John Keel, CPA
State Auditor

A Report on

The Audit of the Employees Retirement System's Fiscal Year 2012 Financial Statements

December 11, 2012

Members of the Legislative Audit Committee:

In our audit report dated November 16, 2012, we concluded that the Employees Retirement System's (System) basic financial statements for fiscal year 2012 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 has posted 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 management, is presented in the attachment to this letter). In that report, auditors identified that while the System implemented new processes for financial reporting of alternative investments in fiscal year 2012, those processes were not operating effectively. Specifically, the System did not:

- Complete and review its alternative investment reconciliations within the required time frames.
- Adequately evaluate the alternative investment valuations that it reported on its annual financial statements.
- Accurately report capitalized management fees within its annual financial statements.
- Include all alternative investments in its accounting and financial reporting processes associated with alternative investments.

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 issue(s) 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. 13-012

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

Sincerely,

John Keel, CPA
State Auditor

Attachment

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

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Attachment

State Auditor's Office
John Keel, CPA
State Auditor

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. Cheryl MacBride, Chair
Mr. Brian D. Ragland, Vice-Chair
Ms. Cydney Donnell
Ms. Yolanda Griego
Mr. I. Craig Hester
Mr. Frederick E. Rowe, Jr.

We have audited 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, 2012, which collectively comprise the System's basic financial statements and have issued our report thereon dated November 16, 2012. 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 deficiencies, 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
2012-1

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 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*.

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, 2012

Schedule of Findings and Responses

Section 1

The System Should Improve Accounting and Financial Reporting Controls over Alternative Investments

Reference No. 2012-1

Type of finding: Significant Deficiency

The Employees Retirement System (System) developed and implemented processes to help ensure that (1) alternative investments transactions are recorded in accordance with generally accepted accounting principles (GAAP) and (2) alternative investments are reported in accordance with GAAP on the System's annual financial statements.

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 $2.12 billion in alternative investments as of August 31, 2012.

Auditors identified a significant deficiency related to the System's accounting and financial reporting processes over alternative investments for fiscal year 2011. While the System implemented new processes for financial reporting of alternative investments in fiscal year 2012, those processes were not operating effectively.

Specifically, the System did not:

- Complete and review its alternative investment reconciliations within the required time frames.
- Adequately evaluate the alternative investment valuations that it reported on its annual financial statements.
- Accurately report capitalized management fees within its annual financial statements.
- Include all alternative investments in its accounting and financial reporting processes associated with alternative investments.

The System's alternative investments comprised 10 percent of its total investment assets as of August 31, 2012, and the System's current investment policy states that it intends to allocate 21 percent of total investment assets to alternative investments in the future.

The System should complete and review its alternative investment reconciliations within the required time frames.

The System implemented a four-way reconciliation process among its custodian bank's accounting records, the statements provided by the partnerships that manage the alternative investments (partnerships), the

System's general ledger, and the internal investment accounting system that runs parallel to the System's general ledger. The System's *Investment Accounting Operating Procedures* require that the reconciliations be completed within 45 days of receiving the statements from the partnerships.

This reconciliation process is adequately designed to provide assurance that the System is recording the value of alternative investments as reported by the partnerships. However, the System did not consistently complete the reconciliations within the required time frames. Specifically, of the 19 reconciliations tested:

- Three (16 percent) were completed within the required 45 days after receiving the statements from the partnerships.
- Three (16 percent) were completed after the required 45 days. On average, those 3 reconciliations were completed 149 days after the receipt of the statements.
- Thirteen (68 percent) could not be evaluated as to whether they were completed in accordance with System policy. The System did not date-stamp the quarterly financial statements upon receipt from the partnerships. On average, those 13 reconciliations were completed 169 days after the end of the statement date.

Not completing and reviewing reconciliations within the required time frames increases the risk that errors will not be identified and corrected in a timely manner.

In addition, in June 2012, the System changed its policy to include a second-level review of the reconciliations. However, the System could not provide any documentation showing that a second review occurred for 3 (17 percent) of the 18 reconciliations tested after the new policy was in effect.

The System should improve its process for independently evaluating the alternative investment valuations that it reports on its annual financial statements.

AICPA Alternative Investments – Audit Considerations, Appendix II

This appendix recommends that the reporting entity review the most recent audited financial statement of each fund, noting the basis of accounting, summary of significant accounting policies and procedures pertaining to the valuation of alternative investments, name of audit firm, and type of opinion.

The System implemented a valuation committee to discuss valuation methodologies, any disputes in valuations, and changes in fair value guidelines for each alternative investment. The design of the valuation committee's review process is consistent with the American Institute of Certified Public Accountants (AICPA) Alternative Investments – Audit Considerations (see text box for more information). However the following considerations were not discussed at the valuation committee's September 21, 2012, meeting.

GASB Statement No. 25
GASB Statement No. 25, paragraph 24, states that plan investments, whether equity or debt securities, real estate, or other investments should be reported at their fair value at the reporting date.

