



AUDIT COMMITTEE MEETING  
DECEMBER 4, 2014



PRESENTED FOR REVIEW AND APPROVAL  
FEBRUARY 24, 2015

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS**

**December 4, 2014  
ERS Board Room  
ERS Building – 200 E. 18<sup>th</sup> Street  
Austin, Texas 78701**

**TRUSTEES PRESENT**

Brian Ragland, Chair  
Doug Danzeiser, Member  
Cydney Donnell, Member  
Yolanda Griego, Member  
I. Craig Hester, Member

Frederick E. Rowe, Jr., Vice-Chair (*Remotely via video conference*)

**ERS STAFF PRESENT**

Ann S. Bishop, Executive Director  
Larry Zeplin, Chief Operating Officer  
Paula A. Jones, General Counsel and Chief Compliance Officer  
Tony Chavez, Internal Auditor  
Robert Kukla, Director of Benefit Contracts  
Shack Nail, Deputy Director of Governmental Affairs  
Ralph Salinas, Director of Human Resources  
Marci Sundbeck, Manager of Enterprise Risk Management  
Catherine Terrell, Director of Governmental Affairs  
Tom Tull, Chief Investment Officer  
Mike Wheeler, Chief Financial Officer  
Nora Alvarado, Benefit Contracts  
Lori Blewett, Benefit Communications  
Kyla Cloutier, Benefit Contracts  
Kelley Davenport, Executive Office  
D'Ann Deleon, Benefit Contracts  
Blaise Duran, Benefit Contracts  
Leah Erard, Governmental Affairs  
Beth Gilbert, Internal Audit  
Bernie Hajovsky, Office Management Support  
Sharmila Kassam, Investments  
Debbie Leatham, Finance  
Patricia Maugham, Executive Office  
Lauren Russell, Benefit Contracts  
MaryJane Wardlow, Governmental Affairs  
Keith Yawn, Governmental Affairs  
Gilbert Mokry, Internal Audit  
Jonathan Puckett, Internal Audit

**ALSO PRESENT**

Kristin Alexander, State Auditor's Office  
Amy Cohen, Gabriel Roeder Smith  
Alyssa G. Martin, Weaver & Tidwell, LLC  
Virgil Meier, Gabriel Roeder Smith  
Reema Parappilly, Weaver & Tidwell, LLC  
Cesar Saldivar, State Auditor's Office

Mr. Brian Ragland, Chairman of the Board of Trustees of the Employees Retirement System of Texas (ERS), called the meeting to order and read the following statement:

“A public notice of the Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 10:48 a.m. on Wednesday, November 25, 2014 as required by Chapter 551, Texas Government Code, referred to as “The Open Meetings Law.”

The Board of Trustees convened as a committee of the whole at 2:21 p.m. to consider Audit Committee agenda items.

### **III. REVIEW AND APPROVAL OF THE MINUTES TO THE AUGUST 19, 2014 ERS AUDIT COMMITTEE MEETING**

Audit Committee Chair, Craig Hester opened the floor for a motion on the approval of the minutes to the Audit Committee Meeting held on August 19, 2014.

**MOTION** made by Mr. Brian Ragland, seconded by Ms. Cydney Donnell and carried unanimously by the present members of the Board of Trustees of the Employees Retirement System of Texas to approve the minutes held on August 19, 2014.

### **IV. PRESENTATION, DISCUSSION AND CONSIDERATION OF AUDIT COMMITTEE AGENDA ITEMS:**

**a. External Audit Reports** – Mr. Craig Hester, Chair of the Audit Committee introduced Mr. Tony Chavez, ERS Director of Internal Audit. Mr. Chavez informed the Committee an audit of the HealthSelect Contract had been performed by the Texas State Auditor’s Office and a report issued in November 2014. Mr. Chavez introduced Mr. Cesar Saldivar, Audit Manager and Kristin Alexander, Project Manager from the State Auditor’s Office (SAO) to present their report over the HealthSelect contract at ERS.

Mr. Saldivar addressed the Committee informing them the report is divided into the four contract management processes mentioned in the Contract Management Guide which are planning, procurement, contract formation, and contract oversight. Ms. Alexander reported the objectives of this audit were to determine whether the system planned, procured, and established selected contracts for goods and services in accordance with applicable statutes, rules, Office of Comptroller Public Accounts requirements, and the state entity policies and procedures to help ensure the State’s interests were protected, and whether managed and monitored selected contracts for good and services to help ensure contractors performed according to the terms of the contract, and contractor billings were valid and supported in accordance with applicable statutes, rules, the Comptroller Office requirements, and state entity policies and procedures.

