An Opinion Audit on the

Employees Retirement System of Texas

Office of the State Auditor

Lawrence F. Alwin, CPA

April 1995

Report No. 95-116

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LAWRENCE F. ALWIN, CPA
State Auditor

SHARON W. COBB, CPA
First Assistant

April 12, 1995

Members of the Legislative Audit Committee:

The fiscal year 1994 component unit financial statements of the Employees Retirement System of Texas (System) are in compliance with generally accepted accounting principles and are correct in all material respects. However, the System can improve controls over assets and the recording of transactions in the following areas:

- The System has not earned an estimated $500,000 in interest on a net underpayment of $14.6 million of uncollected insurance revenues. The System did not promptly resolve significant recorded underpayments and overpayments by participating agencies and universities. The System should actively seek out agencies with large outstanding premium underpayments or overpayments and assist those agencies in reconciling insurance coverage information.

- The System's method of allocating the assets and income for the $10 billion investment pool does not ensure that all participants equitably share in the risks and rewards of all types of investments in the pool.

- Four less significant issues are discussed in the Detailed Issues and Recommendations section of the report. The issues relate to investment reconciliations, anticipation of dividend income, the accounting procedures manual, and collateralization of Deferred Compensation Plan deposits.

This examination of the component unit financial statements was performed in connection with the statewide financial and compliance audit for the fiscal year ended August 31, 1994. The information presented in the following report will be referred to in the *1994 Financial and Compliance Audit Results* report.

Management of the System concurs with the recommendations in this report. We appreciate the cooperation and assistance of management and staff during this audit.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

An Opinion Audit on the Employees Retirement System of Texas

April 1995

Key Facts And Findings

- At August 31, 1994, the Employees Retirement System (System) had total assets of $10 billion, paid $420 million in retirement benefits, and incurred insurance benefit costs of $813 million.

- The fiscal year 1994 component unit financial statements of the System are in compliance with generally accepted accounting principles and are correct in all material respects.

- The System has not earned an estimated $500,000 in interest on a net underpayment of $14.6 million of uncollected insurance revenues. The System did not promptly resolve significant recorded underpayments and overpayments by participating agencies and universities.

- The System's method of allocating assets and income for the $10 billion investment pool does not ensure that all pension plans equitably share in the risks and rewards of all types of investments in the pool.

- Reconciliations between the System's accounting records and the investment custodian for the new international stock portfolio, which was implemented February 1, 1994, were not prepared during the year. Reconciliations for other investment portfolios were prepared, on average, more than two months after the end of the month, and many were not reviewed for six months.

- The System did not have any method of forecasting dividends on international stocks during the year. There were also inaccuracies in forecasting dividends on domestic stocks. During fiscal year 1994, the System received over $98 million in dividend income.

Contact:
Barbara S. Hankins, CPA, Audit Manager (479-4921)

This financial opinion audit was conducted in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States.

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Executive Summary

The fiscal year 1994 component unit financial statements of the Employees Retirement System of Texas (System) are in compliance with generally accepted accounting principles and are correct in all material respects. However, we noted certain significant deficiencies in the design or operation of the internal control structure which we considered reportable conditions. We also noted other matters involving improvements needed in the accounting methods and the internal control structure. We noted one instance of possible noncompliance with state law.

Reportable Conditions

The System has not earned an estimated $500,000 in interest on a net underpayment of $14.6 million of uncollected insurance revenues. The System did not promptly resolve significant recorded underpayments and overpayments by participating agencies and universities. The System should actively seek out agencies with large outstanding premium underpayments or overpayments and assist those agencies in reconciling insurance coverage information.

Reconciliations between the System's accounting records and the investment custodian for the new international stock portfolio, which was implemented February 1, 1994, were not prepared during the year. Reconciliations for other investment portfolios were prepared, on average, more than two months after the end of the month, and many were not reviewed for six months. Timely reconciliations help ensure that errors and irregularities are detected promptly and financial information is accurately reported.

