



Audit Committee Meeting

August 18, 2015



Presented for Review and Approval

December 4, 2015

Table of Contents

I.	Review and Approval of the Minutes to the May 19, 2015 Meeting of the Board of Trustees.....	2
II.	Presentation, Discussion and Consideration of Audit Committee Agenda Items:	
	a. External Audit Reports.....	2
	b. Internal Audit Reports.....	3
	c. Internal Audit Administrative Items.....	5
III.	ADJOURNMENT OF THE AUDIT COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES - Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.....	5

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

**August 18, 2015
ERS Board Room
ERS Building – 200 E. 18th Street
Austin, Texas 78701**

TRUSTEES PRESENT

Brian Ragland, Chair
Frederick E. Rowe, Jr., Vice-Chair
Doug Danzeiser, Member
Cydney Donnell, Member
Yolanda Griego, Member
I. Craig Hester, Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Shack Nail, Interim Deputy Executive Director
Paula A. Jones, General Counsel and Chief Compliance Officer
Tony Chavez, Director of Internal Audit
Robert Kukla, Director of Benefit Contracts
Tom Tull, Chief Investment Officer
Charles Turner, Chief Information Officer
Mike Wheeler, Chief Financial Officer
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Beth Gilbert, Internal Audit
Sharmila Kassam, Investments
Betty Martin, Investments
Patricia Maugham, Executive Office
Karen Norman, Internal Audit
Jonathan Puckett, Internal Audit
Tanna Ridgway, Investments
Chineque Sterns, Human Resources
MaryJane Wardlow, Governmental Affairs
Craig White, Investments

ALSO PRESENT

Verma Elliott, State Auditor's Office
Emmy McDaniel, Retiree
Reema Parappilly, Weaver
Anca Pinchas, State Auditor's Office
Angelica Ramirez, State Auditor's Office
Sonya Tao, State Auditor's Office
Brian Thomas, Weaver

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 9:38 a.m. on Thursday, August 6, 2015 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 8:00 a.m. to consider Audit Committee agenda items.

I. REVIEW AND APPROVAL OF THE MINUTES TO THE MAY 19, 2015 ERS AUDIT COMMITTEE MEETING

Audit Committee Chair, Craig Hester opened the floor for a motion on the approval of the minutes from the Audit Committee Meeting held on May 19, 2015.

MOTION made by Mr. Doug Danzeiser, seconded by Ms. Cydney Donnell, and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to approve the minutes held on May 19, 2015.

II. PRESENTATION, DISCUSSION AND CONSIDERATION OF AUDIT COMMITTEE AGENDA ITEMS:

a. External Audit Reports - Mr. Tony Chavez, Director of Internal Audit presented the agenda item on External Audit Reports and stated the first item for discussion is the Fiscal Year 2014 Pension Schedules. He reported the new schedule is prepared by the Finance division in response to GASB 68 requirements. State agencies issuing stand-alone financial statements must report their portion of the reported pension liability. Mr. Chavez then introduced Ms. Verma Elliott, State Auditor's Office Audit Manager and Ms. Anca Pinchas, State Auditor's Office Project Manager to present their results.

Ms. Elliott reported to the board that in addition to the regular opinion on the financial for the statements, the SAO will also be issuing opinions on the schedules every year going forward. She stated that GASB 68 requires the state put the liability on the face of the financial statements rather than in the notes.

Ms. Pinchas stated that in the SAO report dated May 29, 2015, it concluded the system schedules of employer allocation and schedule of collected pension amounts presents fairly. The report on Internal Controls did not identify any material weaknesses in internal control over financial reporting of the schedules or any noncompliance with laws or regulations that materially affected the schedules.

The Audit Committee then took the following motion:

MOTION made by Ms. Cydney Donnell, seconded by Mr. Doug Danzeiser and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to accept the financial audit report as prepared by the State Auditor's Office.

Mr. Chavez then proceeded with the next report on the Incentive Compensation Audit and introduced Angelica Ramirez, State Auditor's Office Audit Manager and Sonya Tao, State Auditor's Office Project Manager to present an update to the Board. Ms. Tao reported the audit objective was to determine whether ERS calculated and paid incentive compensation in accordance with policies and procedures for the 2014 plan year. She reported ERS awarded approximately \$2.2 million to 54 employees. Ms. Tao reported that while ERS awarded PY2014 incentive compensation in accordance with its policies and procedures, it did not always pay incentive compensation accurately. ERS did not accurately make necessary corrections to certain payment amounts to adjust for errors it had made in prior years. In addition, the SAO recommended ERS should implement recommendations that its Internal Auditor made in November 2014 report to strengthen the plans performance goals, improve plan information that ERS provides to its Board of Trustees and key stakeholders and formalize its plan review procedures.

