



A Report on

The Audit of the Employees Retirement System's Fiscal Year 2011 Financial Statements

John Keel, CPA
State Auditor

December 14, 2011

Members of the Legislative Audit Committee:

In our audit report dated November 16, 2011, we concluded that the Employees Retirement System's (System) basic financial statements for fiscal year 2011 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. The System published our audit report as part of its basic financial statements, which it intends to post on its Web site at http://www.ers.state.tx.us/About_ERS/Reports/.

We also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards (that report, including responses from System management, is presented in the attachment to this letter). In that report, auditors identified the following deficiencies in the System's internal control structure over accounting for and financial reporting of alternative investments:

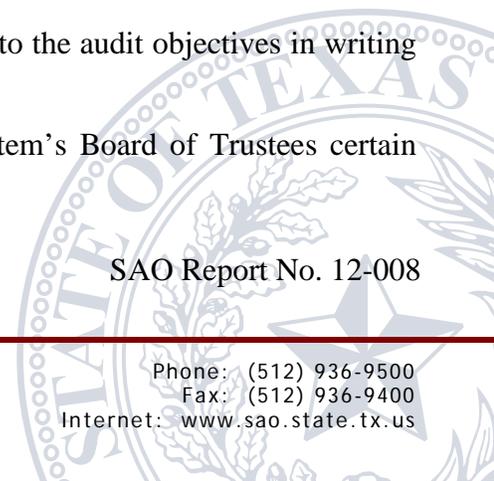
- The System does not have documented accounting policies or procedures to ensure that (1) it directs its custodian bank to record transactions associated with the System's alternative investments in accordance with generally accepted accounting principles (GAAP) and (2) the System reports those investments in accordance with GAAP on its financial statements.
- The System does not independently evaluate the reasonableness of alternative investment valuations that it reports on its annual financial statements.
- The System does not review the transactions related to alternative investments that its custodian bank records in the System's general ledger.

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. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting or on compliance with laws and regulations.

Auditors communicated certain issues that were not material or significant to the audit objectives in writing to the System's management.

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

SAO Report No. 12-008



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

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the Employees Retirement System Board of Trustees
Ms. Yolanda Griego, Chair
Mr. I. Craig Hester, Vice Chair
Ms. Cydney Donnell
Ms. Cheryl MacBride
Mr. Brian D. Ragland
Mr. Frederick E. Rowe, Jr.
Ms. Ann S. Bishop, Executive Director, Employees Retirement System



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Attachment



Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Employees Retirement System Board of Trustees

Ms. Yolanda Griego, Chair
Mr. I. Craig Hester, Vice Chair
Ms. Cydney Donnell
Ms. Cheryl MacBride
Mr. Brian D. Ragland

We have audited the financial statements of Employees Retirement System (System) as of and for the year ended August 31, 2011, and have issued our report thereon dated November 16, 2011. Except as discussed in the following paragraph, 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*, issued by the Comptroller General of the United States.

We have chosen not to comply with a reporting standard that specifies the wording to be used in discussing restrictions on the use of this report. We believe the use of such wording is not in alignment with our role as a legislative audit function.

Internal Control over Financial Reporting

Management of the System is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

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, or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, as described in the accompanying schedule of findings and responses, we identified certain deficiencies in internal control over financial reporting that we consider to be a significant deficiency. 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.

Summary of Findings and Responses
Finding Number
2011-1

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free of material misstatement, we performed tests of the System's compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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*.

We noted certain matters that we reported to management of the System in writing.

The System's response to the finding identified in our audit is included in the accompanying schedule of findings and responses. We did not audit the System's response and, accordingly, we express no opinion on it.

This report is intended for the information and use of the Board of Trustees, System management, and the Legislature. However, this report is a matter of public record, and its distribution is not limited.

John Keel, CPA
State Auditor

November 16, 2011

Schedule of Findings and Responses

Section 1

The System Should Develop and Implement Accounting and Financial Reporting Controls Over Alternative Investments

Reference No. 2011-1

Type of finding: Significant Deficiency

The Employees Retirement System (System) should develop and implement policies and procedures to review transactions associated with alternative investments to ensure that those transactions are recorded in accordance with generally accepted accounting principles (GAAP) and to ensure that the System fairly presents and discloses the fair value of those investments on its financial statements.

It is important to note that the System's custodian bank¹ recorded transactions associated with alternative investments in the System's general ledger. However, authoritative guidance specifies that the System is still responsible for ensuring that its custodian bank records transactions accurately. Specifically, the American Institute of Certified Public Accountants' (AICPA) Codification of Statement of Auditing Standards, AU Section 328.04, states:

Alternative Investments

According to the American Institute of Certified Public Accountants (AICPA), alternative investments are "assets that are not listed on any national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System [NASDAQ]. These investments generally do not fall under any federal or state regulator and have greater flexibility in investment strategies than registered investment companies."

