



A Report on
The Audit of the Employees Retirement **System's**
Fiscal Year 2017 Financial Statements

December 29, 2017

Members of the Legislative Audit Committee:

In our audit report dated December 20, 2017, we concluded that the Employees Retirement System's (System) basic financial statements for fiscal year 2017 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 <https://ers.texas.gov/About-ERS/Reports-and-Studies/Reports-on-Overall-ERS-Operations-and-Financial-Management>.

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 management, is presented in the attachment to this letter). In that report, auditors reported the System had material accounting errors in the financial statements for the System's active and retiree insurance plans and that the System did not properly implement part of a new accounting standard. However, the System corrected and disclosed all material errors previously omitted or recorded in error that auditors brought to its attention before it finalized the financial statements. 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.

Testing of Plan Member Census Data

Auditors conducted census data testing for fiscal year 2017 (see text box for the key data elements tested) as part of this audit. The completeness and accuracy of employees' census data is important because the System uses that data to calculate the System's liabilities for pensions and other postemployment benefits.

Auditors implemented a risk-based approach for selecting System members for fiscal year 2017 census data testing as required by American Institute of Certified Public Accountants (AICPA) guidance. That resulted in auditors selecting members from 19 participating state agencies for which census data was tested. (A list of the state agencies that employed the members selected for testing is presented in the attachment to this letter). Testing included reviewing documentation to verify that the census data that the employers submitted to the System was accurate.

Employee Census Data

Employee census data is key demographic data that affects the actuarial estimate of the pension and other postemployment benefit liability amounts that the System presents in its financial statements.

Key data elements include:

- Name.
- Date of birth.
- Service credits.
- Pensionable earnings.
- Gender.
- Employment status.
- Dependent information (name, gender, and date of birth).

Source: Chapters 13 and 14 in *State and Local Governments-Audit and Accounting Guide*, American Institute of Certified Public Accounts, March 1, 2017.

SAO Report No. 18-011

In addition, to help determine the System's other postemployment benefit liability, auditors relied on census data testing performed by the State Auditor's Office at the Teacher Retirement System for higher education institutions, community colleges, and junior colleges, whose employees are part of the System's other postemployment benefit plan.

Based on the testing performed, auditors determined that the underlying census data was materially complete and accurate to support the System's plan's financial statement amounts. That was reflected as part of our unmodified audit opinion on the System's financial statements for fiscal year 2017.

Additionally, auditors will be issuing an opinion later this fiscal year on the System's fiscal year 2017 pension and other postemployment benefit liability allocation schedules. Those schedules provide employers with the information they need to record their share of the associated liabilities in their financial statements, in accordance with AICPA requirements. Auditors previously issued an opinion on the System's pension liability allocation schedules for fiscal year 2016. The System published our audit opinion along with the pension liability allocation schedules, on its Web site at <https://ers.texas.gov/About-ERS/GASB-Requirements>.

Other Issues

Auditors communicated certain issues that were not material or significant to the audit objectives separately 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.

We appreciate the System's cooperation during this audit. If you have any questions, please contact Hillary Eckford, Audit Manager, or me at (512) 936-9500.

Sincerely,

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

Attachment

cc: The Honorable Greg Abbott, Governor
Members of the Employees Retirement System's Board of Trustees
Mr. Doug Danzeiser, Chair
Ms. Cydney Donnell, Vice-Chair
Ms. Ilesa Daniels
Mr. I. Craig Hester
Ms. Catherine Melvin
Ms. Jeanie Wyatt
Mr. Porter Wilson, Executive Director, Employees Retirement System



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Attachment

Section 1

List of Employers Selected for Census Data Testing

Table 1 lists the 19 employers for which auditors tested the accuracy of census data to determine whether that data was materially complete and accurate to support the Employees Retirement System's financial statement amounts.¹