Ms. Alexander stated the overall conclusion was the System established processes for planning and procuring the contract and to form the HealthSelect contract it awarded to United Healthcare services in February 2012. However, those processes did not always ensure compliance with State and System criteria for contracts. Ms. Alexander stated ERS had weaknesses and inconsistencies in its processes for planning and procuring the HealthSelect contract, including not defining best value. As a result it is not possible to determine whether ERS selected the contractor that provided the best value to the State. She reported the System generally managed and monitored the HealthSelect contract to help ensure the contractor performed according to the terms of the contract; however, until July 2014, the System did not have a process to reconcile its daily reimbursement payments to detailed health care claims, and it should improve the timeliness of its monitoring activities.

Ms. Alexander reported the findings related to planning were that the System’s process for planning and procuring the HealthSelect contract did not involve the System’s Purchasing Department, and the System did not assign staff who met State training and certification requirements to the planning and procuring of the HealthSelect contract.

The System's process did not ensure the System prepared and maintained all required planning documentation or that the requests for proposals complied with statutory requirements and/or System policies. Ms. Alexander reported the finding related to procurements were that the System's process for evaluating the HealthSelect contract proposals did not include many of the required or suggested contract elements of the Texas Contract Management Guide, and did not always follow established system policies.

Ms. Alexander informed the Committee the evaluation process the System established did not result in a scoring tool with criteria that consistently related to the published RFP, and it did not ensure each proposal was evaluated by the same number of evaluators. The process also did not verify the mathematical accuracy of the evaluation documentation and didn't include a methodology for handling additional evaluation factors not anticipated during planning.

Ms. Alexander reported on the findings related to contract formation were the HealthSelect contract does not contain all essential contract clauses required by statute in the State of Texas Contract Management Guide. She informed the Committee that while the Office of the Attorney General reviewed the preliminary HealthSelect contract the System included in the RFP, the System did not request the Office review the final HealthSelect contract prior to signing the contract.

The findings related to contract oversight were that the System monitored payments to United Healthcare for administrative fees and established a process to determine whether health care management incentive payments are required. Ms. Alexander reported the System performed contract monitoring to ensure United Healthcare services is providing services in accordance with contract terms; however, the System should strengthen those processes to help ensure its monitoring is comprehensive and performed in a timely manner.

Brian Ragland, Board Chair, thought it would be helpful for context purposes to distinguish between a compliance audit [as performed by the SAO in this audit] with an audit evaluating risk, compensating controls and materiality.

Mr. Saldivar responded that what the SAO did was to look at the criteria and determine if it was followed. Mr. Ragland responded that he wanted everyone to understand that they take the findings very seriously and will work diligently to improve upon the process, but he didn't want anyone to misunderstand or misconstrue the audit in that the SAO didn't make an assertion as to whether or not the best vendor was selected.

Mr. Ragland further stated that based on the materials that were presented to the Board and the process that was followed in the procurement, the Board firmly believes that the best vendor was chosen for the contract. Moreover, it was noted that there was no doubt that the Board selected the vendor that was going to provide the best value to our members.

In response to the SAO's comment about not being able to determine best value, Mr. Hester stated that based on the data that as a Board we were given when we made this decision I don't think there was any doubt in our mind that we selected the vendor that was going to provide the best value to our members. Mr. Hester also reported that there was evidence of lowering administrative cost, as the claims cost trends were projected to decline, and there was definitely a benefit in terms of the incentive coverage for both bonuses and penalties if certain criteria were not made or achieved by the vendor. Mr. Hester continued by stating that the Board tries to make the decision with a minimal impact to our members and preserve benefits while at the same time trying to control the costs, and he said he believed we did that.

Mr. Hester noted that the board would follow through and make sure some of the issues addressed in the audit will be followed in the future.

Mr. Chavez continued with the next item of an actuarial audit of the System's Health Plan financial projections reported in the 2016-2017 Legislative Appropriations Request (LAR). Mr. Chavez noted this audit engagement is based on the Government Finance Officers Association's best practices that this engagement be performed at least once every five years. He also stated this engagement was a level three actuarial audit which states the actuarial auditors will review the methodology and assumptions used by the System's consultant actuary but they will not recalculate the projections themselves. Mr. Chavez introduced the actuarial auditor's Mr. Virgil Meier and Amy Cohen from Gabriel Roeder Smith (GRS).

Mr. Meier reported a level three audit was performed which included the review of the methodology and the assumptions that were put into the model to carry the projections out through the end of the biennium. GRS found the projection methodology and assumptions to be reasonable when calculating the financial projection through the 2016-2017 biennium. Mr. Meier reported GRS looked at the assumptions used in the model, which primarily are the claim cost trend for the medical side as well as the pharmaceutical side. GRS also looked at each of the pharmacy trends for the HealthSelect plan, the Humana plan, as well as the HMO plan. The pharmacy cost trends were about 14.5% assumption.

There were no questions or further discussion, and no action was required on this item.

