



A Report on
The Audit of the Employees Retirement **System's**
Fiscal Year 2017 Employer Pension and Other
Post Employment Benefits
Liability Allocation Schedules

July 26, 2018

Members of the Legislative Audit Committee:

We have issued two audit reports dated June 27, 2018, related to the Employees Retirement System's (System) pension and other post employment benefits (OPEB) liability schedules for fiscal year 2017.

Pension Liability Schedules

We concluded that the System's Schedules of Employer Allocations and the columns titled net pension liability, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer specific amounts, and pension expense (specified column totals) included in the Schedules of Collective Pension Amounts and the related notes as of August 31, 2017, were materially correct and presented in accordance with accounting principles generally accepted in the United States of America (see text box for pension liability reporting requirements). The Schedules of Employer Allocations and Schedules of Collective Pension Amounts are for the following defined benefit pension plans: Employees Retirement System Plan, Law Enforcement and Custodial Officer Supplemental Retirement Plan, and Judicial Retirement System of Texas Plan II.

OPEB Liability Schedules

We concluded that the System's Schedule of Employer Allocations for Other Post-Employment Benefits (OPEB) and the columns titled net OPEB liability beginning September 1, 2016, net OPEB liability ending August 31, 2017, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer specific amounts, and OPEB expense included in the Schedule of Collective OPEB Amounts for the Other Post-Employment Benefits (OPEB) Fund and the related notes as of August 31, 2017, were materially correct and presented in accordance with accounting principles generally accepted in the United States of America (see text box for OPEB liability reporting requirements).

Pension and OPEB Liability Reporting Requirements

Pension Reporting Requirements

Governmental Accounting Standards Board Statement No. 68, *Accounting and Financial Reporting for Pensions* (GASB 68), which became effective for fiscal years beginning after June 15, 2014, requires governments to begin recording on the face of their financial statements a liability for pension plans administered through trusts, rather than disclosing those amounts in the notes to their financial statements.

OPEB Reporting Requirements

Governmental Accounting Standards Board Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* (GASB 75), which became effective for fiscal years beginning after June 15, 2017, requires governments to begin recording on the face of their financial statements a liability for OPEB plans administered through trusts, rather than disclosing those amounts in the notes to their financial statements.

Employers in the respective plans will need to recognize their portion of the reported pension and/or OPEB liability in the financial statements they produce.

The System prepared the audited schedules to help participating employers comply with requirements of GASB 68 and GASB 75. Employers may use the pension and OPEB liability schedules prepared by the System to aid them in determining their portion of the reported pension or OPEB liability.

Sources: GASB Statement Nos. 68 and 75, and the American Institute of Certified Public Accountants State and Local Government Expert Panel Pension Whitepapers Series, Governmental Employer Participation in Cost-Sharing Multiple Employer Plans: Issues Related to Information for Employer Reporting.

SAO Report No. 18-040

The System intends to post the pension liability schedules, the OPEB liability schedules, and our audit reports on its Web site at <https://www.ers.texas.gov/>.

We also issued a report on internal control over financial reporting and on compliance and other matters of the pension liability schedules as required by auditing standards. Our procedures did not identify any material weaknesses in internal control over financial reporting or any noncompliance with laws or regulations that materially affected the pension liability schedules. In addition, the major internal controls that we tested for the purpose of forming our opinions on the pension liability schedules were operating effectively.

We also issued a report on internal control over financial reporting and on compliance and other matters of the OPEB liability schedules as required by auditing standards (that report, including responses from management, is presented in the attachment to this letter). In that report, auditors determined that the System did not accurately implement the requirements of Governmental Accounting Standards Board (GASB) Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*. As a result, auditors identified material weaknesses in the System's preparation and review of the Schedule of Collective OPEB Amounts for Other Post-Employment Benefits (OPEB) Fund for fiscal year 2017.

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 issues 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 this 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
Employees Retirement System 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

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 OPEB Schedules 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 Schedule of Employer Allocations for Other Post-Employment Benefits (OPEB) of the Employees Retirement System (System) as of and for the year ended August 31, 2017, and the related notes. We have also audited the columns titled net OPEB liability beginning September 1, 2016, net OPEB liability ending August 31, 2017, total deferred outflows of resources excluding employer specific amounts, total deferred inflows of resources excluding employer specific amounts, and OPEB expense included in the Schedule of Collective OPEB Amounts for Other Post-Employment Benefits (OPEB) Fund of the System as of and for the year ended August 31, 2017, and related notes, and have issued our report thereon dated June 27, 2018 (OPEB schedules).