Ms. Tao informed the board that ERS did not correctly calculate payment amount for certain employees for Fiscal Year 2015 because they did not accurately make certain payment adjustments necessary to correct award calculation errors that the State Auditor's Office identified for Plan Year 2013 and as a result ERS made \$8,000 in overpayments to four individuals and \$3,000 in underpayments to

three individuals. The plan award payments were spread out over a three-year period, so Fiscal Year 2015 payments included award amounts for plan years 2014 (50%), 2013 (25%) and 2012 (25%).

Chair, Craig Hester asked Mr. Chavez to review with the board what procedures are being put in place to make sure calculations going forward are correct. Mr. Chavez stated that previously the investment division added additional procedures including hiring an external review to ensure the accuracy of the information.

There were no questions or further discussion on this item.

b. Internal Audit Reports – Mr. Tony Chavez, Director of Internal Audit presented the next agenda item, Database Administration Audit. This audit performed by Weaver was completely outsourced. Mr. Chavez introduced Brian Thomas, Partner with Weaver and Reema Parappilly, Senior Auditor with Weaver to present on this item.

Ms. Parappilly reported the primary focus was to determine whether the controls around the database administration processes are properly designed and operating to meet the needs of ERS and its members. Weaver performed a design evaluation, which included reviewing documentation and performing inquiry procedures with information systems department of ERS to be able to get an understanding of the procedures, processes and documentation that is retained. She continued by reporting that based off of the results of the design evaluation a risk assessment was performed to develop an understanding of what the higher priority and more risk focus areas were. As a result, Weaver assessed four database environments for the four different scope areas. Ms. Parappilly noted they looked at primarily one database based off of its overall significance to ERS as well as the security availability, change management and data management. She stated they also assessed another database system from a design evaluation but did not perform detailed operating effectiveness procedures. For the scope areas and its databases they focused on FY2015 through May 2015 the initiation of fieldwork procedures. The overall rating for the internal audit procedures is satisfactory.

In a response to a question asked by Mr. Danzeiser wanting clarification on the security of the data, Ms. Parappilly stated Weaver did assess the security administration procedures and reviewed the user administration process, reviewed who has access to the environment and looked at it from a design component of what the process information systems goes through.

Mr. Chavez introduced the next audit report on the Service Credit Purchases Audit presented by Jonathan Puckett, Internal Auditor. Mr. Puckett thanked the Finance, Customer Benefits and Information Systems divisions for all their hard work in providing flexibility and quick turnaround for all of his requests. Mr. Puckett stated the audit objective was to access the purchases for additional service credit and military service in accordance with ERS rules and that funds are appropriately collected.

Mr. Puckett stated ERS members can purchase six types of service credit which include additional service credits, refunded service credit, calendar year, military, services not previously established and waiting period service credits. Mr. Puckett stated that 26,400 years of service credits were purchased during the audit period which equates to about \$196 million.

For the first scope area, service credit purchase accuracy, the sub-objectives were to determine if service credits are appropriately certified and calculated correctly; if payments received for service credits are accurately recorded; and if credit balances are updated appropriately once service credits are purchased. Mr. Puckett reported that not all objectives were satisfied and the overall rating for this area was needs improvement due to instances of improper salary information used to calculate service credit purchase amounts which resulted in errors.

The incorrect salary was used in the automated calculation for two different service credit purchases; additional service credit and waiting period service credit. He noted in this observation ERS found that the system selected the current salary instead of the average salary, which resulted in overpayments by the member. A root cause analysis is currently being performed by Information Systems

and further research is also being done to determine the full extent of the error before deciding what action to take. Mr. Puckett reported that the board approved factor tables which were implemented in September 2014 which eliminates the need for a logic test between current vs. average salary.

In a response to a question asked by Mr. Hester wanting to know how many observations of service credit purchases that ERS looked at, Mr. Puckett responded that five different calculations were looked at.

The sub-objective of the second scope area, compliance, was to determine if service credit purchases were following regulatory requirements and if credits were awarded to eligible members. The report that was used in the annual access review does not include all roles specific to each user. Annually, the division directors review access for the different PeopleSoft production environments. The report is compiled manually. Upon review division directors will notify Information Systems of any necessary changes to user access rights. PeopleSoft user access rights were reviewed to ensure proper segregation of duties between service credit processing and service credit payments. One finance staff member has access to create and approve service credits, which was not necessary to perform their job responsibilities. Mr. Charles Turner, Chief Information Officer reported that in 2014, ERS redesigned all the security roles in the systems and in that process did not accurately update the report of those new roles. That report will be corrected and will be available for this year's audit process.