The System did not have any method of forecasting dividends on international stocks during fiscal year 1994. There were also inaccuracies in forecasting dividends on domestic stocks. During fiscal year 1994, the System received over $98 million in dividend income. Without an accurate income anticipation system, the System cannot determine if all dividend revenue due has been received.

Other Matters

The current method of allocating the assets and income of the $10 billion investment pool does not ensure that all pension plans equitably share in the risks and rewards of all types of investments in the pool. Each participating pension plan has a different investment diversification. As a result, a specific pension plan's future investment income may not be maximized. Further, the smaller plans are unnecessarily susceptible to market value changes in one type of investment security.

The Accounting Policy and Procedure Manual does not include all current accounting systems and procedures. Significant sections of the manual became outdated during fiscal years 1993 and 1994. Lack of documentation has led to errors and inconsistencies in reporting financial transactions.

Due to recent changes in rules of the Federal Deposit Insurance Corporation, some Deferred Compensation Plan (457 Plan) deposits might not be fully insured or collateralized. Therefore, deposits could be lost in the event of failure of a financial institution. Total 457 Plan deposits in banks and savings and loan associations were $43 million at August 31, 1994. The amount potentially subject to loss cannot be estimated but is probably a much smaller amount. The System needs to determine if the Legislature intends for all 457 Plan deposits at financial institutions to be fully insured or collateralized.

Executive Summary

Most Prior Year Recommendations Have Been Implemented

The System has implemented our prior year recommendations relating to the following:

- verifying the accuracy of data sent to actuary
- ensuring all adjusting entries are included in financial statements
- restricting programmers' access to automated resources
- strengthening mailroom control of cash receipts
- improving internal audit review process
- improving internal audit procedures for death match testing

The recommendation relating to prompt collection of funds owed for the employee insurance program has not been resolved and is repeated in this letter. We will follow up on the recommendation relating to updating the disaster recovery plan in a future audit.

Summary of Management's Responses

Management concurred with the findings and recommendations in this report. They have begun the process of implementing several of the recommendations.

Summary of Audit Objective and Scope

The objective of this audit was to express an opinion on the System's financial statements for the year ended August 31, 1994. The scope of this audit included examination of the most significant control structures, including cash receipts, cash disbursements, investments, and journal vouchers. Our examination also included the most significant accounts, including cash, investments, fund balances, revenues, and expenditures.

Detailed Issues and Recommendations

Section 1:

Reportable Conditions

We noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Section 1-A:

Promptly Resolve Balances Owed by Agencies to Employee Insurance Program

(Prior Audit Issue)

The System did not promptly resolve significant recorded underpayments and overpayments of insurance premiums by participating agencies. A net underpayment of $14.6 million, consisting of $28.5 million in receivables and $13.9 million in payables, was recorded on the books as of the end of fiscal year 1994. Because $8.4 million of the net underpayment related to fiscal year 1993 premiums, it may be too late for the System to be able to fully resolve and collect these amounts. Approximately $23 million of the recorded receivable was still outstanding as of November 22, 1994. As a result of the long outstanding net underpayments, the System did not earn an estimated $500,000 in interest.

As administrator of the group insurance program, the System should ensure that coverage information and premiums are submitted accurately and timely by participating state agencies. The System needs accurate coverage information to ensure that the correct payments are made to insurance carriers. Timely receipt of premiums permits the System to maximize interest earnings.

The following interrelated factors contributed to the System's difficulty in promptly resolving and collecting insurance premiums owed by agencies:

- The System implemented a new automated insurance system at the beginning of fiscal year 1993. In designing the system, management decided to delegate to the agencies the reconciliation of premiums submitted to premiums billed by the System. Premiums are billed based on coverage information submitted by those agencies. The System is dependent on agencies performing timely, accurate reconciliations to identify billing or payment errors. Under the previous insurance system, the System performed the initial reconciliation function.