Internal Control Over Financial Reporting

In planning and performing our audit of the OPEB schedules, we considered the System's internal control relevant to the System's preparation and fair presentation of the OPEB schedules (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the OPEB schedules, 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 System's OPEB schedules will not be

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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 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 material weaknesses.

Summary of Findings and Responses
Finding Number
2018-1

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System's OPEB schedules 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 OPEB schedule 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

The 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 schedules 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 of the OPEB schedules and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control relevant to the System's preparation and fair presentation of the OPEB schedules 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 relevant to the System's preparation and fair presentation of the OPEB schedules and compliance. Accordingly, this communication is not suitable for any other purpose.

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

June 27, 2018

Schedule of Findings and Responses

Section 1

The System Did Not Accurately Implement the New Accounting Standards Related to the Schedule of Collective OPEB Amounts

Reference No. 2018-1

Type of finding: Material Weakness

The Employees Retirement System's (System) did not accurately implement the requirements of Governmental Accounting Standards Board (GASB) Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions* (see text box for more information about that standard). As a result, auditors identified material weaknesses in the System's preparation and review of the Schedule of Collective OPEB Amounts for Other Post-Employment Benefits (OPEB) Fund (OPEB Liability Schedule) for fiscal year 2017. Specifically, those errors were related to the System:

- Not correctly calculating the beginning balance of the total OPEB liability for fiscal year 2017.
- Not accurately calculating the changes in OPEB liability resulting from (1) the difference between expected and actual experience and (2) changes in assumptions.

GASB OPEB Reporting Requirements

GASB Statement No. 75 requires governments to begin recording on the face of their financial statements a liability for OPEB plans administered through trusts, rather than disclosing those amounts in the notes to their financial statements.

Employers in the respective plans will need to recognize their portion of the reported OPEB liability in the financial statements they produce.

The System prepared the audited schedules to help participating employers comply with requirements of GASB 75. Employers may use the OPEB liability schedules prepared by the System to aid them in determining their portion of the reported OPEB liability.

Source: GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which became effective for fiscal years beginning after June 15, 2017.

Beginning Balance of the Total OPEB Liability

In its initial OPEB Liability Schedule for fiscal year 2017, the System did not recalculate the beginning balance of the total OPEB liability for fiscal year 2017 in compliance with GASB 75. Instead, it incorrectly used the fiscal year 2016 total OPEB liability ending balance, which it had calculated under the previously applicable requirements of GASB Statement No. 43¹, as the beginning balance. As a result, that schedule understated the beginning balance of total OPEB liability by \$14.1 billion.

¹ GASB Statement No. 43 (Superseded), *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*.

The System then took steps to correctly implement GASB 75 requirements in calculating its OPEB Schedule for fiscal year 2017. However, the System did not accurately calculate the beginning balance of the total OPEB Liability because it used the incorrect discount rate (see discussion below for more information).

Changes in OPEB Liability

The System did not correctly calculate certain changes in OPEB liability. Specifically, as a result of an inaccurate interpretation of GASB 75, the System determined that certain deferred inflows/outflows of resources should be reported as zero.² To accomplish this, the System applied the incorrect discount rate to calculate those totals. That resulted in errors totaling \$16.6 billion. Specifically the System:

- Used that same discount rate to calculate the beginning balance of total OPEB liability that resulted in the \$8.3 billion understatement (as discussed above).
- Understated OPEB Deferred Inflows of Resources by \$7.5 billion.
- Overstated OPEB Deferred Outflows of Resources by \$3.0 million.
- Overstated OPEB Expense by \$795.9 million.

The System is responsible for ensuring that it prepares its OPEB schedules 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 OPEB Liability Schedule.

Correctly implementing GASB Statement No. 75 is important because the employers participating in the OPEB plan will use this schedule to report their proportionate share of the components of the Net OPEB Liability in their financial statements for fiscal year 2018. Adequate preparation and review of the OPEB schedules, including new accounting standards, are critical to helping ensure that the System's OPEB Schedules and note disclosures are complete, accurate, and comply with financial reporting standards.

² These were the deferred inflows/outflows of resources arising from (1) the difference between expected and actual experience and (2) the changes in assumptions.

Recommendation

The System should establish processes to implement new GASB pronouncements that include determining the applicable requirements and evaluating the necessary changes.

Management's Response

ERS agrees with the recommendation to improve processes for implementing new GASB pronouncements. GASB 75 had numerous complexities and nuances which created challenges in its implementation. ERS is currently modifying its procedures to:

- *provide for more detailed documentation of the impact and disposition of each requirement within a new GASB standard,*
- *obtain documentation of its actuaries' review and disposition of new GASB standards when applicable, and*
- *obtain input from GASB staff on specific ERS implementation considerations.*