

A Review of Internal Controls of

Certain Programs Administered by the Employees Retirement System of Texas



Office of the State Auditor
Lawrence F. Alwin, CPA

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OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH ST., SUITE 1900
AUSTIN, TEXAS 78701

MAILING: P.O. BOX 12067
AUSTIN, TEXAS 78711-2067

PHONE: (512) 479-4700 FAX 479-4884

LAWRENCE F. ALWIN, CPA
State Auditor

SHARON W. COBB, CPA
First Assistant

July 17, 1995

Members of the Legislative Audit Committee:

Management of the Employees Retirement System of Texas has generally established effective controls for the Flexible Benefits and Deferred Compensation Plans. However, the System should strengthen controls to ensure that income deferral limitations established by federal statute (Internal Revenue Service Code) are not exceeded by participants in the Deferred Compensation Plan. Also, the System contracts with a third-party administrator to process flexible benefit claims. The System needs to obtain assurance from its third-party administrator that the control structure for processing flexible benefit claims, including controls to ensure compliance with federal and state laws, are designed correctly and function effectively.

Management has generally established effective controls to safeguard investments held in foreign countries. However, the System's policy for obtaining foreign currency bids could be improved by expanding its list of approved brokers for currency trades and by obtaining at least three bids for each currency trade.

Management of the Employees Retirement System of Texas concurs with the recommendations in this report. We have included management's responses.

We appreciate the cooperation and courtesy management showed during the course of this review.

Sincerely,

A handwritten signature in cursive script that reads "Lawrence F. Alwin".

Lawrence F. Alwin, CPA
State Auditor

LFA/rmn

Key Points Of Report

A Review of Internal Controls of Certain Programs Administered by the Employees Retirement System of Texas

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Key Facts and Findings

- The System should expand its list of approved foreign currency brokers to ensure that favorable exchange rates are obtained when trading foreign currency. The dollar amount of international securities traded in the first six months of fiscal year 1995 was \$290 million.
- The System has assurances of the safety of foreign held assets through its custodial trust agreement. Total market value of international securities held in foreign countries at March 9, 1995, was approximately \$965 million. These securities were held in depositories in 16 different countries.
- The System should strengthen controls to ensure that income deferral limitations established by federal statute (Internal Revenue Service Code) are not exceeded by participants in the Deferred Compensation Plan. The Deferred Compensation Plan had approximately 10,000 participants in the 457 Plan and 30,200 participants in the TexaSaver 401(k) Plan at August 31, 1994. At August 31, 1994, total market value of Deferred Compensation Plan assets was estimated at \$214 million and \$140 million for the 457 and 401(k) Plans, respectively.
- The System does not receive assurances that the control structure over claims processing by its third-party administrator for the Flexible Benefits Plan is designed correctly and functions effectively. The System does not know if claims are being processed in accordance with federal and state law because it has not received any assurances about the design and effectiveness of the claims processing internal control structure used by the third party administrator. The Flexible Benefits Plan had 9,220 participants in the health care reimbursement plan and 2,568 in the dependent care reimbursement plan at August 31, 1994.
- Management of the Employees Retirement System have generally established effective controls for the Flexible Benefits and Deferred Compensation Plans.

Contact:

Barbara Hankins, CPA, Audit Manager (479-4921)

This review of financial/management controls was conducted in accordance with Government Code, §321.0131, 321.0132 and 321.0133.

Table of Contents

Issues and Recommendations 1

Section 1:

Controls Are Generally Effective To Safeguard Foreign Held Investments; the System Should Expand Its List Of Approved Foreign Currency Brokers 1

Section 1-A:

The System Should Expand Its List Of Approved Foreign Currency Brokers 1

Section 1-B:

The System Has Assurances Of The Safety Of Foreign Held Assets Through Their Custodial Trust Agreement 2

Section 2:

Controls Are Generally Effective In The Deferred Compensation Plan; however, Controls To Monitor Income Deferral Limitations Should Be Strengthened 3

Section 2-A:

The System Needs To Improve Controls To Ensure That Deferral Limitations Are Not Exceeded By Participants 3

Section 3:

Controls Are Generally Effective In The Flexible Benefits Plan; however, The System Should Obtain Assurances On The Effectiveness Of Controls Over Claims Processing 4

Section 3-A:

The System Should Obtain Assurance That The Internal Control Structure Over Claims Processing Is Designed Correctly, Operates Effectively, And Ensures Compliance With Federal And State Laws .. 5

Appendix 1:

Objectives, Scope, and Methodology 7

Appendix 2:

Background Information - International Investments 8

Issues and Recommendations

Section 1:

Controls Are Generally Effective To Safeguard Foreign Held Investments; the System Should Expand Its List Of Approved Foreign Currency Brokers

The System should expand its list of approved foreign currency brokers to ensure that a favorable price is obtained in currency transactions. There are several types of risk associated with assets held in foreign countries. The System generally has effective controls in operation to reduce these risks.

