State Auditor's Office

John Keel, CPA
State Auditor

A Report on

The Audit of the Employees Retirement System's Fiscal Year 2007 Financial Statements

February 15, 2008

Members of the Legislative Audit Committee:

In our audit report dated December 18, 2007, we concluded that the Employees Retirement System's (System) basic financial statements for fiscal year 2007 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards. Our procedures identified a material weakness in internal control over financial reporting that could have materially affected the financial statements. Specifically, the System made four death benefit payments for commissioned peace officers from the wrong fund. These payments were appropriate, but they were made from the wrong fund. *Statement No. 34 of the Governmental Accounting Standards Board - Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* (GASB 34) required that the particular fund affected by this error be classified as a "major" fund; therefore, auditors identified this error as a material weakness in the System's control structure. However, it is important to note that the error totaled $1 million, but the System paid a total of $1.4 billion in benefit payments during fiscal year 2007. In addition, after auditors brought this error to the System's attention, the System corrected it and properly recorded and reported the payments.

Auditors did not identify any instances of non-compliance with laws or regulations that would materially affect the financial statements. However, our procedures were not intended to provide an opinion on internal control over financial reporting or to provide an opinion on compliance with laws and regulations.

Background Information

The Employees Retirement System (System) is authorized to provide retirement and related benefits for employees of the State of Texas, universities, colleges, and certain other entities. The System also administers health care plans for retirees, active employees, and their dependents.

The System is responsible for investing funds under its stewardship and for delivering benefits to members as authorized by the Legislature. The System's pension plan is a defined benefit plan, with retirement benefits determined by a pre-established formula.

As of August 31, 2007, the System served 314,273 pension members (169,449 active members, 76,864 annuitants, and 67,960 individuals no longer employed by the state but due benefits). The System provides services for employees and/or retirees of state agencies, colleges, universities, and other entities.

The pension plan's net assets totaled approximately $24.5 billion as of August 31, 2007. The System paid $1.4 billion in benefit payments during fiscal year 2007.

With the exception of controls over death benefit payments for commissioned peace officers, the other major internal controls that we tested for the purpose of forming our opinion on the financial statements were generally operating effectively. However, we reported the material weakness and other less significant issues in accounting and financial reporting controls and information technology controls to System management in a separate letter.

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As required by professional auditing standards, we will also communicate to the Audit Committee of the System's Board of Trustees certain matters related to the conduct of a financial statement audit.

Conducting our audit of the System's financial statements enabled us to obtain information on the actuarial funding status of the pension plan and retiree health care plan. That information is summarized below.

Pension Plan Financial Highlights and Actuarial Funding Status

The plans managed by the system had an unfunded actuarial accrued liability (UAAL), which represents the deficit of the plans' actuarial assets compared with their actuarial liabilities of $1.1 billion as of August 31, 2007. That amount includes unfunded actuarial accrued liabilities of $1 billion for the Employees Retirement System (ERS) plan, $14.9 million for the Law Enforcement and Custodial Officers' Supplemental Retirement Fund (LECOSRF) plan, and $9 million for the Judicial Retirement System II (JRS II) plan.

In spite of the large actuarial funding deficit, the pension plans' overall funding position improved during fiscal year 2007. The plans' investments earned 13.9 percent during fiscal year 2007, which is higher than the 8 percent assumed long-term rate of return used for actuarial valuation purposes. This drove the combined funded ratio for the plans to be 95.7 percent as of August 31, 2007, which was an increase from the previous year's combined funded ratio of 95.4 percent. The funded ratio for the ERS pension plan was 95.6 percent; the funded ratio for the LECOSRF plan was 98 percent; and the funded ratio for the JRS II plan was 95.9 percent.

As of August 31, 2007, the combined pension plans' net assets exceeded $24.5 billion. The combined pension plans paid $1.4 billion in benefit payments in fiscal year 2007. As of that same date, the rate of annual required contribution (ARC) of the State for fiscal year 2007 (the contribution rate that is needed to eliminate the actuarial funding deficit within the next 30 years) was 13.10 percent for the ERS plan and 1.61 percent for the LECOSRF plan.

The JRS II plan is actuarially sound based on a contribution rate of 22.81 percent. A 30-year amortization period is important because state law prohibits making certain changes to the pension plan, such as increasing benefits, if (1) the amortization period is 31 or more years or (2) the changes would increase the amortization period to 31 or more years (see Texas Government Code, Section 821.006). According to calculations made by the System's actuary, the current total annual contribution rate of 12.45 percent of pay for the ERS plan (6.45 percent from the State and 6.0 percent from active members) and 1.59 percent for the LECOSRF plan is not sufficient to amortize the current UAAL over 30 years.

Retiree Health Care Plan Actuarial Funding Status

The System has implemented *Statement No. 43 of the Governmental Accounting Standards Board - Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (GASB 43).

In accordance with GASB 43, the initial actuarial valuation of the retiree health care plan disclosed the following as of August 31, 2007:

- The unfunded actuarial accrued liability was $17.7 billion. The plan's funded ratio (actuarial assets/actuarial liabilities) was zero because the plan is funded on a "pay as you go" basis, with no assets set aside for future payments.

- The actuarially determined annual required contribution (ARC, or the annual contribution rate that would be sufficient to eliminate the unfunded actuarial accrued liability within the next 30 years) from employers and other contributing entities for fiscal year 2007 was $1.48 billion. This represents 16.8 percent of the related $8.8 billion payroll. However, the retiree health care plan historically has been funded on a "pay as you go" basis (contribution rates are intended to be sufficient to meet the current year's health care costs), rather than being funded on an actuarially determined basis.

- The actuarial assumed rate of return on plan investments, which include both short-term and long-term investments, was 6 percent.

We appreciate the System's cooperation during this audit. If you have any questions, please contact Michael C. Apperley, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

cc: Members of the Employees Retirement System
Board of Trustees
Mr. Bill Ceverha, Chair
Ms. Yolanda Griego, Vice Chair
Ms. Cydney Donnell
Mr. Don Green
Mr. I. Craig Hester
Mr. Owen Whitworth, CPA, CIA
Ms. Ann Fuelberg, Executive Director, Employees Retirement System

Summary of
Objective, Scope, and Methodology

The objective of the audit was to issue an opinion on the Employees Retirement System's (System) fiscal year 2007 financial statements.

The audit scope covered the System's basic financial statements for fiscal year 2007.

The audit methodology included performing a review of internal control over financial reporting, an analytical review of material account balances, detailed tests of sample transactions, confirmations of investment holdings and market values, and tests of compliance with laws and regulations.

The audit was conducted in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. The following staff of the State Auditor's Office performed the audit:

- William Morris, CPA (Project Manager)
- Michael Clayton, CPA, CFE (Assistant Project Manager)
- Cody Tubbs
- Kelli Davis
- Hillary Eckford, CIA
- Amadou Ngaide, MBA, CFE
- Anca Pinchas, MAcy, CPA
- Dorothy J. Turner, MPA, CPA
- Kenneth F. Wade
- Jules Hunter, CPA,CIA
- Marlen Kraemer, MBA, CISA (Information Systems Audit Team)
- Rachelle Wood (Information Systems Audit Team)
- Worth Ferguson, CPA (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)