January 14, 2010

Members of the Legislative Audit Committee:

In our audit report dated November 18, 2009, we concluded that the Employees Retirement System’s (System) basic financial statements for fiscal year 2009 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

Auditors also issued a report on internal control over financial reporting and on compliance and other matters as required by auditing standards. The System’s internal control over section 218 billing agreements failed to detect a potential material misstatement that constituted a material weakness in internal control over financial reporting for the Social Security Administration Fund. Specifically, the System charged some entities that had section 218 agreements with the System incorrect amounts for administration fees. (Section 218 agreements allow entities to participate in the federal Social Security retirement program. According to information the System provided, more than 2,200 entities had section 218 agreements as of August 31, 2009.) Although the balance of the Social Security Administration Fund was $59,777 as of August 31, 2009, 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 this fund be classified as a “major” fund; therefore, auditors identified this error as a material weakness in the System’s control structure. After auditors brought this error to the System’s attention, the System corrected it and properly recorded and reported an adjustment to the billing amounts. However, the error was not initially identified by the System’s internal control.
Auditors also identified significant deficiencies in controls related to information technology, securities lending, financial accounting and reporting, and entity-wide risk assessment. Most of these issues had been identified in previous audits. The System has not fully corrected some of these issues, but it has partially addressed several of the information technology issues previously identified. The significant deficiencies in control that auditors identified were as follows:

- Auditors identified certain areas in which the System should strengthen information technology controls:
  - Weaknesses in user access controls over the System’s benefits system, financial system, and investment accounting system increase the risk of unauthorized access to these systems. The risk of unauthorized access also is increased by weaknesses in password account management practices, user access permissions, management of segregation of duties, and user password requirements for these systems. It is important to note, however, that auditors did not identify any instances of unauthorized system access.
  - The System has not updated or developed information systems policies and procedures to comply with the requirements of Title 1, Texas Administrative Code, Chapter 202. Specifically, the System has not fully implemented information security policies and standards, documented an information security risk assessment, performed periodic reviews of system access, conducted ongoing information security awareness training, and documented owner-defined data security requirements for the benefits and financial systems. Implementing these controls could enhance user accountability and the integrity of information systems.
  - The System does not consistently log all changes to source data for key fields in the database and does not use system auditing functionality properly. Logging changes to data and maximizing the use of system auditing functionality could enhance user accountability and the integrity of information systems.

- Auditors did not identify any instances of non-compliance with laws or regulations that would materially affect the financial statements. However, auditors identified certain instances related to non-compliance:
  - As of August 31, 2009, the System held securities lending collateral that did not represent 100 percent of the value of the loaned securities. Texas Government Code, Section 815.303, requires the amount of securities lending collateral to be at least 100 percent of the amount loaned. As of August 31, 2009, the System held collateral for certain securities that was valued at $70,124.81 (0.002 percent) less than the $3.47 billion in collateral required by state law.
  - As of August 31, 2009, the System’s securities lending program may not have complied with state law because it accepted non-cash collateral, which included U.S. government agency securities, from borrowers in exchange for loaned securities. Based on Texas Government Code, Section 815.303, it is unclear whether U.S. government agency securities are approved collateral. Therefore, the System should obtain clarification regarding whether government agency securities can be accepted as collateral under statute.
Auditors identified the following issues related to financial accounting and reporting controls:

- The System does not fully reconcile investment income and investment cash account information in its subledger with amounts recorded by its custodian bank, JP Morgan Chase, as intended. The System also did not record necessary adjustments it identified during reconciliations. Properly reconciling this information and recording associated adjustments enhances the reliability of financial information.

- The System has not completed an enterprise-wide risk assessment process. Performing this risk assessment could help the System identify areas in which controls must be implemented or strengthened.

The System generally agreed with the recommendations the State Auditor’s Office made to address the issues discussed above. The System’s responses to those recommendations indicate that the System has begun to address some of these issues and has plans to address most of the remaining issues.

Auditors’ 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. With the exception of controls over billings for the Social Security administration fund, the other major internal controls that auditors tested for the purpose of forming an opinion on the financial statements were generally operating effectively. Auditors reported the material weakness and the other significant deficiencies identified during this audit in detail to System management in a separate letter.

As required by professional auditing standards, auditors also will 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 actuarial information is summarized below.

**Pension Plan Financial Highlights and Actuarial Funding Status**

The plans the System manages had an unfunded actuarial accrued liability (UAAL, which represents the deficit of the plans’ actuarial assets compared with their actuarial liabilities) of $3.5 billion as of August 31, 2009. That amount includes unfunded actuarial accrued liabilities of $3.4 billion for the Employees Retirement System (ERS) plan, $126.3 million for the Law Enforcement and Custodial Officers’ Supplemental Retirement Fund (LECOSRF) plan, and $7.3 million for the Judicial Retirement System II (JRS II) plan.

The pension plans’ overall funding position decreased during fiscal year 2009. The plans’ investments earned negative 6.60 percent during fiscal year 2009, which is well below the 8.00 percent assumed long-term rate of return used for actuarial valuation purposes. This drove the combined funded ratio for the plans to be 90.2 percent as of August 31, 2009, which was a decrease from the previous year’s combined funded ratio of 94.0 percent. The funded ratio for the ERS pension plan was 87.4 percent; the funded ratio for the LECOSRF plan was 86.1 percent; and the funded ratio for the JRS II plan was 97.1 percent. As of August 31, 2009, the combined pension plans’ net assets exceeded $19.9 billion. The combined pension plans paid $2.2 billion in benefit payments in fiscal year 2009. As of August 31, 2009, the rate of annual required
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 2009 financial statements. The audit scope covered the System’s basic financial statements for fiscal year 2009. 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:

- Michael O. Clayton, CPA, CFE, CISA, CIDA (Project Manager)
- Hillary Eckford, CIA (Assistant Project Manager)
- John Boyd, CIDA
- Matthew Byrnes
- Ben Carter
- Erin Cromleigh
- Michael Yokie, CISA (Information Systems Audit Team)
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Lisa R. Coller, CPA (Assistant State Auditor)

contribution (ARC) of the State for fiscal year 2009 (the contribution rate that is needed to eliminate the actuarial funding deficit within the next 31 years) was 15.84 percent for the ERS plan and 2.58 percent for the LECOSRF plan.

The JRS II plan is actuarially sound based on a contribution rate of 22.83 percent. According to calculations the System’s actuary made, the current total annual contribution rate of 12.9 percent of pay for the ERS plan (6.45 percent from the State and 6.45 percent from active members) and 2.09 percent for the LECOSRF plan is not sufficient to amortize the current UAAL over 30 years. 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).

Retiree Health Care Plan and Actuarial Funding Status

In accordance with Statement No. 43 of the Governmental Accounting Standards Board - Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans (GASB 43), the initial actuarial valuation of the retiree health care plan disclosed the following as of August 31, 2009:

- The unfunded actuarial accrued liability was $22 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 2009 was $2 billion. This represents 19.9 percent of the related $10 billion payroll. However, the plan has historically 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 5.5 percent.
We appreciate the System’s cooperation during this audit. If you have any questions, please contact Lisa Collier, CPA, 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. I. Craig Hester, Chair
    Ms. Cydney Donnell, Vice Chair
    Ms. Yolanda Griego
    Ms. Cheryl MacBride
    Mr. Owen Whitworth
    Mr. Donald Wood
    Ms. Ann Fuelberg, Executive Director, Employees Retirement System