

Audit Report

State Retirement Agency

April 2009



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

April 13, 2009

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the State Retirement Agency for the period beginning December 1, 2005 and ending September 30, 2008. The Agency provides administrative support services and investment functions for the State Retirement and Pension System of Maryland, a cost-sharing multiple-employer public employee retirement system.

Our audit disclosed that the Agency's information security review processes and related security reporting were inadequate. We also noted that the Agency did not have a process in place to help ensure that the State paid the proper share of retirement costs for employees of local school systems, libraries, and community colleges.

The Agency's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us by Agency personnel during the course of this audit.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Background Information

Agency Responsibilities

The State Retirement Agency provides administrative support services and investment functions for the State Retirement and Pension System (System) of Maryland, a cost-sharing multiple-employer public employee retirement system consisting of a State pool and a Municipal pool. The State pool consists of State agencies, boards of education, community colleges, and libraries while the Municipal pool consists of participating governmental units that elected to join the System. The System was established by the State Personnel and Pensions Article of the Annotated Code of Maryland and comprises the following individual systems: Teachers' Retirement and Pension Systems, Employees' Retirement and Pension Systems, State Police Retirement System, Judges' Retirement System, Law Enforcement Officers' Pension System, and the Local Fire and Police System. Responsibility for the administration and operation of the System is vested in a 14-member Board of Trustees. According to the State's records, total Agency operating expenditures were approximately \$21.8 million during fiscal year 2008.

Financial Statement Audits

For fiscal years 2008, 2007, and 2006, the Agency engaged an independent accounting firm to perform the audit of the System's financial statements. The firm expressed an opinion that the System's financial statements presented fairly, in all material respects, the plan net assets of the System as of June 30, 2008, 2007, and 2006, and the changes in plan net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Select System Financial Information

According to its records, as of June 30, 2008, the System had approximately 112,000 retirees and beneficiaries, and approximately 199,000 active participants. The following table provides select System financial information.

Select System Financial Information					
Fiscal Year	Total Contributions	Net Investment Income (Loss)	Benefit Payments	Total Net Assets at June 30	Unfunded Actuarial Accrued Liability
2008	\$1.5 billion	(\$2.1 billion)	\$2.1 billion	\$36.6 billion	\$10.7 billion
2007	\$1.1 billion	\$5.9 billion	\$2.0 billion	\$39.4 billion	\$9.3 billion
2006	\$936 million	\$3.2 billion	\$1.8 billion	\$34.4 billion	\$7.4 billion

Source: Audited System Financial Statements

Note: The Unfunded Actuarial Accrued Liability (UAAL) is the amount by which the Actuarial Accrued Liability exceeds the Actuarial Value of Assets as determined by the System's actuary. Beginning July 1, 2006, the system changed its funding method from the Aggregate Entry Age Normal method to the Individual Entry Age Normal Method. Due to an actuarial error, the UAAL presented in the June 30, 2007 Comprehensive Annual Financial Report was overstated. The 2007 UAAL presented in this table reflects the corrected actuarial valuation results.

Actuary Contract Claim

The former consulting actuary for the System was under contract from July 1, 1982 until August 4, 2006. On October 27, 2004, the actuary disclosed that, for 22 years, beginning with its first actuarial valuation in 1982, it understated the liabilities associated with the survivor benefits for the State Police Retirement System, Judges' Retirement System, and Law Enforcement Officers' Pension System (LEOPS). As a result, the actuary miscalculated and understated the amount of annual employer contributions required to fund the State Police and Judges Systems from July 1, 1983 through June 30, 2005, and understated the amount of annual employer contributions required to fund the LEOPS from July 1, 1992 through June 30, 2005.

On February 9, 2006, the Agency made a claim against the former consulting actuary based on the actuary's failure to detect, correct, and disclose its calculation errors in its annual actuarial valuations for 22 years. Based on information supplied by the actuary, the Agency, after consultation with an

independent actuary, estimated that the affected retirement systems suffered a funding shortfall of \$73 million in lost contributions, and in lost earnings on those contributions, as a result of these errors. The Agency's claim seeks to recover contributions of \$34.2 million and investment income of \$38.8 million to restore the affected systems to their proper positions had this error not occurred. The Agency advised us that the actuary has filed an appeal with the Maryland Board of Contract Appeals and, as of February 11, 2009, a final decision had not been made by the Board.

Actuary Contract Termination

The Agency contracted with a new actuary, effective March 27, 2006, to provide actuarial services to the Systems. However, on May 16, 2008, the Agency and the actuarial firm negotiated a mutual termination of this contract, effective May 30, 2008, based on numerous errors made by the firm over the preceding two years. For example, the actuary disclosed that it had made an error when calculating the fiscal year 2009 employer contributions due from the State for the various systems. The error resulted in a contribution shortfall of approximately \$88 million. We were advised by Agency management that the State is in the process of determining the manner in which this contribution shortfall will be addressed in future budgets. On December 17, 2008, an agreement was reached with the actuary that effectively settled all claims and disputes between the two parties. The agreement also specifies that neither of the parties shall have any further obligation to the other.