Table 1

List of Employers Selected for Census Data Testing for Fiscal Year 2017
<ul style="list-style-type: none">▪ Commission on Environmental Quality▪ Court of Criminal Appeals▪ Department of Aging and Disability Services ^a▪ Department of Criminal Justice▪ Department of Family and Protective Services▪ Department of Insurance▪ Department of Juvenile Justice▪ Department of Public Safety▪ Department of State Health Services▪ Department of Transportation▪ First Court of Appeals District, Houston▪ Health and Human Services Commission▪ Library and Archives Commission▪ Office of the Comptroller of Public Accounts▪ Office of the Comptroller of Public Accounts Judiciary Section▪ Texas Cooperative Inspection Program ^b▪ Texas Education Agency▪ Texas Military Department▪ Third Court of Appeals District, Austin
<p>^a The Department of Aging and Disability Services was abolished as of September 1, 2017, and its programs and services were transferred to the Health and Human Services Commission.</p> <p>^b This is a program within the Department of Agriculture. Its employees contribute to the Employees Retirement System.</p>

¹ Auditors followed the American Institute of Certified Public Accountants' sampling guide methodology and selected a representative population of employees from each employer selected for testing.

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters as Required by Auditing Standards



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

Independent Auditor's Report

Employees Retirement System's Board of Trustees

- Mr. Doug Danzeiser, Chair
- Ms. Cydney Donnell, Vice-Chair
- Ms. Ilesa Daniels
- Mr. I. Craig Hester
- Ms. Catherine Melvin
- Ms. Jeanie Wyatt

We have audited, in accordance with the 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, the financial statements of the governmental activities and the aggregate remaining fund information of the Employees Retirement System (System) as of and for the year ended August 31, 2017, and the related notes to the financial statements, which collectively comprise the System's basic financial statements and have issued our report thereon dated December 20, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting (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 the System's internal control. Accordingly, we do not express an opinion on the effectiveness of the System'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, or 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 entity's financial statements will not be prevented, or 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

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that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. We did identify certain deficiencies in internal control described in the accompanying schedule of findings and responses that we consider to be a material weakness.

Summary of Findings and Responses
Finding Number
2017-1

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's financial statements are free from material misstatement, we performed tests of its 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*.

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

System's Response to Findings

System's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. The System'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

The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control over financial reporting or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control over financial reporting and compliance. Accordingly, this communication is not suitable for any other purpose.

Lisa R. Collier, CPA, CFE, CIDA
First Assistant State Auditor

December 20, 2017

Schedule of Findings and Responses

Section 1

The System Had Material Accounting Errors in the Financial Statements for Its Active and Retiree Insurance Plans and It Did Not Properly Implement Part of a New Accounting Standard

Reference No. 2017-1

Type of finding: Material Weakness

The Employees Retirement System's (System) fiscal year 2017 financial statements had material accounting errors in the proprietary fund related to (1) inappropriately reporting the net position of the retiree insurance plan as an asset in the active insurance plan, (2) lacking support for a loan between insurance plans, and (3) inappropriately applying a change in an accounting estimate retroactively.

Additionally, the System did not properly implement part of a new standard, Governmental Accounting Standards Board (GASB) Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, related to its special funding situation in the fiduciary fund.

Specifically, the following material accounting errors were detected during auditors' review of the financial statements:

- The System incorrectly reported an asset in the wrong fund because it reported the entire net position balance of the retiree insurance plan as an asset of the active insurance plan for each fiscal year since fiscal year 2011. As of fiscal year 2017, the cumulative effect of that error was \$502,258,659. To correct that error, the System recorded a restatement of \$502,258,659 for both the active insurance plan and the retiree insurance plan in its fiscal year 2017 financial statements.

- The System initially recorded a loan to the active insurance plan from the retiree insurance plan of \$250,000,000 as a transfer incorrectly. The System asserted the loan was made to address the cash flow needs of the active insurance plan. Although the loan was made in January 2017, the System did not correct the entries, create the loan documentation, or account for the associated interest of \$1,909,640 until October 2017, after auditors requested documentation. Additionally, the System did not have supporting documentation showing that the initial transaction complied with GASB Statement No. 74 requirements for ensuring that the retiree insurance plan (also known as other postemployment benefits, or OPEB) met the definition of a trust as defined by accounting standards (see text box for the GASB definition of a trust).