- The new insurance software contained some programming errors. This created uncertainty in the true amount of insurance premiums due from state agencies. These errors were corrected in fiscal year 1994, and the premium calculations now appear to be correct. However, during the automated system's instability, timely reconciliation by the agencies of insurance coverage was extremely difficult. Therefore, the System was reluctant to follow up on apparent outstanding premiums due.

- The System has not developed and implemented formal monitoring and collection procedures. Monitoring procedures would identify agencies who are not submitting accurate payments or coverage information. Collection procedures would include taking appropriate corrective action when payments are past due.

- Although the System has provided agencies with information to facilitate timely reconciliation, agencies need additional training in the use of this information.

- The System currently has no viable penalty for nonpayment of premiums to entice agencies to perform the necessary reconciliations. Some agencies may need to reconcile two full years of insurance data and may be reluctant to expend the significant resources required to accomplish that task.

Recommendations: To ensure that the System promptly collects insurance revenues, we recommend the following:

- Actively seek out those agencies with large outstanding premium underpayments or overpayments, and offer the expertise of the System's personnel to help in reconciling the insurance coverage information between the agency and the System.

- Develop an ongoing training program for agencies to educate them on the capabilities of the automated system and on the responsibilities of the agencies in performing timely reconciliations.

- Develop written procedures for the timely identification of problems in collection of insurance premiums. Include a process to communicate the problem to a participating agency's upper management and the State's leadership if it continues to be unresolved.

Management's Response: We agree with the recommendations of the State Auditor. Insurance, accounting, and technical ERS staff members will work together to develop an ongoing training program and to assist agencies in reconciling. We will also formalize procedures necessary to assure the timely identification of significant variances between premiums due and collections, as well as the communication process to be followed to resolve significant variances.

The ERS successfully completed insurance system (IEBS) premium calculation revisions in May 1994, resulting in more reliable data. Work continues toward *further improving IEBS data and providing management reporting that enables the prompt identification of problems and collection of premiums. As of February 28, 1995 the net recorded underpayment had been reduced from $14.6 million to $5.1 million, which is .3% of the $1.6 billion that was actually collected during the period associated with the recorded net underpayment.*

Section 1-B:

Perform Timely Investment Reconciliations

Investment reconciliations are not performed in a timely manner, and many have not been reviewed by supervisory personnel. The System's Accounting Division Policy and Procedure manual does not establish a time frame for preparation of reconciliations. The System owned more than $10 billion in investments at the end of fiscal year 1994. Timely reconciliations help ensure that errors and irregularities are detected promptly and financial information is accurately reported.

Reconciliations between the System's accounting records and the investment custodian for the new international stock portfolio, which was implemented February 1, 1994, were not prepared during the year. Reconciliations for other investment portfolios were prepared, on average, more than two months after the end of the month. Reconciliations between the investment accounting system and the general ledger system were prepared, on average, three months after month end.

Most investment reconciliations for the last six months of the fiscal year have not been reviewed by supervisory personnel. Review of prepared reconciliations occurred, on average, five months after month end. Reconciliations to the master custodian's monthly statements should be prepared and reviewed promptly, if practical, within 30 days after the end of the month.

Recommendation: We recommend that the System prepare and review investment reconciliations on a timely basis. We also recommend that the System update the Accounting Division Policy and Procedure Manual to include required completion times for preparation and review of investment reconciliations.

Management's Response: We agree with the State Auditor's recommendations. On February 1, 1994, the Investment Accounting Section implemented a new investment accounting system; began accounting for a new international investment program; and implemented an investment pool for the System's pension funds. At the same time, the Section experienced critical personnel shortages due to major surgeries, maternity leave, and turnover. Although the remaining staff worked extensive overtime, reconciliations could not be kept current. All reconciliations have since been completed, and almost all have been reviewed. No material errors have been found. Policies and procedures are in the process of update to include required completion and review time frames.