The System began acquiring foreign currency-denominated international equities in February 1994. The controls for recording and processing international investment transactions at the System are basically the same as those for domestic equities. However, controls over custody of international securities are different because the securities are held in the country of origin. There are also foreign currency exchange matters to deal with that are not applicable when trading domestic securities. (Appendix 2 contains additional information about the System's investment in international securities.)

Section 1-A:

The System Should Expand Its List Of Approved Foreign Currency Brokers

The System currently obtains foreign currency bids from only two sources when executing international stock transactions--the master custodian and the sub-custodian (NationsBank and Chase Manhattan Bank, respectively). These rates are compared to exchange rates on the Bloomberg Financial Services system. The System would have more assurance that it is obtaining a favorable exchange rate if it

obtains more bids from a more diversified list of foreign currency brokers.

The System's current policy for foreign currency trades is to obtain a forward rate contract at the time a stock trade occurs. The contract is timed to settle on the same date as the related stock trade. The foreign exchange rate is a major factor in the total rate of return received on international investments.

The System has a fiduciary responsibility to obtain the highest rate of return over the long term on its investments. Obtaining more favorable exchange rates would enhance the rate of return in the international investments portfolio.

Recommendation:

We recommend that the System expand the list of approved brokers for currency trades and obtain at least three bids for each currency trade.

Management's Response:

The System currently uses the foreign exchange desks of its custodians for its foreign currency transactions--NationsBank and Chase Manhattan Bank. It is not unusual for a fund to use the custodian's foreign exchange desk to execute these types of transactions. This was established by ERS as a trade and settlement control measure in the initial implementation of the international portfolio, and the use of two desks provided some assurance of competitive rates.

Staff and the custodian have established reasonably successful procedures in the trade and settlement process of the international portfolio; we therefore agree that it would now be appropriate to expand the list of brokers through which these foreign exchange

Issues and Recommendations

transactions are executed. However, there can be no assurance that the rates obtained will be any more favorable than those obtained from the current trading relationships.

Section 1-B:

The System Has Assurances Of The Safety Of Foreign Held Assets Through Their Custodial Trust Agreement

Overall, the System's international investments are safe although it faces risks not ordinarily faced with domestic securities.

International investment securities are held in depositories in the country of origin. There are several types of risk associated with custody of international securities. The most significant risks are political risk, including expropriation or nationalism, custodial credit risk, and risks related to physical security. Custodial credit risk is the risk that a party will not be able to recover deposits if the depository financial institution fails or recover the value of investment or collateral securities that are in the possession of an outside party. Physical security is concerned with the possibility of losing assets due to theft, fire, or other disasters.

The System has a unique risk relating to its investment in foreign corporate stocks. The System could lose its investments through adverse actions, such as expropriation or nationalization of the governments of the countries where investments are made. Based on information compiled by the global sub-custodian, Chase Manhattan Bank, such actions are not likely in the countries in which the System has invested. The System also has two international investment advisors. The probability of expropriation and nationalization of foreign governments are

two of many factors considered by the advisors when recommending countries for the System to invest in.

The System has investments in Australia and the major European and Asian countries. All assets held in these countries, other than Belgium, are held physically in vaults in banks affiliated with their sub-custodian. Although there are greater risks associated with the physical custody of assets compared to book entry, these risks are assumed by the custodian, NationsBank. The custodian would be responsible for replacing any securities lost due to theft or disaster.

The reason for physical custody of these assets is to facilitate security lending. Based on information from Chase Manhattan Bank, securities which are properly segregated pursuant to the custodian agreement would be protected from the claims of creditors in the event of bankruptcy of the bank holding the securities.

The countries in which the System invests are all considered developed markets, according to the Bloomberg Financial Services system. There are no investments in emerging markets. The credit ratings of these countries, according to Standard and Poors, are all "A" or better. Eighty-five percent of the total international investments are in seven countries with a credit rating of AAA. The credit rating is an indication of a country's ability to repay its debts and a measure of its financial stability. In addition, a country with a high credit rating, such as "A" or better, is more likely to provide a sound business environment.

