December 6, 2016

Members of the Legislative Audit Committee:

In our audit report dated December 1, 2016, we concluded that the Employees Retirement System’s (System) basic financial statements for fiscal year 2016 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/Overview/](http://www.ers.state.tx.us/About_ERS/Reports/Overview/).

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 identified that the System should strengthen controls to help ensure the accuracy of the active employees census data reported to the System’s actuaries.

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 2016 (see text box for the key data elements tested) as part of this audit. The completeness and accuracy of that data is important because the System’s actuary uses that data to calculate the System’s pension liability.

Auditors selected a sample of the System’s members for fiscal year 2016 census data testing, as required by American Institute of Certified Public Accountants (AICPA) guidance. That resulted in auditors selecting members from 25 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.

Based on the testing performed, auditors determined that the underlying census data was materially complete and accurate to support the System’s financial statement amounts. That was reflected as part of our unmodified audit opinion on the System’s financial statements for fiscal year 2016.

**Census Data Tested**

Census data is key demographic data that affects the actuarial estimate of the pension liability amount that the System presents in the notes to its financial statements. Auditors identified and tested the following key data elements for the System’s census data:

- Name.
- Date of birth.
- Years of service.
- Eligible compensation.
- Gender.

Source: Chapter 13 in *State and Local Governments - Audit and Accounting Guide*, American Institute of Certified Public Accountants.
Additionally, auditors will be issuing an opinion later this fiscal year on the System’s fiscal year 2016 pension liability allocation schedules. Those schedules provide employers with the information they need to record their share of the pension liability 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 2015. The System published our audit report, along with the schedules, on its Web site at http://www.ers.state.tx.us/About_ERS/Reports_and_Studies/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. I Craig Hester, Chair
   Mr. Doug Danzeiser, Vice Chair
   Ms. Ilesa Daniels
   Ms. Cydney Donnell
   Mr. Brian D. Ragland
   Ms. Jeanie Wyatt
   Mr. Porter Wilson, Executive Director, Employees Retirement System
Section 1

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

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, 2016, 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 1, 2016.

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

<table>
<thead>
<tr>
<th>Summary of Findings and Responses</th>
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<tbody>
<tr>
<td>Finding Number</td>
</tr>
<tr>
<td>2016-1</td>
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</table>

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.

The System’s Response to Findings

The System’s response to the finding identified in our audit is included 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, CIA
First Assistant State Auditor

December 1, 2016
Schedule of Findings and Responses

Section 1
The System Should Strengthen Controls to Help Ensure the Accuracy of the Active Employees Census Data Reported to the System’s Actuaries

Reference No. 2016-1
Type of finding: Material Weakness

The Employees Retirement System (System) should strengthen controls over active employee census data extracts (see text box for additional information) to help ensure that the data is accurate. The accuracy of the active employees’ census data extract is important because the System uses that data to calculate the pension liability amount that the System presents in its financial statements.

The System’s controls over active employees’ census data are not sufficient to ensure that the data for the Law Enforcement and Custodial Officer Supplemental Fund (LECOS) plan is accurate. Specifically, the System’s member employment statuses reported on the actuarial file was not always consistent with the current employment status of the members. For the LECOS plan that the System administers, auditors’ testing of the census data file as of February 29, 2016, identified 1,277 plan members that the System had incorrectly reported to the actuary for use in the actuarial calculation of pension liability amounts. Those employees previously had been certified peace officers or custodial officers for the State and had been contributing members of the LECOS plan. However, as of February 29, 2016, those 1,277 people were still state employees but were no longer classified as certified peace officers or custodial officers. However, the System continued to report them as active members of the LECOS plan. The System had been misreporting the employment status for some of those employees for several years.

This misclassification resulted in the pension liability amount being overstated for the LECOS plan. If the System continues to misreport the number of active participants, it could result in a material overstatement of the pension liability.

As noted in guidance issued by the American Institute of Certified Public Accountants (AICPA)\(^1\), a material weakness is a deficiency, or a combination of

\(^1\) See Chapter 4 in Government Auditing Standards and Single Audits- Audit Guide, American Institute of Certified Public Accountants.
deficiencies, in internal control such that there is a reasonable possibility that a material misstatement will not be prevented, or detected and corrected on a timely basis.

Recommendation

The System should strengthen controls for employer census data reporting to ensure that the member employment status is properly reported in the data that is sent to the actuary.

Management’s Response

ERS agrees that 1,277 individuals were incorrectly identified as active members in the LECOS plan in the file submitted to the actuary for 2015. While these individuals are active members of ERS and have service in the LECOS plan, they were not accruing additional LECOS service at August 31, 2015. ERS informed the actuary of this extract file error and the valuation as of August 31, 2016 does not reflect these individuals as active LECOS members. Eliminating the 1,277 records from LECOS contributory status would reduce the LECOS Total Pension Liability as of August 31, 2015 from $1.45 billion to $1.44 billion, a difference of $10 million.

In reviewing the specific issue identified by this audit, ERS took additional validation steps to ensure the accuracy of the fiscal year 2016 files submitted to the actuary for all the plans. Management believes the error to be limited to the specific population identified. We will continue to analyze the programs used to extract the data used for valuation purposes and correct any issues identified.

The errors identified were not in ERS’ system used to determine benefits and thus, these errors would not result in overpayment of benefits.

During fiscal year 2016, ERS strengthened its controls over census data and will continue to do so. Activities over the last year included developing several queries and reports and incorporating them into the review process to identify and manage potential data concerns. During fiscal year 2017, we plan to acquire a data profiling tool to augment current activities.

Implementation Date: Ongoing
Responsible Positions: Chief Financial Officer

Chief Information Officer

Director, Customer Benefits
Section 2

List of Employers Selected for Census Data Testing

Table 1 lists the 25 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 plan’s financial statement amounts.¹

Table 1

<table>
<thead>
<tr>
<th>List of Employers Selected for Census Data Testing for Fiscal Year 2016</th>
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<tbody>
<tr>
<td>▪ Alcoholic Beverage Commission</td>
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<tr>
<td>▪ Office of the Comptroller of Public Accounts</td>
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<tr>
<td>▪ Commission on Environmental Quality</td>
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<tr>
<td>▪ Credit Union Department</td>
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<tr>
<td>▪ Department of Aging and Disability Services</td>
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<td>▪ Department of Criminal Justice</td>
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<td>▪ Department of Family and Protective Services</td>
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<td>▪ Department of Insurance</td>
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<td>▪ Department of Public Safety</td>
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<tr>
<td>▪ Department of State Health Services</td>
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<td>▪ Fifth Court of Appeals District, Dallas</td>
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<tr>
<td>▪ Health and Human Services Commission</td>
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<tr>
<td>▪ Historical Commission</td>
</tr>
<tr>
<td>▪ House of Representatives</td>
</tr>
<tr>
<td>▪ Judiciary Section, Comptroller’s Department</td>
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<tr>
<td>▪ Ninth Court of Appeals District, Beaumont</td>
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<td>▪ Office of the Attorney General</td>
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<tr>
<td>▪ Preservation Board</td>
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<td>▪ Supreme Court of Texas</td>
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<td>▪ Department of Transportation</td>
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<td>▪ Texas Education Agency</td>
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<tr>
<td>▪ Juvenile Justice Department</td>
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<tr>
<td>▪ Texas Workforce Commission</td>
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<tr>
<td>▪ Third Court of Appeals District, Austin</td>
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<tr>
<td>▪ Veterans Commission</td>
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</tbody>
</table>

¹ Auditors followed the American Institute of Certified Public Accountants’ sampling guide methodology and selected a random sample of employees for testing.