**b. Internal Audit Reports** – Mr. Tony Chavez, ERS Director of Internal Audit presented the next agenda item, Internal Audit Reports. The first report was the Retirement Rules Management and System Implementation audit. This audit was a co-source engagement performed as part of the 2014 audit plan. Mr. Chavez introduced Ms. Reema Parappilly and Alyssa Martin from ERS' co-source audit firm Weaver & Tidwell, LLC.

Mr. Chavez reported the overall rating was satisfactory. The audit reviewed project implementation and change management of the Oracle Policy Automation (OPA) Project. The purpose of the OPA implementation was to make retirement rule changes in ERS PeopleSoft more efficient and more productive. Mr. Chavez reported that overall the project had a successful implementation. However, the expected project benefits should include greater measurable analysis to assist in evaluating value and cost effectiveness of IT projects. Ms. Parappilly reported in reviewing the process, Weaver identified the change management process had not been formalized to ensure a sustainable process.

The next engagement presented was the Incentive Compensation Plan (ICP). Mr. Chavez introduced Mr. Gilbert Mokry of Internal Audit, Mr. Tom Tull, ERS Chief Investment Officer, and Mr. Ralph Salinas, ERS HR Director.

Mr. Chavez stated the State Auditor's Office (SAO) has conducted a review of the ICP over the last 2 fiscal years and reported errors in ERS award calculations. The two scope areas for this engagement were 1) ICP participation and establishment, and 2) ICP award calculations. Mr. Chavez noted the overall assessment was a "Needs Improvement".

Mr. Chavez walked the Committee through the ICP participation first and stated the ICP can be awarded based on both quantitative and qualitative goals. The quantitative goals are straightforward calculations relative to a benchmark. Quantitative goals are objective and the plan provides specific guidelines related to those goal weights. Qualitative or discretionary goals are also awarded. Qualitative goals are determined by subtracting 100% minus any quantitative goals an ICP participant may have. Mr. Chavez noted the approved ICP guidelines for this process are not specific enough to support this method. As such, qualitative goal weights vary with certain participants with a high percentage of qualitative goals compared to quantitative goals.

Mr. Chavez also noted that for qualitative goals, the percent of performance goal earned was not aligned with Plan intent. The Plan specifically states that qualitative performance goals should be difficult to achieve and require outstanding performance. Overall, the realization earned for qualitative goals was 95%.

Mr. Mokry presented the observations for Award Calculations. For the calculations, there is an overall spreadsheet used by investments with supporting schedules. All of the information regarding supporting information and formulas was correct. However, there was one instance an incorrect date was used for an ICP participant resulting in an error of \$547. Mr. Mokry reported the reviews done by management over this calculation are by the Chief Investment Officer and HR director. Their review concentrated on salaries but there were other areas that needed review due to past errors.

Mr. Mokry reported there was an additional review this year by the third party auditor who performed agreed-upon procedures approved by Investments management. Overall the only error was this miscalculation of \$547 which was due to implementation of wrong dates.

The next item was the Quarterly Investment Compliance procedures and the overall assessment was satisfactory.

There were no questions or further discussion, and no action was required on this item.

**c. Internal Audit Administrative Items** – Mr. Chavez provided to the Committee a copy of the Internal Audit handbook which is to provide some assistance to the Committee in its governance and oversight functions.

The next item was Internal Audit's Performance Measures for FY2014. Mr. Chavez provided an overview of the four performance measures and how the measures were developed to improve Internal Audit's accountability and efficiency.

Internal Audit's Annual Audit Report was presented next. This report is a statutorily required report that is submitted to the board and also to the Governor's Office, the SAO, Administrative Budget Board and the Sunset Advisory Commission. It's an overview of what has been completed in fiscal year 2014 and provides the audit plan for fiscal year 2015.

The final item was a status update on Internal Audit's Peer Review recommendations. Internal Audit had fully implemented recommendations with the exception of one related to a separate audit committee charter. This recommendation was dependent on Committee acceptance. ERS Internal Audit developed a proposed audit committee charter for review and discussion. Ms. Donnell wanted to ensure the Director and Internal Audit staff have a way to communicate with the Audit Committee. Mr. Hester said that he meets privately with the Audit Director on a regular basis.

There being no further questions or discussion, the Board then took the following action:

**MOTION** made by Mr. Brian Ragland, seconded by Ms. Cydney Donnell and carried unanimously by the present members of the Board of Trustees of the Employees Retirement System of Texas accept the revised version of the Proposed Audit Committee Charter as discussed in this agenda item.

**V. ADJOURNMENT OF THE AUDIT COMMITTEE – FOLLOWING ADJOURNMENT OF THE AUDIT COMMITTEE, THE BOARD OF TRUSTEES WILL TAKE UP THE REMAINING AGENDA ITEMS.**