Status of Finding From Preceding Audit Report

Our audit included a review to determine the status of the one finding contained in our preceding audit report dated April 27, 2006. We determined that the Agency adequately addressed this finding.

Findings and Recommendations

Information Systems Security and Control

Background

The State Retirement Agency's information system included an internal computer network with Internet connectivity. The Agency's information system also supported retirement and pension contributions and benefits processing by use of applications executed on the Comptroller of the Treasury's Annapolis Data Center. The system is secured using the Center's security software product to control access to data and program files and individual online transactions.

Finding 1

Security review processes and related security reporting were inadequate.

Analysis

Security review processes and related security reporting were inadequate. Specifically, we noted the following conditions:

- Although the Agency advised that security officers reviewed critical mainframe security reports and investigated entries on these reports, there was no documentation supporting these reviews and investigations. As a result, there was a lack of assurance as to the sufficiency and timeliness of these reviews and investigations.
- The security officers, who established security access rules and modified user accounts, also reviewed the related security reports and had direct modification access to the underlying production programs. As a result, the security officers could make unauthorized changes to access rules, user accounts, and production programs and conceal any unauthorized activity (for example, rule modifications).

Recommendation 1

We recommend

- a. that reviews and investigations of critical mainframe security reports be documented and that this documentation be retained for verification purposes, and**
- b. that adequate separation of duties be established such that the individuals responsible for reviewing these security reports not have the ability to make changes to the related access rules, user accounts, and production programs.**

Local Retirement and Pension Contributions

Finding 2 (Policy Issue)

Procedures were not in place to help ensure that the State paid the proper share of retirement costs for participating local jurisdiction employees.

Analysis

The Agency did not have a process to ensure that the State paid the proper share of retirement costs for employees of certain local school system, library, and community colleges who were members of the System.

The State provides financial assistance to various local jurisdictions through the Maryland State Department of Education (MSDE) and the Maryland Higher Education Commission (MHEC). This assistance is used to fund part of the employers' portion of the retirement contribution for their employees who are members of the System. In this regard, because the local jurisdictions also receive federal financial assistance for some of these benefits, the local jurisdictions are required to reimburse MSDE and MHEC for the portions of these costs paid on behalf of employees that were covered by federal funds (that is, for which they received duplicate payments).

Various sections of the Education Article of the Annotated Code of Maryland state that the Agency may examine the records of the local jurisdictions to determine whether the State's payment for retirement contributions are in accordance with the law and to recover any duplicate payments. Furthermore, in an opinion dated June 26, 2008, the Attorney General concluded that the Agency retains the authority to audit the aforementioned records and seek repayments for any duplicate payments made by the state, specifically mentioning those duplicate payments resulting from federal funding.

Additionally, although the Agency contracts with independent CPA firm to perform a compliance review of the eligibility of the participants in the State retirement and pension system, the review does not include any procedures to ensure the propriety of the aforementioned remittances for duplicate payments. Agency management advised us that, according to MSDE and MHEC records, during fiscal year 2008, the local jurisdictions remitted \$30.4 million related to these duplicate payments.

We were advised by management at MSDE and MHEC that, although the original retirement funding for the applicable entities' employees is included in their annual State appropriations, they do not have any processes in place to verify the recovery of duplicate payments given the Agency's aforementioned audit authority in State law. Consequently, in part based on consideration of the

aforementioned Attorney General's opinion, the Agency issued a new contract for the compliance reviews performed by an independent certified public accounting firm. While not included as a specific task within the contract scope, Agency management advised us that the contractor would be required, as an additional audit procedure, to include a review of duplicate payments within the scope of its reviews. This contract was approved by the Board of Public Works on January 7, 2009.

Recommendation 2

We recommend that the Agency, in consultation with MSDE and MHEC, establish procedures to ensure that the full amounts are remitted by the local jurisdictions for duplicate payments.

Audit Scope, Objectives, and Methodology

We have audited the State Retirement Agency for the period beginning December 1, 2005 and ending September 30, 2008. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the Agency's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the finding contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the Agency's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

The Agency's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

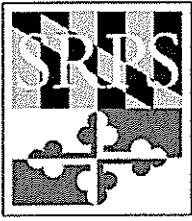
Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes a finding relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the Agency's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our audit did not disclose any significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to the Agency that did not warrant inclusion in this report.

The Agency's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the Agency regarding the results of our review of its response.

