State Auditor's Office
John Keel, CPA
State Auditor

A Report on

The Audit of the Office of the Fire Fighters' Pension Commissioner's Fiscal Year 2013 Financial Statements

December 30, 2013

Members of the Legislative Audit Committee:

In our audit report dated December 20, 2013, we concluded that the Office of the Fire Fighters' Pension Commissioner's (Office) basic financial statements for fiscal year 2013 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America. The Texas Emergency Services Retirement System (System) published our audit report on the Office as part of its basic financial statements, which it intends to post on its Web site at http://www.tesrs.texas.gov/.

Subsequent Event

As a result of legislation passed by the 83rd Legislature, the Office was abolished on August 31, 2013, and the administration of the Office's pension funds was transferred to a new entity, the Texas Emergency Services Retirement System (System).

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 significant deficiencies in the Office's control environment. Auditors determined that the System should improve the control environment over financial reporting and develop and implement controls related to its information systems.

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 Office'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 System 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. 14-015

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

Sincerely,

John Keel, CPA
State Auditor

cc: Members of the Texas Emergency Services Retirement System Board of Trustees
Mr. Frank Torres, Chairman
Ms. Gracie G. Flores, Vice Chairman
Mr. Max Patterson, Secretary
Mr. Dan Key
Mr. Ron Larson
Ms. Jenny Moore
Mr. Dennis R. Rice
Mr. Don Shipman
Mr. Stephen Williams
Ms. Michelle Jordan, Executive Director, Texas Emergency Services Retirement System

Attachment

State Auditor's Office
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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*

Independent Auditor's Report

Texas Emergency Services Retirement System Board of Trustees
Mr. Frank Torres, Chairman
Ms. Gracie G. Flores, Vice Chairman
Mr. Max Patterson, Secretary
Mr. Dan Key
Mr. Ron Larson
Ms. Jenny Moore
Mr. Dennis R. Rice
Mr. Don Shipman
Mr. Stephen Williams

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, each major fund, and the aggregate remaining fund information of the Office of the Fire Fighters' Pension Commissioner (Office) as of and for the year ended August 31, 2013, and the related notes to the financial statements, which collectively comprise the Office's basic financial statements and have issued our report thereon dated December 20, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Office'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 Office's internal control. Accordingly, we do not express an opinion on the effectiveness of the Office'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.

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SAO Report No. 14-315

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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses 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 significant deficiencies.

Summary of Findings and Responses
Finding Numbers
2013-1
2013-2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Office'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*.

Office's Response to Findings

The Office's response to the findings identified in our audit is described in the accompanying schedule of findings and responses. The Office'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.

John Keel, CPA
State Auditor

December 20, 2013

Schedule of Findings and Responses

Section 1

The System Should Ensure That It Has an Effective Control Environment Over Financial Reporting

Reference No. 2013-1

Type of finding: Significant Deficiency

During fiscal year 2013, the Office of the Fire Fighters' Pension Commissioner (Office) did not have effective controls over its operations, including controls over financial reporting. It should be noted that, as a result of legislation passed by the 83rd Legislature, the Office was abolished on August 31, 2013, and the administration of the Office's pension funds was transferred to a new entity, the Texas Emergency Services Retirement System (System). In addition, the commissioner position was replaced with an executive director position. The most recent commissioner separated from the Office effective May 27, 2013. While an interim executive director was appointed, the position was held by more than one individual for the remainder of the year.

Effective management of any organization requires a set of specific controls to provide the necessary framework through which each employee can carry out his or her assigned responsibilities. Many of the controls the Office used were informal and undocumented. In addition, auditors identified several weaknesses in the Office's control environment. Those weaknesses related to information technology systems, which supported all functions of the organization, and to the general operations of the Office. Those weaknesses in their totality limited the Office's ability to meet its goals and objectives and produce accurate and complete financial reporting.

Specifically:

- **Delegation of authority.** As a result of the structural changes discussed above, the Office experienced a high degree of turnover in the management of its organization during fiscal year 2013. That resulted in a control environment in which the Office's day-to-day operations, including financial reporting decisions, and the selection and application of accounting policies were under the direction, oversight, and approval of the pension director, rather than the commissioner, or interim executive director. As a result, the effectiveness of the overall control environment, particularly with respect to management's direct control over the exercise of authority delegated to others and its ability to effectively supervise and monitor the Office's activities, was compromised.