Section 1-C:

Dividend Revenues Are Not Accurately Forecast

The new income anticipation system used by the System does not accurately forecast the amount of dividend revenues due. During fiscal year 1994, the System received over $98 million in dividend income. Without an accurate income anticipation system, the System cannot determine if all dividend revenue has been received. The inaccuracies in the automated reports required many manual corrections resulting in an inefficient use of the efforts of the investment accounting staff. In addition, the inaccuracies in the reports relating to international dividends left the System without any reliable method of anticipating those dividends.

The investment accounting system calculates revenues based on the number of shares owned at the date the income anticipation report is prepared. Dividend revenue should instead be calculated based on the number of shares owned on the ex-dividend date. The ex-dividend date is set by the company issuing the dividend and determines who will receive the dividends at the future pay date. Calculating revenues on a date other than the ex-dividend date will cause errors if the number of shares owned has changed after the ex-dividend date.

In addition, the investment accounting system incorrectly projects dividends for international stocks. These dividends are projected as if they are declared and paid quarterly although international stocks typically pay dividends only twice a year.

<u>Recommendation</u>: We recommend that the System actively work with the software vendor to modify the accounting system so that dividend income will be accurately forecast.

*<u>Management's Response</u>: We agree with the State Auditor's recommendations. During 1994, a new investment accounting system, PORTIA, was implemented. The system **projected** revenues but did not **anticipate** revenue collections. The next release, which was installed in February 1995, appropriately anticipates dividend income on equities held on ex-date rather than report date. The additional problems related to international dividends have also been addressed. The System now anticipates dividends from all of the foreign countries in which it invests. In addition, the frequency of dividend anticipation has been changed to accurately anticipate foreign dividends.*

Section 2:
Other Matters

We noted the following other matters involving the accounting system and compliance with state laws which were not reportable conditions but were considered significant.

Section 2-A:
Change Method of Allocating Investment Pool

The System's method of allocating assets and income for the recently formed investment pool does not provide proportionate ownership of all types of investments in the pool. Each participating pension plan has a different investment diversification. As a result, a specific pension plan's future investment income may not be maximized. Further, the smaller plans are unnecessarily susceptible to market value changes in one type of investment security. The investment pool has a total market value of $10 billion and produced income of $750 million for the fiscal year.

The August 31, 1994, balances of assets and income for each plan would have been different had a different allocation method been used. However, we cannot assess the actual dollar impact on each plan of using a different method without performing a comprehensive reallocation of the pool's transactions.

The System was given authority by the 73rd Legislature to invest, as a pool, the assets of the three pension plans which hold investment assets. An investment pool should be structured to maximize both investment yield and diversification for all participants. Ownership interest in assets and income of the pool should be based only on the relative market value of contributions, not on the type and timing of the contributions.

The current method essentially set up three separate pools for each type of investment (fixed income, domestic stocks, and international stocks). Each participant has a different proportionate ownership in each type of investment. The allocation is heavily dependent on the types of investment owned before the investment pool was created and the timing of cash flows and investment purchases. For example, one participant only owned fixed income securities prior to the pool and was initially allocated a proportional interest only in the pool's combined fixed income securities. Although this participant has been allocated some subsequent purchases of international and domestic stocks, it still has a much higher proportion of its pooled investment in fixed income securities. The following table illustrates the relative allocations for each participant for each type of security at the inception of the pool and the end of the fiscal year.

Plan Name	Total Market Value		Fixed Income Securities		Domestic Stocks		International Stocks	
	2/1/94	8/31/94	2/1/94	8/31/94	2/1/94	8/31/94	2/1/94	8/31/94
Employees Retirement Fund	95.98%	95.99%	93.53%	93.94%	99.66%	98.58%	100%	96.96%
Law Enforcement & Custodial Officer Fund	3.87%	3.83%	6.47%	6.01%	0%	1.08%	0%	2.80%
Judicial Retirement System Plan Two	.15%	.18%	0%	.05%	.34%	.34%	0%	.24%
Totals	100%	100%	100%	100%	100%	100%	100%	100%

Each participant's interest in the securities purchased by the pool is currently based on the cash available to invest each month. For example, if a participant did not input cash in a month when large purchases of international stocks were made, it would not share ownership of those stocks. Therefore, this participant would not obtain any income from dividends or gains on sale of this type of security.