APPENDIX



STATE RETIREMENT
and PENSION SYSTEM
of MARYLAND

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R. Dean Kenderdine
Executive Director
Secretary To The Board

April 6, 2009

Mr. Bruce A. Myers, CPA
Legislative Auditor
State of Maryland
Office of Legislative Audits
State Office Building, Room 1202
310 West Preston Street
Baltimore, Maryland 21202

Dear Mr. Myers:

We are providing this letter in response to your letter dated March 20, 2009 addressed to the Honorable Nancy K. Kopp, Chair Board of Trustees of the State Retirement and Pension System of Maryland in connection with your fiscal/compliance audit of the Maryland State Retirement Agency for the period beginning December 1, 2005 and ending September 30, 2008. Enclosed with your letter was a draft copy of your Audit Report identifying two audit findings and the Office of Legislative Audits recommendations along with your request for the Agency's response to the audit findings and recommendations.

Referring to page 7 of your draft "Findings and Recommendations", the two findings and OLA recommendations along with the Agency's responses are as follows:

Finding 1
Security review processes and related security reporting were inadequate.

Recommendation 1
We recommend:

- a. **that reviews and investigations of critical mainframe security reports be documented and that this documentation be retained for verification purposes, and**

Agency Response - MSRA agrees and has modified its security report review process. The present daily and monthly review process is now supported by adequate documentation. This documentation confirms the review of mainframe security reports by agency security officers is both timely and thorough. All documentation will be retained for verification purposes.

- b. that adequate separation of duties be established such that the individuals responsible for reviewing these security reports not have the ability to make changes to the related access rules, user accounts, and production programs.**

Agency Response - MSRA is in agreement and has taken measures to eliminate all separation of duties lapses related to its security review process. Reviewers no longer have unrestricted access to sensitive mainframe data or programs.

Finding 2 (Policy Issue)

Procedures were not in place to help ensure that the State paid the proper share of retirement costs for participating local jurisdiction employees.

Recommendation 2:

We recommend that the Agency, in consultation with MSDE and MHEC, establish procedures to ensure that the full amounts are remitted by the local jurisdictions for duplicate payments.

Agency Response - *The Agency does have procedures in place to ensure that State paid the proper share of retirement costs for all local education employees who are members of the Teachers' Systems and whose compensation is paid from federal aid. However, the Agency believes the State's interests would be best served by transferring this responsibility to other State agencies that are better positioned to oversee this process.*¹

In 1990, responsibility to examine the records of local education agencies (boards of education, community colleges and public libraries) to determine whether the State's payments for social security and retirement contributions for employees of the Teachers' Systems are in accordance with the provisions of Division II of the State Personnel and Pensions Article (SPP) of the Annotated Code of Maryland was transferred to the State Retirement Agency ("Agency"). Chapter 217, Laws of Maryland 1990, *codified at* ED §§5-203, 16-306, and 23-504. Since assuming responsibility for the audits, the Agency has contracted with independent public accounting firms to conduct periodic audits of the 65 local education agencies.

¹**Auditor's Comment:** In the last paragraph of its response, the Agency agrees with our recommendation and states that it is endeavoring to work with MSDE to ensure the full amounts are remitted by the local jurisdictions. While the remainder of the Agency's response is germane to the issue in general, it does not specifically address the audit recommendation.

Subsequent to the transfer of the audit responsibility to the Agency, however, the State's financial assistance to local education agencies changed. Specifically,

- Effective July 1, 1992, the formula for computing State financial assistance to community colleges was changed to specifically exclude payments for the employer's share of retirement contributions. Chapter 465, Laws of Maryland 1991, *codified at* ED §16-305(c)(9); and
- Effective July 1, 1993, the State discontinued providing financial assistance for social security taxes to the local boards of education, community colleges and public libraries. Chapter 1, §1, 2nd Spec. Sess., Laws of Maryland 1992, *amending* Former ED §§5-202(d), 16-403(b)(9), and 23-403(c) & (d); and

These changes significantly impacted the scope of the audits and related assessments as follows:

<u>Audit Period</u>	<u>Assessment</u>	<u>Audit Fee</u>	<u>Net Recovery</u>
1991-1994	\$1,934,464	\$252,000	\$1,682,464
1995-1997	294,732	143,835	150,897
1998-2000	83,077	139,440	(56,363)
Total	\$2,312,273	\$535,275	\$1,776,998

The audit assessments for the initial audit period (1991 -1994) were higher because the recoveries included duplicate payments to the community colleges for retirement contributions as well as recoveries of social security taxes (FICA) for certain ineligible positions. However, beginning with Fiscal Year 1992, the funding formula for State aid to the community colleges was changed to specifically exclude retirement contributions and in Fiscal Year 1994, the State discontinued financial assistance for social security taxes to the local education agencies. As these changes became fully implemented, audit assessments declined significantly to the point of being less than the amount needed to cover the cost of the audits themselves.