- **Management override of controls.** The potential for management to override controls depends to a great extent on an organization's control environment and, in particular, management's attitudes about the importance of internal control. Auditors noted numerous instances in which the Office's management exercised poor judgment and attempted, or completed, an inappropriate management override of controls. Specifically:

  - Management exercised an attitude of "use it or lose it" with regard to unspent budgetary funds at fiscal-year-end and attempted to override controls in order to use those funds. For example:

    - Management placed two orders for new executive and staff office furniture on August 31, 2012, to use the Office's remaining budget funds, rather than allow those unspent budget funds to lapse. The executive furniture was received, invoiced, and paid for in fiscal year 2013. However, due to size restraints, the Office placed that furniture into storage upon receipt.

    - Due to technical difficulties, the original order for staff furniture, was misplaced and in October 2012, the commissioner requested that staff furniture be reordered using the original fiscal year 2012 purchase order so that prior-year funds could be used. As of August 31, 2013, however, the purchase of additional staff furniture had not been completed.

    - The Office surplussed most of its existing furniture in September 2012 in anticipation of receiving the new furniture discussed above. Because the new furniture was never received or was too large to be used, the Office continues to use folding tables as temporary work stations to replace the surplussed items.

  - Office management tried to override controls in order to grant a recent retiree additional leave hours that included an unsupported recalculation of sick leave. To accomplish that, the Office made two attempts to enter the additional hours in the Uniform Statewide Payroll/Personnel System (USPS). It should be noted that application controls in USPS prevented that from occurring.

- **Inventory management.** As of August 31, 2013, none of the Office's inventory, including its controlled assets, had been tagged or otherwise inventoried. That included the new furniture received in September 2012 (discussed above), which was still in its original shipping crates and in storage.

- **Supporting documentation.** The Office did not consistently obtain sufficient supporting documentation to monitor its pension payments.

- **Reconciliations.** The Office employed a contract accountant who performed all entry, invoice, payment processing, and record-keeping duties, including reconciling the Office's investments and financial systems. While Office management reviewed and approved the reconciliations between the Office's accounting system, investment custodian, and the Uniform Statewide Accounting System, it did not consistently perform those reconciliations in a timely manner. In addition, management did not have access to the Office's internal accounting system. As a result, management relied on reports the contract accountant provided to perform those reviews. Without access to the appropriate financial reporting systems, management cannot verify the accuracy and completeness of the reconciliations.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a framework to help management implement better internal controls (see text box for additional details). The System could use the COSO framework to help it evaluate and, if needed, strengthen its overall control environment over operations, reporting, and compliance related to pension funds.

Auditors communicated additional details about the findings related to the Office's controls over its financial reporting and pension processes in fiscal year 2013 separately in writing to System management.

Five Components of an Internal Control Integrated Framework

- **Control Environment:** Sets the tone of an organization, influencing the control consciousness of its people.
- **Risk Assessment:** An organization's identification and analysis of risks relevant to achievement of its objectives, forming a basis for determining how risks should be managed.
- **Control Activities:** Established by policies and procedures and should be performed at all levels and at various stages of business processes to ensure that management directives are carried out.
- **Information and Communication:** The identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- **Monitoring:** A process that assesses the quality of internal control performance over time.

Source: Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Recommendations

The System should:

- Ensure that controls over financial reporting provide the necessary framework through which each employee can carry out his or her assigned responsibilities and that those controls are documented.

- Perform a complete inventory of all System assets and ensure that all assets are appropriately tagged and recorded.

- Ensure that management has read-only access to all financial reporting systems so that management can view source documentation when reviewing reconciliations.

Management's Response

We are in agreement with the finding. Nearly all of the deficiencies in controls that led to the identified issues have been cured and the few that haven't will be accomplished by January 31, 2014. While we are in agreement with the findings and took steps to immediately implement an effective control environment, it should be noted that the Trustees of the Texas Emergency Services Retirement System were not aware of the deficiencies that existed within the office of the Firefighter's Pension Commissioner. The structure of the previous agency was such that the Commissioner was responsible for controls over the expenditure of General Revenue funds. Therefore, the weaknesses brought to light in the control environment were not previously known to the Board of Trustees.

