Retiree Health Insurance. In addition, we have audited the following proprietary funds administered by ETF as of and for the year ended December 31, 2017: Duty Disability Insurance, Health Insurance, Income Continuation Insurance, and Life Insurance. We have issued our report thereon dated October 2, 2018. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, which is issued by the Comptroller General of the United States. The financial statements and related auditor's report have been included in ETF's *2017 Comprehensive Annual Financial Report.*

Internal Control over Financial Reporting

Management of ETF is responsible for establishing and maintaining effective internal control over financial reporting (internal control). In planning and performing our audit of the financial statements, we considered ETF's internal control to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ETF's internal control. Accordingly, we do not express an opinion on the effectiveness of ETF's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent misstatements, or to detect and correct misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement of ETF's financial statements will not be prevented, or that a material misstatement will not be detected and corrected on a timely basis. A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a deficiency in internal control, described in the accompanying Finding and Response Schedule, related to the Wisconsin Employee Benefit System (WEBS) security. We consider this deficiency to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the financial statements are free from material misstatement, we performed tests of compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Response to Finding

ETF's written response to the finding identified in our audit is described in the accompanying Finding and Response Schedule. ETF's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of This Report

This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be used when considering ETF's internal control and compliance. The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of ETF's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU

Joe Chrisman
State Auditor

October 2, 2018

Finding and Response Schedule

Finding 2018-001: Wisconsin Employee Benefit System Security

Criteria:

WEBS is a DB2 system implemented by ETF in 1992 to administer Wisconsin Retirement System (WRS) data and serve as a central repository for benefit data for programs administered by ETF. WEBS is maintained on the Department of Administration's Division of Enterprise Technology's mainframe. To access WEBS, users require access to both the mainframe and to WEBS. WEBS contains information for all WRS participants, including sensitive information such as social security numbers, birthdates, earnings, and beneficiary information for state and local government employees. Due to the sensitive nature of this information, WEBS access should be appropriately limited.

To ensure access remains appropriate, the Bureau of Information Technology Services (BITS) completes an annual review of access to WEBS. As part of this review, BITS sends a listing of WEBS access to managers in each division and requests the managers review the access for appropriateness and notify BITS of any needed changes to a user's access. BITS is responsible for updating the WEBS access based on the information provided by the managers.

Condition:

We reviewed the process BITS performed to conduct the annual WEBS access review. We reviewed all responses BITS received from the managers, and we identified access that changes were requested by managers for 25 users. We found that BITS did not make the requested access changes for 21 of the 25 users. Further, one of the users who continued to have access was no longer employed at ETF. We did identify that this user's access to the mainframe had been revoked. Therefore, the user would not have been able to access WEBS.

Context:

In performing our testing, we requested the emails sent by BITS to managers, the responses from managers, and current WEBS access listings. Our review focused on manager responses and whether BITS made the access changes requested by managers.

Effect:

Inappropriate access to WEBS increases the risk that personal and confidential state and local employee information could be inappropriately changed or compromised. For example, access was not removed for one user who had the ability to change a beneficiary.

Cause:

BITS did not track the WEBS access review responses to ensure the access was removed as requested.

☑ **Recommendation**

We recommend the Department of Employee Trust Funds review its procedures for tracking the responses from managers for WEBS access changes and update as necessary to ensure that access changes are made as requested.

Agency Response: As noted in the finding, BITS staff provides ETF managers a report listing staff that have update access to WEBS. Managers review this report to ensure access is consistent with staff's current job responsibilities and report any changes needed to BITS. This is done on an annual basis.

ETF acknowledges that during the last annual review, some changes requested by managers were not made in the system. Fortunately, with the instances identified, we believe the risk of inappropriate updates was low due to other internal controls in place. For example, when a beneficiary payment is processed, staff verify the payee matches the paper beneficiary form that was signed by the member. In addition, other security controls such as removing user credentials and requiring dual factor authentication prevent former employees from accessing any ETF mainframe systems.

ETF agrees further process changes are necessary to ensure requested access changes are completed in the system. ETF has or will implement the following process changes to improve tracking WEBS annual review responses and updating system access rights:

1. Going forward, a security ticket will be created in our ticket tracking system (RAMS) to provide a uniform way of tracking update requests. A master ticket will be created and sub-tickets / tasks will be created for each Division and Office from the master ticket. Requests for access updates will be added to the tickets for the respective Divisions or Offices. This will provide better visibility and tracking of the update requests.

2. Going forward, requests processed by a member of the security team will be reviewed and verified by another member of the security team. BITS management will review to ensure accuracy and completeness.

3. To assist managers in better understanding the access noted in the report, a document describing the WEBS screens will be provided. This will be done by November 30, 2018.