- The System incorrectly recorded the value of three alternative investments at cost in its fiscal year 2012 financial statements, which resulted in those investments being understated by $10,517,604. Government Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, requires investments to be listed at fair value (see text box).
- The System did not value 14 alternative investments based on the most current investment values available. The System used values dating as far back as March 31, 2012. The difference in valuation was $19,169,230.
- The System did not include in documentation submitted to the valuation committee five alternative investments in which the System had invested after December 31, 2012, and for which quarterly financial statements were available to value these investments.

The System should ensure that it accurately reports capitalized management fees in its annual financial statements.

On its fiscal year 2012 financial statements, the System reported prepaid alternative investment management fees twice. Specifically, the System reported the fees within two separate line items on the Statement of Fiduciary Net Assets. That error caused the System to overstate Net Assets by $3,482,192 for fiscal year 2012 and overstate Net Appreciation in Fair Value of Investments by the same amount for fiscal year 2012 on the Statement of Changes in Fiduciary Net Assets.

The System should ensure that all alternative investments are included in its accounting and financial reporting processes associated with alternative investments.

The System entered into a partnership agreement whose value is based on the System's ownership percentage of the fund's net asset value (as opposed to a quoted market price). The System did not include that investment in its accounting and financial reporting processes for alternative investments. The System did not perform regular reconciliations of the value recorded in its general ledger with the partnership statements received throughout the year (as it did for all of its other alternative investments). The System also did not present the investment for valuation committee review. The investment meets the AICPA's definition for alternative investments (see text box on page 1); therefore, it should be included in all of the System's processes for alternative investments.

In addition, the System overstated its ownership interest in the investment on its fiscal year 2012 financial statements by $9,746,659. Specifically, the

System reported that it owned 100.00 percent of that investment. Using confirmation audit procedures and the August 31, 2012, partnership statement, auditors determined that the System held a 96.85 percent ownership interest in that investment. It should be noted that the System conducted a year-end performance review of that investment. However, that year-end review did not accurately identify the System's percentage ownership, was not signed by a preparer or a reviewer, and was not dated. Conducting regular reconciliations between its general ledger and the partnership statements would help the System to identify errors in a timely manner and accurately report the fair value of the investment.

Recommendations

The System should:

- Complete and review its alternative investment reconciliations within the required time frames.
- Improve its process for independently evaluating alternative investment valuations that it reports on its annual financial statements. Specifically the System should ensure that it:
  - Includes accurate and complete information in valuation committee discussions.
  - Reports all alternative investments at the most current fair value as of the end of the fiscal year.
- Review alternative investment transactions to ensure that it accurately reports those transactions in its annual financial statements.
- Include all alternative investments in its accounting and financial reporting processes associated with alternative investments.
- Ensure that alternative investments are valued using the correct ownership percentage.

Management's Response

Subsequent to the FY 2011 State Auditor's Office (SAO) financial audit, the Employees Retirement System (System) management made a concerted effort to improve processes and procedures relating to alternative investments. More detailed and robust reconciliation procedures were implemented. Alternative Investment Issues were added to the agenda for weekly Finance Division staff meetings and an environment of continuous improvement was encouraged. An internal audit was scheduled to test controls and procedures. Our co-sourced internal audit partner, which has expertise in alternative investments, was consulted and advised System management on best practices.

- *Although the majority of the reconciliation work was performed within the then-existing timeframe requirements, enhancements have been made to the procedures to ensure all reconciliations are date stamped. Management added an additional step to strengthen the process by requiring a second level management review. This resulted in final completion of reconciliations from the first part of the fiscal year being beyond the established deadlines. All of the reconciliations for the June 2012 quarter were completed within the prescribed timeframes. Management considers this issue to be fully addressed and implemented.*

- *To improve the valuation process, System management has adopted valuation guidelines based on best practice recommendations from our co-sourced internal audit partner.*

  - *Management has taken appropriate action to address all of the issues raised by the auditors, including steps to ensure that complete and accurate information is discussed in Valuation Committee meetings.*

  - *Management has taken steps and added procedures to ensure that the three investments identified by the auditors and similar investments in the future are reported at fair value. The amounts for the valuation issues discussed above were below the two percent materiality threshold established by System valuation guidelines. These recommendations have been implemented.*

- *The System custodian inadvertently generated investment transactions to adjust net asset values in addition to the accounting entries to record prepaid management fees for alternative investments. This issue was corrected in coordination with the System custodian in October 2012. Additional reconciliation procedures were added to prevent this type of problem in the future. This recommendation has been implemented.*

- *Management has taken steps to include all appropriate investments when performing alternative investment processes including one partnership of exchange trade stocks that had been included in the Domestic Equity component processes. Although the investment is managed as part of the Domestic Equity component, it meets the accounting definition of an alternative investment. Management has agreed to treat this investment and similar investments in the future as alternative investments for reconciliation and valuation purposes. This recommendation has been implemented.*
- *The ownership percentage for the investment referenced above that is managed in the Domestic Equity Component was not adjusted for management fees. By including it in the alternative investment reconciliation and valuation processes, the ownership percentage is now a regular part of the process. This recommendation has been implemented.*