The Trustees of the Texas Emergency Services Retirement System are committed to a control environment that safeguards the integrity of financial reporting and operations, as is the newly hired Executive Director. The identified weaknesses were apparent to new management upon arrival, who immediately began steps to establish procedures and controls. Specifically:

A. ***Delegation of Authority – due to high turnover during fiscal year 2013, management's control over the exercise of authority delegated to others and its ability to monitor the agency's activities was compromised.*** *The Executive Director has taken steps to reduce turnover.*

   A reorganization of the agency was accomplished in early September of 2013, with staff moved into positions better suited to their capabilities. In addition, individual tasks and responsibilities were rearranged and assigned to the positions where they make good operational sense. The Executive Director is a hands-on manager and so there is no delegation of authority for overall agency operations. ***Implemented September 6, 2013.***

B. ***Management override of Controls – numerous instances were noted in which agency management exercised poor judgment and attempted, or completed, and inappropriate management override of controls.*** *Managers responsible for the agency during fiscal year 2013 are not employed by the new agency. The new Executive Director is knowledgeable of state policies, procedures, and necessary controls; and further, responsible for approval of all financial-related transactions, in addition to being responsible for overrides in any system. Each employee's role in entering or approving changes within the operational framework will be documented as part of job descriptions. Scenarios similar to what occurred will not be an issue because the control environment will prevent it.* ***Implemented September 9, 2013, except for changes to job descriptions, which will occur by January 31, 2014.***

a. ***Management attempted to override controls in order to use unspent funds at fiscal year-end.*** *State guidelines require that agencies not make a capital expenditure after 90 days prior to the end of a fiscal year and the agency will observe that rule without exception. If there are unobligated funds in the General Revenue fund at year-end, they will be lapsed to the state treasury as required.*

b. ***Management tried to override controls in order to grant a recent retiree additional leave hours.*** *State guidelines and best practices require documentation for leave adjustments and the agency will observe those requirements without exception. As an agency whose chief responsibility is to administer a pension plan, we consider adjustments to retiree accounts a serious matter. Because the Executive Director is required to sign off on every departure from state guidelines, policies, and system controls, an adjustment or override absent of documentation, will not occur in the future. The individual responsible for this attempt is no longer employed by the agency.*

C. ***Inventory management – as of August 31, 2013, none of the Office's inventory, including its controlled assets had been tagged or inventoried.*** *In October 2013, the agency ordered inventory tags and for the first time, completed an inventory of all furniture and equipment. These items were tagged with property tags and entered into the Comptroller's State Property Accounting (SPA) system, for both controlled and capitalized assets. State guidelines require that a complete inventory be conducted every year and reconciled to items in the SPA system, and the agency will comply with those guidelines.* ***Implemented October 31, 2013.***

D. ***Supporting documentation – the office did not consistently obtain sufficient supporting documentation to monitor its pension payments.*** *We have implemented procedures that include checklists and supervisory signoff, in order to ensure that documentation for pension-related payments is obtained prior to making payment.* ***Implemented November 1, 2013.***

E. ***Reconciliations – reconciliations by the Contract Accountant for the office accounting system, investment custodian, and the Comptroller's USAS system were not performed in a timely manner. In addition, management did not have access to the internal accounting system.*** *A policy has been implemented to require that reconciliations of the systems mentioned above be performed within 20 days after the close of a previous month, including adjusting entries as required. In addition, read-only access will be obtained for the Executive Director to MIP, the agency's internal accounting system.* ***To be implemented by March 20, 2014.***

Section 2

The System Should Develop and Implement Controls Over Its Information Systems

Reference No. 2013-2

Type of finding: Significant Deficiency

The System should develop and implement controls related to the development, implementation, and monitoring of its information systems, including its pension application (the Texas Emergency Services Retirement System Online Pension System, or TOPS) and financial systems, to ensure that logical access is adequate, that changes to the TOPS application and data are authorized and appropriate, and that it has adequate password policies to ensure accountability as required by Title 1, Texas Administrative Code, Section 202.25 (see text box). The System uses TOPS to record member data for participating volunteer emergency service personnel and to ensure that correct pension contributions are paid to administer the pension plan. TOPS also records and processes pension retiree/beneficiary information, including the calculation of pension benefit payments.

Texas Administrative Code Information Security Standards

Title 1, Texas Administrative Code, Section 202.25, requires agencies to implement information resources security safeguards. Those include:

- Managing access to information systems to ensure that the users are authorized.
- Protecting the confidentially of data and systems and ensuring that only authorized users have access to the data.
- Implementing password controls based on industry best practices to identify and track users.
- Maintaining appropriate audit trails to provide accountability for updates to information.
- Using a change management process that helps ensure the information owner approves system changes prior to implementation.
- Developing and documenting security policies, including those for account management, application security, and change management.