Cash held in foreign banks does not receive the same protection from bank creditors in the event of bankruptcy of that bank. In every country in which the System invests, all cash

Issues and Recommendations

held would be subject to loss. There is no federal insurance similar to that available by Federal Deposit Insurance Corporation (FDIC) in these countries. Therefore, without additional collateralization, there would be substantial risks in holding foreign currency. The System's current policy is to immediately convert all foreign currency to U.S. dollars and wire the dollars back to their account at the State Treasury. However, ERS has requested a legal opinion and is considering holding foreign currency. The System should take these additional risks and any costs associated with collateralization into consideration when evaluating whether to hold foreign currency.

Management's Response:
The System concurs with this finding.

Section 2:

Controls Are Generally Effective In The Deferred Compensation Plan; however, Controls To Monitor Income Deferral Limitations Should Be Strengthened

The System took over the administration of the Deferred Compensation Plan on January 1, 1991, from the Texas Comptroller's Office. At the time of transfer, there were significant weaknesses in the financial and management controls. The System has made much progress in correcting those weaknesses. It has generally established effective controls for the Plan. However, controls to monitor income deferral limitations need to be strengthened.

Section 2-A:

The System Needs To Improve Controls To Ensure That Deferral Limitations Are Not Exceeded By Participants

Internal controls to ensure that maximum deferrals are not exceeded by participants need to be strengthened. These maximum income deferral limitations are established by federal statute (Internal Revenue Service Code). The System's current policy pertaining to maximum deferrals is to rely on individual agencies to monitor participants' deferrals to determine if they exceed the maximum. The System has provided agency coordinators with policies and procedures pertaining to maximum income deferral and is in a better position to monitor agencies that are on the Uniform State Payroll System (USPS).

In some instances, individuals are in the "catch-up" mode which allows deferrals in excess of the usual maximums, and the paperwork documenting that situation is missing from the System's records. Although the System receives quarterly reports which identify participants who may be exceeding the deferral limitations, the reports do not contain enough information for a complete follow-up by the System. The System summarizes the quarterly reports in its own report, but this report contains errors and is not reliable.

Errors sometimes occur in these reports when the System requests "catch-up" forms from agencies, but the agencies will not honor the request on a timely basis.

If participants exceed the maximum deferrals allowed by statute, the Internal Revenue Service (IRS) could deem the plan ineligible. Even if the Plan was not deemed ineligible, the IRS could require participants to pay additional taxes, interest, and penalties on

Issues and Recommendations

amounts deferred over the maximum allowed. The System has a responsibility to provide a plan which is in compliance with the applicable federal and state statutes.

Recommendation:

We recommend that the System establish a process that will ensure that it can monitor maximum deferrals in the Plan. The System should enact such rules/regulations to require the necessary reporting by agencies to support the monitoring process.

Management's Response:

The quarterly reports that are referenced in the audit report are not intended to monitor maximum deferrals, but rather are used by the ERS as an early warning tool or process to assist state agencies in identifying participants who may potentially exceed deferral limits.

The ERS has established proactive processes to prevent deferrals from exceeding the annual limit determined by the Internal Revenue Service. Such processes include providing maximum deferral worksheets for participants and Benefits Coordinators to use to determine if a desired deferral amount is within the annual limit. Such worksheets, which are contained in the Deferred Compensation Agency Coordinator Procedures Manual, are reviewed during Coordinator training sessions. These worksheets are designed to test a deferral amount before it is even entered into a payroll system.

Another process involves the programming of maximum deferral limit calculations in the Uniform Statewide Payroll/Personnel System (USPS). ERS staff and legal counsel worked diligently with USPS staff and consultants to assure that maximum deferral limits would not be exceeded. USPS automatically stops

deferrals from being deducted from a paycheck when the limit is reached. ERS monitoring of deferral limits for state agencies utilizing the USPS would be a duplication of effort and resources.

The ERS Deferred Compensation Division staff will work with ERS Information System Division staff to study the feasibility of developing a system to monitor the \$7,500 annual deferral limit. Since additional staff time and computer resources will be required to implement this recommendation, it will need to be considered within the scope of the ERS's overall program responsibilities and available budget resources. We agree that requirements for state agencies to support the monitoring process should be incorporated into the Plan rules.

Section 3:

Controls Are Generally Effective In The Flexible Benefits Plan; however, The System Should Obtain Assurances On The Effectiveness Of Controls Over Claims Processing

The Flexible Benefits Plan offers state and higher education employees three pretax benefit options: premium conversion, health care reimbursement, and dependent care reimbursement. Participants realize both federal income and social security tax savings. The State realizes savings from social security matching taxes. The System generally has established effective controls in the Plan. However, the System has not obtained assurances that controls over claims processing by their third party administrator are effective and designed correctly. Without knowing the design and effectiveness of

Issues and Recommendations

claims processing controls, the System has no assurances that claims are processed in accordance with applicable federal and state laws.