The System reported having \$1.05 billion in alternative investments as of August 31, 2011.

Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with [generally accepted accounting principles] GAAP.

¹ The System changed its custodian bank at the beginning of fiscal year 2012. Any references to specific custodian bank activities in this document are references to activities performed by the entity that served as the System's custodian bank during fiscal year 2011.

The AICPA's practice aid for auditors entitled *Alternative Investments – Audit Considerations* clarifies management's role as follows:

This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management. Although the investor entity's management may look to the fund manager for the mechanics of the valuation, management must have sufficient information to evaluate and independently challenge the fund's valuation. The underlying investments generally are measured at estimated fair value by the fund manager in accordance with its stated valuation policies for determining net asset value.

A strong internal control structure is important to ensure that the System's financial statements report the most current and accurate alternative investment valuations. Examples of deficiencies that auditors identified are detailed below.

**Internal Control over
Alternative Investments**

The American Institute of Certified Public Accountants' (AICPA) practice aid for auditors entitled *Alternative Investments - Audit Considerations* states the following:

"The nature and extent of management's process for valuing investments, and the related internal controls, are particularly important when the investor entity invests in securities for which readily determinable fair market values do not exist. In these instances, management should have in place a process and internal control over that process to ensure that its alternative investments are recorded at amounts in accordance with its stated accounting policies."

The System should develop policies and procedures related to alternative investments.

The System does not have documented accounting policies or procedures to ensure that (1) it directs the custodian bank to record transactions associated with alternative investments in accordance with GAAP and (2) that the System reports those investments in accordance with GAAP on its financial statements.

The System should perform an independent evaluation of alternative investment valuations that it reports on its annual financial statements.

The System does not independently evaluate the reasonableness of alternative investment valuations that it reports on its annual financial statements.

**Internal Control Related to
"Roll Forward" Periods**

In addition, the American Institute of Certified Public Accountants' (AICPA) practice aid for auditors entitled *Alternative Investments - Audit Considerations* states:

"If management estimates the fair value of a significant portion of its alternative investments as of an interim date, management will need a robust process and strong internal control over the roll-forward period to the balance sheet date. Because the valuation assertion embedded in the financial statements is as of the balance sheet date, management needs to have the ability to obtain sufficient information to record the investments at estimated fair value as of the balance sheet date, including changes in the estimated fair value during the roll forward period."

Although the System reviews the valuations of alternative investments on external fund managers' quarterly statements, it does not compare those valuations to the amounts its custodian bank records in the System's general ledger. In addition, the System does not have a process to account for changes in valuation during the "roll forward" period between the external fund managers' most recent quarterly statements and the System's financial reporting date. (See text box for information regarding the "roll forward" period.)

In the absence of an independent evaluation process, the System is unable to challenge the alternative investment valuations that external fund managers' report and, instead, relies solely on the external fund managers for those valuations. Specifically, the System indicates that its custodian bank uses the most recent quarterly statement from the external fund managers, as well as any cash transactions that may have occurred, to determine the value of the System's alternative investments and then records applicable transactions in the System's general ledger.

In addition, the System did not ensure that the values of the alternative investments recorded in its general ledger were based upon the most recent information available. For example, in some instances, the values were recorded based on external fund managers' March 31, 2011, quarterly statements when the System had received quarterly statements from the external fund managers after March 31, 2011.

After auditors brought the matters discussed above to the System's attention, the System developed draft valuation guidelines for alternative investments and provided them to auditors on September 19, 2011. The draft guidelines specify general valuation guidelines, establish a valuation methodology, and require the formation of a valuation committee. According to the draft guidelines, the valuation committee will meet at least at the end of each fiscal year to review valuation methodologies and discuss disputed investment valuations and changes in fair value guidelines. Auditors did not evaluate those guidelines because they were not in place during fiscal year 2011.

The System should review alternative investment transactions.

The System does not review the transactions related to alternative investments that its custodian bank records in the System's general ledger. As a result, the System was unable to reconcile amounts for net appreciation and depreciation and external fund manager fees and expenses that the custodian bank recorded in the System's general ledger throughout the year to the corresponding amounts that the external fund managers for the alternative investments reported on quarterly statements.

Recommendation

The System should develop and implement policies and procedures to review transactions associated with alternative investments to ensure that (1) its custodian bank records those transactions in accordance with GAAP and (2) the System fairly presents and discloses the fair value of those investments on its financial statements.

Management's Response

The Employees Retirement System of Texas (ERS) has developed and implemented procedures to review transactions associated with alternative investments to ensure that (1) its custodian bank records those transactions in accordance with GAAP and (2) ERS fairly presents and discloses the fair value of those investments on its financial statements. Additional staff resources have been allocated to further improve controls, processes, procedures, valuation, and reporting relating to alternative investments.