

Report 20-9
September 2020

Retirement Funds Investment Activity

Calendar Year 2019

State of Wisconsin Investment Board

STATE OF WISCONSIN



Legislative Audit Bureau ■

Retirement Funds Investment Activity

Calendar Year 2019

State of Wisconsin Investment Board

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OPINION PUBLISHED SEPARATELY

The financial statements and our opinions on them are included in the
State of Wisconsin Investment Board's *2019 Retirement Funds Annual Report*



STATE OF WISCONSIN | Legislative Audit Bureau

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Joe Chrisman
State Auditor

September 1, 2020

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

Dear Senator Cowles and Representative Kerkman:

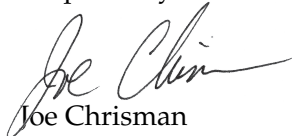
As required by ss. 13.94 (1) (df) and 25.17 (51), Wis. Stats., we have completed a financial audit of the Core Retirement Investment Trust Fund (Core Fund) and the Variable Retirement Investment Trust Fund (Variable Fund) managed by the State of Wisconsin Investment Board (SWIB) as of and for the year ended December 31, 2019. SWIB invests assets of the Wisconsin Retirement System through the Core Fund and Variable Fund, and together these funds are known as the Retirement Funds. The financial statements report the investment activity for the Retirement Funds. The financial statements and our unmodified opinions on them are included in SWIB's *2019 Retirement Funds Annual Report*, which may be found on SWIB's website.

Net investment position provides a measure of overall financial condition. On the basis of generally accepted accounting principles (GAAP), the net investment position of the Core Fund increased from \$93.5 billion as of December 31, 2018, to \$107.8 billion as of December 31, 2019. The Core Fund reported a net investment loss of \$3.6 billion in 2018 and a net investment gain of \$17.8 billion in 2019. The one-year investment return for the Core Fund increased from a negative 3.3 percent in 2018 to 19.9 percent in 2019. The Core Fund investment return in 2019 is primarily attributed to strong investment returns from public equity, public fixed income, and private equity investments.

The net investment position of the Variable Fund increased from \$7.1 billion as of December 31, 2018, to \$8.7 billion as of December 31, 2019. The Variable Fund reported a net investment loss of \$0.6 billion in 2018 and a net investment gain of \$2.0 billion in 2019. The one-year investment return for the Variable Fund increased from a negative 7.9 percent in 2018 to 28.6 percent in 2019. The Variable Fund investment return in 2019 is attributed to strong investment returns from public equity investments.

The Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters, which is required by *Government Auditing Standards*, begins on page 5. We report a significant deficiency in internal control related to errors in the reporting of unfunded commitments in the notes that accompany the financial statements. The note disclosure, which was misstated by a total of \$1.5 billion, was corrected for presentation in SWIB's *2019 Retirement Funds Annual Report*. We recommend SWIB review its procedures and financial reporting process to address the deficiency we identified.

Respectfully submitted,


Joe Chrisman
State Auditor

JC/CS/ss

Auditor's Report ■



Report 20-9

**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 Board of Trustees, and
Mr. David Villa, Executive Director/Chief Investment Officer
State of Wisconsin Investment Board

We have audited the financial statements and the related notes of the Core Retirement Investment Trust Fund and the Variable Retirement Investment Trust Fund (Retirement Funds) managed by the State of Wisconsin Investment Board (SWIB) as of and for the year ended December 31, 2019, and have issued our report thereon dated August 26, 2020. 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 opinions have been included in SWIB's 2019 *Retirement Funds Annual Report*.

Internal Control over Financial Reporting

Management of SWIB 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 SWIB's internal control to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of SWIB's internal control. Accordingly, we do not express an opinion on the effectiveness of SWIB'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 the Retirement Funds' 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 Finding and Response Schedule, that we consider to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Retirement Funds' 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*.


Management's Response

The response from SWIB management to the significant deficiency in internal control we identified in our audit is included in the accompanying Finding and Response Schedule. This 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 SWIB'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 SWIB's internal control or on compliance. Accordingly, this report is not suitable for any other purpose.

LEGISLATIVE AUDIT BUREAU


Joe Chrisman
State Auditor

August 26, 2020

FINDING AND RESPONSE SCHEDULE

Note Disclosure—Unfunded Commitments

Background:

SWIB provides professional investment management for the funds entrusted to it, including the assets of the Wisconsin Retirement System (WRS), and SWIB invests assets of the WRS through the Retirement Funds. SWIB invests some assets of the Retirement Funds in limited partnership investments, the majority of which are investments in private equity funds that invest in non-publicly traded companies and real estate funds. When investing in limited partnerships, SWIB enters into an agreement with a general partner. The agreement specifies the total amount that SWIB, as a limited partner, will commit to the investment. When funds are needed, the general partner will make a request to SWIB for funding. The amount that SWIB committed to the investment, but has not yet funded, is considered an unfunded commitment. According to SWIB legal staff, once a limited partnership investment agreement is signed by SWIB and accepted by the general partner, SWIB is legally obligated to make payment on the unfunded commitment when requested by the general partner.

Criteria:

SWIB is responsible for maintaining effective internal controls to ensure the financial information reported for the financial statements is fairly presented in accordance with Governmental Accounting Standards Board (GASB) standards, and that misstatements are prevented, or detected and corrected, in a timely manner.