GASB Definition of a Trust

GASB Statement No. 74 defines other postemployment benefit (OPEB) plans administered through a "trust" for financial reporting purposes as meeting the following requirements:

- Contributions from employers and nonemployer contributing entities to the OPEB plan and earnings on those contributions are irrevocable.
- OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms.
- OPEB plan assets are legally protected from the creditors of employers, nonemployer contributing entities, the OPEB plan administrator, and plan members.

Source: GASB statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which is effective for financial statements for fiscal years beginning after June 15, 2016.

- The System improperly recorded a \$77,679,097 adjustment in its fiscal year 2017 financial statements. During fiscal year 2017, the System performed an analysis of its pharmacy rebate revenues. As a result, there was a change in the accounting estimate for the allocation of the pharmacy rebate revenue between the active and retiree insurance plans. However, the System incorrectly applied that change retroactively for four fiscal years, resulting in the \$77,679,097 audit adjustment that the System corrected by a reversing entry. According to GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, the effects of a change in an accounting estimate should be accounted for in the period of change and/or future periods, and they should not be retroactively applied.

In addition, auditors identified the following:

- The System did not record state contribution revenue totaling \$44,433,743 as a separate contribution revenue line item for “non-employer contributing entities,” as required by GASB Statement No. 74.
- The System did not disclose its special funding situation associated with the retiree insurance plan (see text box for a definition of a special funding situation).

However, the System added the appropriate line item and included the required disclosures after auditors requested the correction. The System has a special funding situation because a portion of retiree insurance contributions for community and junior colleges are paid by the State of Texas, but those colleges are not state entities. Correctly implementing the new standard is important because the System uses the reported contribution amounts and how they are categorized to create the Schedule of Employer Allocations for Other Post Employee Benefits (OPEB) for use by the System’s reporting entities. Without reporting the State’s portion of the colleges’ OPEB contributions in a separate line item, those OPEB liability schedules will not be accurate.

The System is responsible for ensuring that it prepares its financial statements in accordance with generally accepted accounting principles as prescribed or modified in GASB statements. The System corrected and disclosed all material errors previously omitted or recorded in error that auditors brought to its attention before it finalized the financial statements. Adequate preparation and review of the financial statements, including new accounting standards, are critical to helping ensure that the System’s financial statements and note disclosures are complete, accurate, and comply with financial reporting standards.

Special Funding Situations

GASB Statement No. 74 states:

Special funding situation: Circumstances in which a nonemployer entity is legally responsible for making contributions, including amounts for Other Post Employee Benefits (OPEB) as the benefits come due, directly to an OPEB plan that is used to provide OPEB to the employees of another entity or entities.

Additions section on financials: The additions section of the statement of changes in fiduciary net position should include separate display of the following, if applicable:

- a. Contributions from employers.
- b. Contributions from nonemployer contributing entities.

Source: GASB Statement No 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*.

Recommendations

The System should:

- Improve its review of journal entries to ensure that accounting entries are properly recorded and supported in accordance with generally accepted accounting principles.
- Review new GASB statements in advance to ensure proper implementation and compliance with requirements.

Management's Response

ERS agrees that the review of journal entries can be improved to ensure all accounting entries are properly recorded and supported in accordance with generally accepted accounting principles.

There are unique challenges in the recording of entries for the Texas Employees Group Benefit Plan (GBP) due to the reporting requirements for other post-employment benefits (OPEB). We appreciate the State Auditor's thorough review of these entries and their suggestions for improvement. ERS is working with GASB to make the day to day program management of the Group Benefit Plan efficient, while ensuring appropriate OPEB accounting for purposes of the financial statements. We anticipate completion of these changes and a thorough review of associated journal entries by August 31, 2018.

ERS will continue to review and apply new GASB Statements to ensure our full compliance with new standards and requirements. For those standards which have the potential to materially impact ERS' or the Employers' financial statements, ERS will consult with GASB or other advisors to ensure proper implementation and compliance with the requirements.