Recommendation: We recommend that the System change its method of allocating the assets and income from the investment pool. The new method should ensure that all participants equitably share in the risks and rewards of all types of investments in the pool. We also recommend that the revised methodology be implemented retroactively to the beginning of the investment pool, February 1, 1994.

Management's Response: The System concurs with the recommendation. We have developed a new methodology based on units of ownership. We are in the process of re-calculating the pooling allocation beginning February 1, 1994 using the unitization method.

The difference between the old allocation and the new allocation results will be recorded effective September 1, 1994. No re-statement of prior year balances will be needed because the difference is immaterial.

Section 2-B:

Revise Accounting Policy and Procedures Manual

The Accounting Division Policy and Procedure Manual does not include information about changes in the accounting systems and procedures. Significant sections of the manual became outdated during fiscal years 1993 and 1994 as a result of those changes. Lack of documentation has led to errors and inconsistencies in reporting financial transactions.

The methodology used to allocate income and assets for pooled investments did not follow the System's intended methodology. The Budget Statements (Exhibits III and A-3) in the annual financial report were not prepared consistently with the prior year. These errors were detected by external parties and have been corrected by the System. Although the errors were not material to the financial statements, they represent examples of the types of errors that can occur when procedures are not accurately documented.

Among the major changes that have occurred in the last few years which are not reflected in the Accounting Manual are the following:

- Preparation of vouchers changed due to the implementation of the Uniform Statewide Accounting System (USAS).
- New methods were added to account for insurance on the Integrated Employee Benefits System (IEBS).
- The System developed a spreadsheet to allocate income and assets for pooled pension investments.
- Many procedures changed when the System began using a new investment accounting system (PORTIA).
- The direct investment in international stocks created the need for many unique accounting procedures.

In addition, there are no procedures documented for complex annual financial report statements such as the Budget Statements.

An accounting policy and procedure manual helps ensure consistent and accurate recording and reporting of financial transactions. In addition, written procedures help to cross train employees to perform duties in the absence of key personnel.

<u>Recommendation</u>: We recommend that the Accounting Policy and Procedure Manual be revised to include all current accounting systems and procedures. We also recommend that the manual be revised periodically as changes occur.

<u>Management's Response</u>: We concur with the recommendation of updating the Accounting Policy and Procedure Manual.

Most changes in procedures have occurred during fiscal year 1994 as a result of USAS, USPS, SPAS, PORTIA, investment pooling, international investments, and Accounts Payable and Purchasing implementations. An action plan has been developed to update the procedures manual.

- *The USAS procedures have been documented and will be distributed in March 1995.*
- *The procedures impacted by IEBS will be revised by July 1995.*
- *The methodology of allocating the pool of pension investments has been changed in February 1995, and will be documented by August 1995.*
- *The investment accounting procedures impacted by the PORTIA investment accounting system will be developed by August 1995.*
- *The accounting procedures for the new investments in international stocks will be documented by August 1995.*
- *The procedure to prepare annual financial statements is to review the prior year workpapers and follow the format used in the prior year audited report. A step by step procedure of preparing financial statements is not considered practical.*

Section 2-C:

Clarify Legislative Intent Regarding Collateralization of Deferred Compensation Plan Deposits

Some Deferred Compensation Plan (457 Plan) deposits at financial institutions may not be fully insured or collateralized, as required by state law and System rules. The System administers the 457 Plan for state employees. Some 457 Plan deposits could be lost in the event of failure of a financial institution. Total 457 Plan deposits in banks and savings and loan associations were $43 million at August 31, 1994. The amount potentially subject to loss cannot be estimated but is probably a much smaller amount.

