



Audit Committee Meeting

March 6, 2019



Presented for Review and Approval

May 22, 2019

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**AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
March 6, 2019
TRS Board Room, E513
TRS Building – 1000 Red River Street
Austin, Texas 78701**

TRUSTEES PRESENT

Catherine Melvin, Audit Chair
I. Craig Hester, Board Chair
Ilesa Daniels, Board Vice Chair
Doug Danzeiser, Member
Cydney Donnell, Member
James Kee, Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Cathy Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director & General Counsel
William Nail, Special Projects & Policy Advisor
Tony Chavez, Director of Internal Audit
Robin Hardaway, Director of Customer Benefits
Sharmila Kassam, Deputy Chief Investment Officer
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director of Procurement and Contract Oversight
Chineque “DeeDee” Sterns, Director of Human Resources
Katherine Tesar, Director of Benefits Communications
Tom Tull, Chief Investment Officer
Chuck Turner, Chief Information Officer
Keith Yawn, Director of Strategic Initiatives
Jason Avants, Information Systems
Kelley Davenport, Executive Office
Juli Davila, Investments
Christi Davis, Customer Benefits
Tressie Landry, Internal Audit
Greg Magness, Internal Audit
Karen Norman, Internal Audit
Aris Oglesby, Investments
Jamey Pauley, Enterprise Planning Office
Susie Ramirez, Executive Office
Tanna Ridgway, Investments
Leighton Shantz, Investments
MaryJane Wardlow, Executive Office

ALSO PRESENT

Sam Austin, NEPC
Tim Bruce, NEPC
Hillary Eckford, State Auditor’s Office
Tina Huo, Weaver
Kelley Ngaide, State Auditor’s Office

Meeting of the ERS Board of Trustees Audit Committee

1. CALL TO ORDER

1.1 Call Meeting of the ERS Board of Trustees' Audit Committee to Order

Ms. Catherine Melvin, Chair of the Board of Trustees Audit Committee of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 8:01 a.m. and read the following statement:

“A public notice of the ERS Board of Trustees' Audit Committee meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 2:45 p.m. on Tuesday, February 26, 2019, as is required by Chapter 551, Texas Government Code, referred to as the “Open meetings Law.”

Ms. Melvin introduced and welcomed Dr. Jim Kee, newly appointed board member, to the Board of Trustees.

2. MINUTES

2.1 Review and Approval of the minutes to the December 11, 2018 ERS Audit Committee Meeting (ACTION)

Ms. Catherine Melvin, Audit Committee Chair, opened the floor for a motion on the approval of the minutes from the December 11, 2018 Audit Committee meeting.

The Board then took the following action:

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes for its meeting held on December 11, 2018.

Motion by Craig Hester, second by Cydney Donnell.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jim Kee, Catherine Melvin

3. AUDIT ITEMS

3.1 Review of External Audit Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Kelley Ngaide and Hillary Eckford with the State Auditor's Office (SAO) to present the annual Financial Opinion Audit. Ms. Ngaide informed the board that the Audit was conducted from August 1, 2018 through December 20, 2018 and the auditors coordinated their work through the internal audit liaisons.

Ms. Ngaide reviewed the three deliverables:

- the Financial Statement Opinion, dated December 20, 2018, noting that the SAO issued an unqualified opinion for the Fiscal Year 2018 financial statements,
- the report on Internal Control over Financial Reporting and on Compliance and Other Matters, dated December 20, 2018 required for audits performed in accordance with generally accepted government auditing standards, noting that the major internal controls that were tested for the purpose of forming their opinions on the financial statements were operating effectively and
- the Report to the Legislative Audit Committee, which is the oversight body of the State Auditor's Office, noting that the report summarizes the results of the previous two reports.

There were no further discussion or questions and no action was taken on this agenda item.

3.2 Review of Internal Audit Reports

Mr. Chavez reported to the Board on the 2018 Incentive Compensation Audit. The Incentive Compensation Plan (ICP) was started in 2006 and is intended to award investment related personnel for exceptional performance. It is considered a key tool in recruiting and retaining investment professionals.