In accordance with GASB Statement 72 *Fair Value Measurement and Application*, SWIB is required to disclose unfunded commitments for limited partnership and other investments. GASB Statement 72, Appendix B, further states that unfunded commitments not included within the requirements of GASB Statement 72, must follow National Council on Governmental Accounting (NCGA) Statement 1, which states that significant commitments are essential to the fair presentation of the financial statements and should be disclosed.

During 2019, SWIB investment management staff used two different information technology applications—Stepstone and eFront—to maintain and track the unfunded commitments for limited partnership investments. Stepstone was used for private equity fund limited partnerships and eFront was used for real estate limited partnerships. SWIB investment management staff annually provide SWIB finance staff with a list of unfunded commitments using information in Stepstone and eFront. SWIB finance staff use the list of unfunded commitments to prepare the required note disclosures.

Condition:

We found SWIB finance staff used an incomplete list of unfunded commitments to prepare the unfunded commitments note disclosure for the period ended December 31, 2019. During our testing of the note disclosure, we identified an unfunded commitment of \$100.0 million that was omitted from the note disclosure. For this individual real estate limited partnership investment, SWIB signed an agreement on December 19, 2019, and the agreement was accepted by the general partner on December 20, 2019. Because SWIB did not provide funding under the terms

of the agreement prior to the end of the reporting period, no disclosure was required under GASB 72. However, SWIB was legally obligated as of the end of the reporting period to provide funding to the general partner when requested in accordance with the terms of the agreement. Because NCGA 1 requires the disclosure of significant commitments, these additional unfunded commitments related to limited partnerships were required to be disclosed.

We discussed our concerns with SWIB finance staff and requested that the staff further review the limited partnership agreements to determine if other unfunded commitments required disclosure. From this review, SWIB finance staff determined additional unfunded commitments of \$1.2 billion related to 19 limited partnership agreements were omitted from the note disclosure, for a total omission of \$1.3 billion in unfunded commitments. One of the omitted agreements had a general partner acceptance date of May 17, 2016, and the remaining 18 agreements had general partner acceptance dates ranging from March 28, 2019, through December 20, 2019. In addition, as a result of our request, SWIB determined that an additional \$250.0 million of disclosures required under NCGA 1 were inaccurately included with the GASB 72 disclosures. In total, unfunded commitments in the note disclosure were misstated by \$1.5 billion.

Context:

We reviewed the disclosures for unfunded commitments, discussed the process used by SWIB to compile the note disclosure, and completed testing.

SWIB's unfunded commitments for 2019 totaled \$10.5 billion, of which \$9.0 billion related to GASB 72 fair value measurement disclosures and the remaining \$1.5 billion related to other unfunded commitments that required disclosure under NCGA 1.

Effect:

The notes to the financial statements for the year ended December 31, 2019, were materially misstated. SWIB finance staff corrected the note disclosure related to unfunded commitments as presented in its *2019 Retirement Funds Annual Report*.

Cause:

The list of unfunded commitments that SWIB investment staff originally provided to SWIB finance staff was incomplete and finance staff did not have a sufficient review process to correctly verify the provided information or to identify that information was missing.

SWIB finance staff noted that, beginning in calendar year 2020, new procedures were put in place to use eFront to record and track unfunded commitments for all limited partnerships. It is important that SWIB investment management staff have procedures to enter unfunded commitments into eFront on a timely basis to ensure staff can track and provide an accurate and complete list of unfunded commitments to SWIB finance staff for financial reporting purposes.

☑ **Recommendation**

We recommend the State of Wisconsin Investment Board:

- *review its procedures to ensure commitments related to limited partnership investments are recorded in a timely manner in the eFront investment software used to track these investments;*
- *review its procedures for identifying commitments, including unfunded commitments related to limited partnership investments, to ensure accurate and complete information is summarized and provided to finance staff to include in the notes to the financial statements;*
- *develop a process for finance staff to review information provided by investment staff to ensure it is complete and accurate; and*
- *review its overall financial reporting process to identify whether there are other areas where errors in the information provided to the finance staff may make SWIB more at risk for misstatements in the preparation of the financial statements and notes for the Retirement Funds, and make improvements to its financial reporting process as necessary.*

Response and Corrective Action Plan from SWIB Management: SWIB agrees to take steps to address the recommendations. The underreporting of unfunded commitments is due to a methodology difference in how the unfunded commitment reports are generated. To date, the private equity group has relied on reports from SWIB's consultant Stepstone's Omni system. That system registers fund commitments once a vintage year has been assigned, which happens when a general partner calls the first capital. Funds that SWIB had committed capital to, but which had not yet called capital, were thus not captured in the reports that Finance relied on to produce the unfunded commitment amounts. Regarding the limited partnership agreement with the general partner acceptance date of May 17, 2016, that fund was raised as an annex fund, with capital and fees to be initiated only if conditions were ripe for the strategy. The fund first called capital in March 2020, which is why it did not appear in prior reports. This amount of delay between the capital commitment and the first capital call is uncommon.

SWIB will modify its reporting going forward using the eFront system to capture all funds to which SWIB has committed capital, whether the funds have called capital or not. SWIB Finance staff will rely on information from the eFront system, which will now include all unfunded commitments. Prior to finalizing the unfunded commitment note disclosure, Finance staff will confirm the completeness and accuracy of unfunded commitment amounts with SWIB Operations, Legal, and Front Office staff.

SWIB Finance staff has established strong controls to reconcile information included in the financial statements to reliable source data and is continually evaluating its processes to identify opportunities to make improvements as may be necessary or warranted.

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