More recent changes will also impact the scope of the audits and will act to either eliminate or further reduce future audit assessments:

- Effective June 1, 2002, members of the Teachers' Systems who are employed by local boards of education and whose salaries are funded by State or local aid, whether general or categorical in nature, are eligible for the State's payment of retirement contributions. Chapter 288, Laws of Maryland 2002, *codified at* ED §5-203(b)(2).

In this regard, of the total audit assessments for the 1998-2000 audit period, \$18,877 was due to ineligible State aid; however, as a result of the above change, all State and local general and categorical aid is now considered an eligible funding source.

- The audit assessments also included \$49,764 for ineligible employees enrolled in the Systems. In response to the audit findings, the Agency implemented new procedures to more effectively pre-determine eligibility for enrollment in the Teachers' Systems. In addition, the Agency began conducting periodic audits of local government employers to verify enrollment eligibility.

In view of these changes and to clarify its audit responsibilities, the Agency requested an opinion from the Maryland Attorney General, who concluded that, "...the Agency is precluded from recovering retirement contributions based on the receipt by local boards of education of State or local categorical aid allocated for staffing by members of the Teachers' Systems. In addition, because the State's financial assistance programs for community colleges and libraries do not allocate funding for retirement contributions, the Agency has little basis on which to make a finding of duplicative payments of retirement contributions of those entities." 93 Opinions of the Attorney General 81 (2008). Therefore, audits of State and local general or categorical aid with respect to the State's retirement contributions are no longer required.

The opinion further stated, however, that, "... to the extent these positions [participants in the Teachers' Systems] are funded by federal aid, the boards of education must continue to reimburse the State for retirement costs that may be chargeable to these grants." Accordingly, the local education agencies continue to reimburse the State for retirement contributions for employees who are members of the Teachers' Systems and whose compensation is paid from federal aid. For example, during Fiscal Year 2008, the local education agencies reimbursed the State's General Fund \$30,414,535. It should be noted that the most recent audits of all 65 local education agencies did not disclose any instances in which the local education agencies were not properly reimbursing the State.

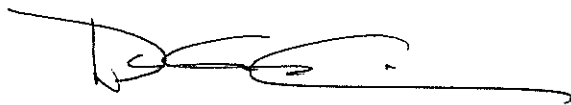
The Agency recognizes the importance of conducting audits to ensure that the local education agencies continue to reimburse the State for retirement contributions for employees who are members of the Teachers' Systems and whose compensation is paid from federal aid. The Agency also recognizes the cost/benefit of relying on audits conducted by other independent auditors to provide this assurance whenever feasible and practical. Specifically, local education agencies are required to have an annual independent audit of their financial statements as part of their Comprehensive Annual Financial Report (CAFR). In addition, the local education agencies are also required to have an annual audit ("Single Audit") of their federal financial assistance programs.

The purpose of the Single Audit is to verify, with reasonable assurance, that federal aid was properly expended in compliance with federal regulations, including federal cost principles (Cir. A-21). This circular defines allowable costs to include fringe benefits, including retirement contributions, which may be charged to federal aid programs either through a fringe benefit factor or direct charge. It is clear that, in order to be an eligible charge, retirement costs, as with any charge to federal aid, must be supported by an actual expense. Since the State paid the retirement contributions on behalf of the local education agencies for employees who are members of the Teachers' Systems, the audits should verify that federal aid was properly used to pay or reimburse the corresponding expense. Thus, these audits should verify that the local education agencies reimbursed the State for the retirement expense it paid on behalf of the local education agencies for employees who are members of the Teachers' Systems and whose compensation is paid from federal aid.

The Agency is aware that the above audits are reviewed by the Maryland State Department of Education (MSDE). This review could include a determination that the auditors verified that local education agencies properly reimbursed the State for retirement contributions it paid on behalf of employees who are members of the Teachers' Systems and whose compensation is paid from federal aid. Accordingly, the Agency is endeavoring to work in cooperation with the MSDE to ensure that the auditors include this audit verification in the scope of their annual financial statement audits and/or their audits of federal financial aid programs. The Agency continues to believe that this is the most cost effective approach to ensure that the local education agencies continue to reimburse the State for retirement contributions it paid on behalf of employees who are members of the Teachers' Systems and whose compensation is paid from federal aid.

If you should have any questions regarding our response, please feel free to contact me.

Sincerely,



R. Dean Kenderdine
Executive Director

cc: Nancy K. Kopp, Chair of the Board of Trustees
Melody Countess, Chief Operating Officer
Ira Greenstein, Chief Information Systems Officer
Brian Rowe, Chief Internal Auditor

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