Section 3-A:

The System Should Obtain Assurance that the Internal Control Structure over Claims Processing is Designed Correctly, Operates Effectively, and Ensures Compliance with Federal and State Laws

The internal control structure for processing flexible benefit claims, including controls to ensure compliance with federal laws, resides at the System's third-party plan administrator. The System does not receive assurances that the control structure at the third-party administrator is designed correctly and functions effectively. Additionally, the System does not require its third-party administrator to obtain an independent audit of the internal control structure over claims processing. The System cannot know if claims are being processed in accordance with federal and state law without knowing the design and effectiveness of the claims processing internal control structure used by the third-party administrator.

The System's flexible benefits plan could potentially be at risk of losing its ability to operate as a qualified pretax benefits plan if claims are not processed in accordance with applicable federal and state laws. The System currently employs a consultant who researches changes in flexible benefit laws and informs the System of those changes. The consultant is also used by the System to answer technical questions. The System has relied on the consultant as an adequate means of ensuring compliance with federal and state laws. However, information obtained from the

consultant does not ensure that the internal control structure used by the third-party administrator is designed correctly or that it is effective when put into operation.

As the primary administrator of the flexible benefits plan for the State of Texas, the System has the responsibility to ensure that the internal control structure over claims processing is designed correctly and functions effectively. The control structure should be designed to detect and prevent errors or irregularities from entering the System's accounting system. The control structure should also ensure that claims are processed in accordance with applicable federal and state laws. The primary federal law which establishes the criteria for a flexible benefits plan is the Internal Revenue Code, §125, as amended. The state law that authorized the establishment of a flexible benefits plan is designated in Vernon's Texas Insurance Code as Article 3.50-2, as amended.

Recommendation:

We recommend that the System obtain assurances from its third-party plan administrator that the internal control structure over processing flexible benefit claims is designed correctly and functions effectively. The System could achieve this by requesting a SAS No. 70 report (*Reports on the Processing of Transactions by Service Organizations*) from the third party administrator.

Management's Response:

The Flexible Benefits Division has informed Erisa Administrative Service, Incorporated (Erisa), claim administrator for the TexFlex Program, of the need to complete AICPA SAS #70.

Erisa has obtained AICPA SAS #70 and their Controller is currently reviewing the rules to insure that they are in compliance with those

Issues and Recommendations

standards. If SAS #70 requires an independent audit, Erisa will obtain quotes. Should an independent audit be required, the ERS would need to study the feasibility of renegotiating the current claims contract. If that is not possible, the audit would need to be included in the next request for proposal for claims administration services.

In addition, since the TexFlex program is self funded, any cost increase will require the ERS to also study the feasibility of increasing the monthly administrative fee and the impact that decision may have upon participation in the program.

Appendix

Appendix 1:

Objectives, Scope, And Methodology

Objectives

One of our objectives was to evaluate the effectiveness of existing financial/ management control systems for the Flexible Benefits and Deferred Compensation Plans administered by the Employees Retirement System and to identify strengths and opportunities for improvement. We also evaluated the effectiveness of controls which ensure compliance with significant federal and state laws for these Plans.

Another objective was to evaluate the efficiency and economy of foreign currency purchases/sales that evolve during international security transactions. We also evaluated the risks involved with custody of international securities in foreign countries and the effectiveness of controls to decrease those risks.

Scope

We reviewed specific custody matters and foreign currency exchange transactions in the international investments portfolio managed by the Investments Division. Our review also covered internal control structures in the Flexible Benefits and Deferred Compensation Plans administered by the System. We concentrated on the most significant control policies and procedures.

Methodology

We gained an understanding of the international investment custody and foreign exchange matters and internal control

structures in the Plans. This was done by interviewing management and staff, reviewing documentation such as Plan administration manuals, investment policy, custodian contracts, and internal audit reports.

We performed tests of significant controls in the Plans and analyzed a random sample of foreign currency transactions.

The audit was conducted in accordance with generally accepted government auditing standards and generally accepted auditing standards.