4. A report will be created and reviewed by BITS staff to identify situations where users are still in the WEBS security tables, but their mainframe logon id has been removed. This will be completed by November 30, 2018.

ETF recognizes the importance of ensuring access to our systems is appropriate. ETF has invested heavily in information security. ETF's recent efforts include hiring a Chief Information Security Officer (CISO), hiring two additional security staff, conducting a 3rd party security assessment against the SANS Top 20 security controls, creating an information security roadmap, and implementing a security incident response plan. ETF believes the process changes noted above will ensure that requested access changes are implemented in a timely manner.

In addition to the above, BITS will consult with the Office of Internal Audit and business units to further analyze current WEBS access. Based on the analysis, new logical roles will be created that more consistently provide WEBS access based on job duties. Access granted to WEBS will be based on these new logical roles. An exception process will be created for unique situations. This should be in place for the 2019 annual security review.

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Appendices ■

Appendix 1

Employee Trust Funds Board Membership

2018

Name	Affiliation	Board Member Since
Wayne Koessl, Chair	Appointed by Wisconsin Retirement Board	1996
John David, Vice Chair	Appointed by Wisconsin Retirement Board	2008
Robert Niendorf, Secretary	Appointed by Teachers Retirement Board	1992
William Ford	Elected by retired WRS participants, and is a WRS annuitant	2011
Michael Langyel	Appointed by Teachers Retirement Board	2009
Leilani Paul	Elected by participating employees of either technical college or school district educational support personnel, and is an active WRS participant	2015
Roberta Rasmus	Appointed by Teachers Retirement Board	2012
Stacey Rolston	Designee of the Administrator, Division of Personnel Management, Department of Administration	2015
Victor Shier[1]	Appointee of the Governor, with advice and consent of Senate, representing the public	2013
Mary Von Ruden	Appointed by Wisconsin Retirement Board	2009
David Wiltgen	Appointed by Teachers Retirement Board	2011
Bob Ziegelbauer	Designee of the Governor	2016
Vacant	Appointed by Wisconsin Retirement Board	

[1] Resigned in September 2018.

Appendix 2

Group Insurance Board Membership

2018

Name	Affiliation	Board Member Since
Michael Farrell, Chair	Appointee of the Governor	2012
Stacey Rolston, Vice Chair	Designee of the Administrator, Division of Personnel Management, Department of Administration	2015
Herschel Day, Secretary	Appointee of the Governor, insured participant in WRS who is a teacher	2013
Charles Grapentine	Appointee of the Governor, insured participant in WRS who is a retiree	2012
Waylon Hurlburt	Designee of the Secretary, Department of Administration	2017
Theodore Neitzke	Appointee of the Governor, insured participant in WRS who is an employee of a local unit of government	2014
Jennifer Stegall	Appointee of the Governor, insured participant in WRS who is not a teacher	2017
Nancy Thompson	Appointee of the Governor, chief executive or member of the governing body of a local unit of government that participates in the WRS	2012
J.P. Wieske	Designee of the Commissioner of Insurance	2016
Bob Wimmer	Designee of the Attorney General	2018
Bob Ziegelbauer	Designee of the Governor	2016

Response ■

STATE OF WISCONSIN
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

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October 1, 2018

JOE CHRISMAN, STATE AUDITOR
LEGISLATIVE AUDIT BUREAU
22 E MIFFLIN ST SUITE 500
MADISON WI 53703

Dear Mr. Chrisman,

Thank you for the opportunity to review and comment on the audit of the Department of Employee Trust Funds (ETF) Comprehensive Annual Financial Report (CAFR) for the year ended December 31, 2017. The Wisconsin Retirement System (WRS) continues to be in a strong financial position. The funding ratio calculated under the Governmental Accounting Standards Board (GASB) financial reporting methodology of 102.9% continues to be the highest funded ratio among the WRS peer group and increased from 99.1% the prior year.

Over the past two years, ETF has focused on transforming its financial reporting process and increasing staff competencies. The results of the audit are a testament to ETF's progress in this area. The positive results also came in a year that included additional challenges as ETF implemented several complex accounting changes, including implementation of new GASB standards related to Other Postemployment Benefits (OPEB). These standards required several new calculations, disclosures and additional reporting by ETF to participating employers of the OPEB plans.

In addition, this year the CAFR will be published months earlier than past years. By completing the entire CAFR earlier, there is no need to issue separate financial reports for the WRS and the OPEB plans to meet participating employers' financial reporting requirements. This has resulted in efficiencies for both ETF and LAB. We appreciate LAB staff working with us to complete the audit of ETF's CAFR to accomplish this goal.

Sincerely,

Robert J. Conlin
Secretary