State law requires financial institutions to collateralize 457 Plan deposits not covered by Federal Deposit Insurance Corporation (FDIC) insurance (title 6, subtitle A, Government Code, chapter 609, subchapter C, section 609.507). The State Treasurer is required to monitor these financial institutions for compliance with that requirement and to notify the System of any noncompliance. System rules state that undercollateralized financial institutions are subject to suspension or expulsion from the 457 Plan.

The state law was passed prior to a change in the FDIC rules. At the time the state law was passed, compliance could be achieved by requiring that financial institutions pledge additional collateral whenever a 457 Plan participant's balance exceeds $100,000. Plan deposits at a financial institution up to that amount were fully insured by FDIC. The FDIC Improvement Act of 1991 requires that a participant's 457 Plan balance be aggregated with certain other personal retirement accounts of that individual in the same financial institution when applying the $100,000 FDIC coverage limit. Financial institutions do not provide the State with account balance information for those other retirement accounts. Without this information, the Treasurer can no longer ensure compliance with collateralization requirements.

The System has taken steps to ensure that financial institutions have notified 457 Plan participants of the change in FDIC coverage. Additional communication of these rules is contemplated. However, the communications will not ensure that all 457 Plan deposits are fully insured or collateralized as required by statute.

Recommendation: We recommend that the System consult with the Legislature to determine if Legislative intent remains the same since the FDIC rule changed. If the intent remains to fully insure or collateralize all 457 Plan deposits, the System may need to modify reporting requirements for financial institutions. The necessary information about participants' other accounts would have to be provided by the financial institutions. The System should coordinate these efforts with the State Treasurer.

Management's Response: This issue will be presented to determine if the Legislature wishes to reconsider its position in view of the FDIC rule changes.

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Appendix 1:

Objective, Scope, and Methodology

Objective

The purpose of this audit was to express an opinion on the System's component unit financial statements for the fiscal year ended August 31, 1994. We designed audit procedures to provide reasonable assurance of detecting material errors or irregularities. We also designed procedures to verify compliance with laws and regulations that may have a material effect on the System's financial statements.

Scope

The most significant accounts examined included cash and investments, totaling $10 billion at August 31, 1994. Also examined were the revenues and expenses/expenditures of the Pension and Expendable Trust Funds. Revenues and expenses of the Pension Trust Fund totaled $1.2 billion and $491 million, respectively. Revenues and expenditures of the Expendable Trust Fund totaled $838 million and $829 million, respectively.

Methodology

We gained an understanding of the internal control structure, including the overall control environment, certain computer-related controls, and controls over cash balances, cash receipts and accounts receivable, cash disbursements and accounts payable, investments, journal vouchers, and fixed assets. We tested controls over cash receipts, cash disbursements, investments, and journal vouchers.

We also tested certain accounts, including cash, investments, accounts receivable, accounts payable, fund balances, revenues, and expenses/expenditures. We also performed procedures to test compliance with significant requirements related to investments, fund balance reserves, and retirement annuities.

Other Information

Fieldwork was conducted from September 1994 through February 1995. The audit was conducted in accordance with applicable professional standards, including:

- generally accepted government auditing standards
- generally accepted auditing standards

The audit work was performed by the following members of the State Auditor's Office staff:

- Roger Ferris, CPA (Project Manager)
- Frank Coleman, CPA
- Darren Flatt, CPA
- Terry Harris, CPA
- Terry Hazel, CIA
- DeAnn Kiser, CPA
- Ed Pier, CPA
- Barbara Hankins, CPA (Audit Manager)
- Deborah Kerr, Ph.D. (Director)

Additionally, we utilized audit work performed by System internal auditors and were assisted by System internal auditors.

Appendix 2:

Agency Profile

Operations

The Employees Retirement System was created to provide benefits for officers and employees of the State. The System was established in 1947 and operates primarily under V.T.C.A., Texas Government Code, Title 8, Subtitle B. During August 1994, the System employed 302 employees.