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

- Terry Harris, CPA (Project Manager)
- DeAnn Kiser, CPA
- Ron Oaks
- Barbara Hankins, CPA (Audit Manager)
- Deborah L. Kerr, Ph.D. (Audit Director)

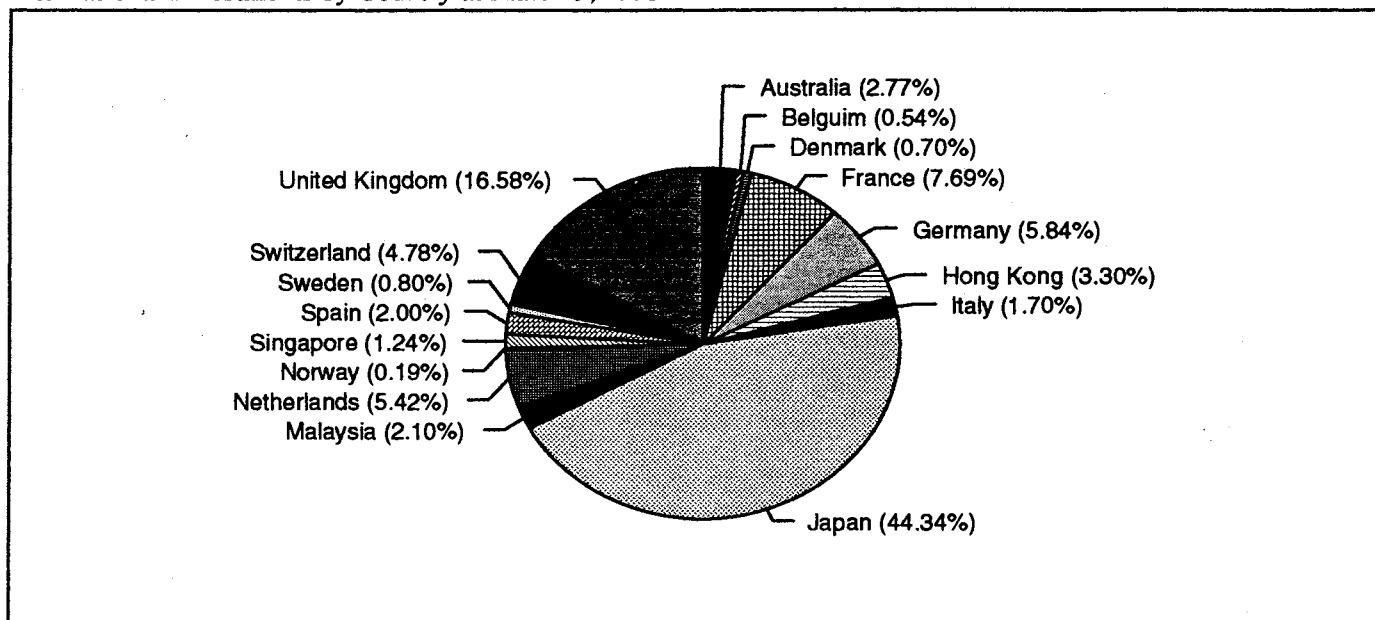
Appendix

Appendix 2:

Background Information - International Investments

Figure 1

International Investments by Country at March 9, 1995



Source: Investment Accounting Division at the Employees Retirement System

In February, 1994, the System began acquiring foreign currency-denominated international equities (commonly called global "ordinaries" at the System). The total market value of international equities owned by the System at March 9, 1995, was approximately \$965 million. Prior to acquiring these "ordinary" equities, the System purchased American Depository Receipts (ADRs) which represent U.S. dollar-denominated equities in foreign corporations. The ADRs were traded and held in the United States.

Unlike ADRs, which are held in the U.S., international "ordinaries" are held in the country of origin. The System's custodian bank, NationsBank, has a sub-custody agreement with Chase Manhattan Bank to hold the securities. If the securities are not

held in book entry form in the foreign countries, Chase Manhattan holds the physical securities in their international branches or in other banks with whom they contract.

As Figure 1 indicates, at March 9, 1995, the System had investments in Australia and the major European and Asian countries. The System had investments in 16 different foreign countries at that time. All assets held in these countries, other than Belgium (which are in book entry form), are held physically in vaults in banks affiliated with the sub-custodian.

The countries in which the System invests are all considered developed markets, according to information obtained from the financial

Appendix

community. There are no investments in so-called "emerging markets." The credit ratings of these countries, according to Standard and Poors, are all "A" or better. Eighty-five percent of the total international investments are in seven countries with a credit rating of AAA.

Copies of this report have been distributed to the following:

Legislative Audit Committee

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Honorable Bob Bullock, Lieutenant Governor, Vice Chair
Senator John Montford, Chair, Senate Finance Committee
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee
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