Mr. Chavez announced the next audit for discussion is the Public Equity Emerging Manager Program and stated it is a carryover audit engagement from FY2014 Audit Plan. The audit objective was to determine whether the Public Equity Emerging Manager Program is effectively designed and operating to meet ERS' investment goals and objectives. The statute defined "emerging fund manager" as a professional investment manager that manages assets of not more than \$2 billion.

ERS contracts out with a general partner who identifies, selects and manages our emerging managers. Investments division is responsible for oversight of the general partner. Mr. Chavez stated there are two general partners, Leading Edge Investment Advisors and Legato Capital Management. The overall assessment for the engagement was satisfactory.

The two scope areas, trading compliance and portfolio composition were satisfactory. Internal controls are effective and substantially address risks related to investment objectives. Most of the control activity that would normally be in investments has been transferred to the general partners resulting in a monitoring activity.

Mr. Chavez reported on the next item, Quarterly Investment Compliance and stated there were five instances identified where the International Risk Management Long Only portfolio is outside its policy limits. There was one vote against the voting policy related to the election of company director. There were six instances where preapproval was not obtained without personal transactions.

Mr. Hester asked Mr. Chavez if there are any additional controls or procedures in place for personal trading. Mr. Chavez responded, "Not for investment division at this time. The control environment within the Investments division regarding personal trading, are aware that they need to get preapprovals. Internal Audit is working with Information Systems division to provide additional information to non-Investments Covered Persons."

Mr. Chavez introduced Ms. Beth Gilbert, Internal Auditor, to report on the Status of Audit Recommendations. Ms. Gilbert reported that there are four Management Action Plan statuses available: Implemented sufficient and appropriate evidence to support all reported management action items; Partially Implemented management has implemented some of the management action items but not all of them to fully address reported risk. Management has not taken action and/or evidence provided to support management action is not provided. Management Acceptance – Executive management has accepted the risk of not fully implementing reported management action plans. Status is based on the audit clients' self-assessment and review of their supporting documentation.

For the Web administration Audit, Benefit Communications and Information Systems will continue to work on an automated process to track and report changes to the ERS website and are scheduled to finish in October 2015. Ms. Gilbert reported for the Retirement Rules and Management System Implementation Audit that Information Systems Division and Customer Benefits Division decided to modify the Oracle Policy Automation support approach during this review changes were made to the Governance Plan in August 2015 to clarify the roles of Information Systems and Customer Benefits employees.

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

c. Internal Audit Administrative Items – The next item for discussion was the Internal Audit Administrative Items which is the Internal Audit Risk Assessment and Proposed FY2016 Audit Plan. Mr. Tony Chavez, Director of Internal Audit reported the objective of a risk-based audit plan is to identify and prioritize operational functions that present the greatest risk to meeting the agencies objectives. In looking back at FY2013, the audit universe was based on organizational charts. It was weighted toward control risk vs. inherent risk and most of the feedback was based on management surveys.

Mr. Chavez discussed the Proposed FY2016 Internal Audit Plan with the board and stated the four core functions identified are Operations, Group Benefits, Retirement and Investments. The Audit Universe was updated. The 10-Point criteria risk factors were revised, weighted and scored. Stakeholder input was received from the Board, executive and senior management and staff. Internal Audits are aligned with ERS strategic direction.

Ms. Donnell complimented the Internal Audit Report format.

There being no further discussion, the Audit Committee took the following action:

MOTION made by Ms. Cydney Donnell, seconded by Ms. Yolanda Griego and carried unanimously by the present members of the Audit Committee of the Employees Retirement System of Texas to approve and adopt the proposed Fiscal Year 2016 ERS Internal Audit Plan as listed in this agenda item.

Mr. Chavez reported ERS Internal Audit is independent in accordance with the Charter provisions. Internal Audit is free from interference by any element in the organization, including matters on audit selection, scope, procedures, frequency, timing or report content. Internal Audit has not implemented any internal controls, developed procedures, installed systems, prepared records or engaged in any other activity that may impair its judgement. Internal Auditors have confirmed they are free from personal or external impairments that would impact audit opinions, conclusions and recommendations.

III. ADJOURNMENT OF THE AUDIT COMMITTEE AND RECESS OF THE BOARD OF TRUSTEES

Following a temporary recess, the Board of Trustees will reconvene with the Investment Advisory Committee to take up the following Joint Board of Trustees and Investment Advisory Committee agenda items.