The System administers retirement benefits for employees, judges, and law enforcement and custodial officers of the State of Texas. The System also administers the Uniform Group Insurance Program for active and retired state employees and employees of certain higher education institutions. It also administers a Flexible Benefits (Cafeteria Plan) and a Deferred Compensation Plan for state employees.

Each of these programs is included as a part of the reporting entity of the System because of the oversight responsibility exercised by the System's Board of Trustees. The System is a component unit of the State of Texas and is included in the State's comprehensive annual financial report.

There were 170,556 individual retirement accounts in the Employees Retirement Program as of August 31, 1994. As of August 31, 1994, annuities were being paid to 32,840 retirees from the Employees Retirement Program. In addition, there were 1,766 annuitants for the Law Enforcement and Custodial Officer Supplemental Retirement Program, 378 annuitants for the Judicial Retirement System Plan One Program, and one annuitant for the Judicial Retirement System Plan Two Program at the end of the fiscal year.

Significant Events

In February 1994, the System pooled the investment assets of the Employees Retirement Fund, the Law Enforcement and Custodial Officer Supplemental Retirement Fund, and the Judicial Retirement System Plan Two Fund. In the same month, the System began directly investing in international stocks.

The System successfully processed an unusually high number of retirements (4,796) during the fiscal year because of the retirement incentive enacted by the 73rd Legislature.

In November 1994, the Board approved a supplemental annuity payment to all annuitants who retired on or before August 31, 1993. The total payment, distributed in December 1993, was approximately $23 million. A second payment of $22 million was approved in December 1994 and distributed in January 1995.

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Appendix 3:

Auditor's Report on Compliance with Laws and Regulations Material to the Component Unit Financial Statements

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SHARON W. COBB, CPA
First Assistant

AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS MATERIAL TO THE COMPONENT UNIT FINANCIAL STATEMENTS

February 6, 1995

Board of Trustees
Employees Retirement System of Texas

Members of the Board:

We have audited the component unit financial statements of the Employees Retirement System of Texas (System) as of and for the year ended August 31, 1994, and have issued our report thereon dated February 6, 1995.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations is the responsibility of management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the System's compliance with certain provisions of laws and regulations. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, the System complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to the items not tested, nothing came to our attention that caused us to believe that the System had not complied, in all material respects, with those provisions.

This report, which is a matter of public record, is intended primarily for the use of the Board and management of the Employees Retirement System as well as for those state officials having oversight responsibility with regard to any aspect of the System's operations.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

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Appendix 4:

Auditor's Report on Internal Controls

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First Assistant

AUDITOR'S REPORT ON INTERNAL CONTROLS

February 6, 1995

Board of Trustees
Employees Retirement System of Texas

Members of the Board:

We have audited the component unit financial statements of the Employees Retirement System of Texas (System) as of and for the year ended August 31, 1994, and have issued our report thereon dated February 6, 1995.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit for the year ended August 31, 1994, we considered the System's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the System's financial statements and not to provide assurance on the internal control structure.

Management of the System is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

Internal Accounting Controls

- Cash balances
- Cash disbursements and payables
- Cash receipts and receivables
- Control environment
- Investments
- Journal vouchers

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the System's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The detailed findings relating to these reportable conditions are included in the System's management letter in the Detailed Issues and Recommendations section.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described in the System's management letter is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported in the System's management letter in the Detailed Issues and Recommendations section.

This report, which is a matter of public record, is intended primarily for the use of the Board and management of the Employees Retirement System as well as for those state officials having oversight responsibility with regard to any aspect of the System's operations.

Sincerely,

Lawrence F. Alwin

Lawrence F. Alwin, CPA
State Auditor

Copies of this report have been distributed to the following:

Legislative Audit Committee

Honorable James E. "Pete" Laney, Speaker of the House, Chair
Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
Representative Robert Junell, Chair, House Appropriations Committee
Representative Tom Craddick, Chair, House Ways and Means Committee

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