Auditors identified the same significant deficiency with controls over the TOPS application during the audit of the Office's fiscal year 2011 financial statements[1] and during the audit of the Office's fiscal year 2012 financial statements.[2] The Office has not implemented corrective actions to address that significant deficiency. It should be noted that, as of August 31, 2013, the System was developing a new version of its pension application to address the deficiencies identified in prior years.

Strong information technology controls are necessary to help ensure that amounts are accurately recorded in the financial statements and that funds are adequately safeguarded. The System reported that the Office received $4.67 million for Texas Emergency Services Retirement System (TESRS) contributions and paid approximately $3.47 million for TESRS benefits for the fiscal year ended August 31, 2013.

Auditors identified the following control deficiencies during the audit of the Office's fiscal year 2013 financial statements:

[1] See *A Report on the Audit of the Office of the Fire Fighters' Pension Commissioner's Fiscal Year 2011 Financial Statements*, State Auditor's Office Report No. 12-013, January 2012.

[2] See *A Report on the Audit of the Office of the Fire Fighters' Pension Commissioner's Fiscal Year 2012 Financial Statements*, State Auditor's Office Report No. 13-017, January 2013.

- **User access.** The Office lacked documented policies and procedures to help ensure that users had the appropriate level of access to TOPS and financial systems and that periodic reviews of access rights for staff were performed and documented. As a result, user access was not always restricted to current employees or employees of the Office, nor did the access provided align with the level required to perform current job duties or establish adequate segregation of duties. Auditors communicated details about findings related to access rights separately in writing to System management.
- **Change management.** The Office had a change management process in place during fiscal year 2013. However, that process was not adequate to ensure that changes to TOPS were appropriately authorized, tested, and approved by Office management. While changes were documented, the programmer maintained the log documenting those changes and did not provide that log to management to verify that appropriate changes were made. Additionally, the programmer had inappropriate access to move code into production. Separate individuals should create code and move that code into production for all changes to the pension system.
- **Monitoring.** TOPS did not have a reliable audit trail to help management identify any changes made to data or programming code.
- **Passwords.** The Office had weak password controls over confidential data in TOPS and financial systems. Auditors communicated details about findings related to passwords separately in writing to management.

Recommendations

The System should:

- Periodically review user access to all of its information systems to ensure that it appropriately restricts access to current employees based on each user's job responsibilities and establishes adequate segregation of duties.
- Establish a change management process that includes System-level review and monitoring to help ensure that program changes to TOPS are authorized and that contractors' access rights are appropriate. That could include the development of mitigating controls to monitor program changes.
- Develop a reliable audit trail in its new pension application that identifies all changes made to data and programming code.
- Strengthen and implement password policies to all of its information systems to increase protection of data.

Management's Response

We are in agreement with the finding. Strengthening controls for access, change management, monitoring, and passwords in our information systems, including in-house processes, financial systems, and the online pension system, is a high priority. Most of the points below require development of policies/procedures and system changes, which we will have accomplished on or before August 31, 2014. Specifically:

A. ***User Access – the office lacked documented policies and procedures to ensure appropriate access for users to the pension and financial systems.*** *Information Resources Policies and procedures for the agency are in the midst of development and will include controls for obtaining access, as well as assignment of a periodic user review task. Meanwhile, the Executive Director reviewed access to the servers, all of the financial systems, and TOPS, in November 2013 and access levels have all been updated.* ***Partial implementation – complete implementation with policies and procedures will be accomplished on or before August 31, 2014.***

B. ***Change Management – the office had an inadequate change management process. In addition, the programmer had inappropriate access to move code into production.*** *We will develop procedures to ensure with our contractor that when changes are made, management has an opportunity to review the change log to ensure changes were made correctly. In addition, we will require that our contractor have an additional person other than the programmer, move developed code into production. We will have security access levels changed to prohibit the programmer from being able to move changes into production.* ***These procedures will be implemented on or before August 31, 2014.***

C. ***Monitoring – the TOPS application did not have a reliable audit trail to help management identify changes made to data or programming code.*** *Our new system will include an audit trail for changes to both data and programming code as a feature of the program.* ***Implementation will be on or before August 31, 2014.***

D. ***Passwords – the office had weak password controls over confidential data in the TOPS application and financial systems.*** *Ensuring the safety of data in our systems is a high priority for the agency. In development of our new pension system, and for access to our servers and accounting systems, we will use guidelines by the Department of Information Resources to build mechanisms within our system to make sure that password controls are strong. In addition, we will develop password guidelines for staff.* ***Implementation will be on or before August 31, 2014.***