Mr. Chavez reported that controls were in place to implement the plan and management continues to improve the control framework. Earned awards in plan year 2018 were approximately \$5.1 million of a potential \$7.3 million. The ICP is structured so that awards are earned on different performance goal types. Goal types include the total trust, discretionary, asset class, and individual portfolio research performance goals. All participants have at least a 25% minimum award based on total trust performance, as established by the plan. As such, performance of the total Trust has the highest impact on earned awards. In Plan Year 2016 the Trust performed well, but did not meet the established benchmark, therefore, no awards were earned for that performance goal.

Over the last several years, management has implemented several steps (actions) to improve the governance process. Plan Year 2016 had significant changes in both the plan policy and related control activities. Changes to control activities in 2016, included transitioning responsibility for program administration to the Human Resources division with support from the Finance division. This segregation of duties vastly improved the control framework.

Management implemented two additional improvements this plan year, including the development of a dedicated database to calculate the awards and the assignment of two program specialists to assist with plan implementation.

Mr. Chavez described the overall objectives and scope of the engagement and stated it was the same as in prior years with the addition of a review of the ICP database. He described that this engagement included assistance from a co-sourced audit firm which allowed the use of specialized skills related to reviewing the relationships and structure of the ICP database. Mr. Danzeiser asked if the database would be reviewed each year going forward and Mr. Chavez responded that it will be included in the review, but not at the level performed this year. Going forward, changes to the database will be reviewed to ensure it continues to be accurate and effective.

Mr. Hester asked if the accuracy of each calculation was validated and Mr. Chavez responded that Ms. Huo looked at each table and relationship to validate the calculation methodology used by the database as well as the relationships to ensure the calculations were accurate. In addition, Mr. Chavez noted management relies on a third party review of all the calculations as a key control. Part of that third party review included a review of the ICP database. So, this plan year there were actually two separate reviews of the ICP database. Mr. Chavez confirmed that Human Resources still has total ownership of this process. He reported that overall assessment was satisfactory and management has made a concentrated effort to transition ICP responsibilities from Investments to Human Resources. Despite this effort, for Plan Year 2018, it was identified that not all personalized goal changes or instances of discretion were communicated to the Human Resource division for approval. This issue has been addressed through new internal processes.

Board member Mr. Kee asked for a summarization of the decision to move the ownership of the ICP process from Investments to Human Resources. Executive Director Porter Wilson said that a previous audit recommended the segregation of duties a best practice Originally, plan administration was performed by investment staff, all of whom are eligible to participate in the plan. Management ultimately decided to have the Finance division assist due to the complexity of the calculation. Ms. Donnell also noted that part of each employee's goals are measurements of their individual performance, and since employee performance evaluation is a standard task of Human Resources, it made sense to include Human Resources in the process.

Mr. Hester asked if reviewing the accuracy of the benchmark data is part of the engagement and Mr. Chavez responded that it is not something reviewed for this engagement. Audit engagements that cover the different asset classes will now include benchmark reviews, as was the case for the recent audit of the infrastructure asset class. Mr. Hester noted the importance in reviewing those benchmarks.

The second observation is for staff to continue to finalize the procedures for their two new control activities established in Plan Year 2018. The ICP database currently only has one process owner who has full knowledge of all objects and associated relationships, including tables, queries, forms and reports. The ICP program specialist should provide specific procedures for key control activities including evidence of performance.

Mr. Danzeiser asked about a benchmark discussed in the audit report that was lowered. Mr. Chavez responded that a benchmark was lowered but it didn't have any impact on the calculation of the award. Mr. Porter Wilson stated that staff is evaluating at executive office level to determine what actions are needed, if any, on the two specific changes to benchmarks that were noted in the audit report.

Ms. Melvin asked about the ratings given to the scope areas by internal audit and asked if it was possible for this particular program to receive the highest rating. Mr. Chavez responded that it is possible; a lot of the consideration included in rating at the highest level is looking at the efficiency of the process.

Mr. Danzeiser asked for an estimated full time equivalent employees for the ICP process, Ms. Sterns, Director of Human Resources, estimated that approximately five FTEs are involved with two of those spending about 50-75% of their time for a majority of the fiscal year on the ICP process, administration is year round. There were no further discussion or questions and no action was taken on this agenda item.

3.3 Review of Internal Audit Administrative Items (Action)

Mr. Tony Chavez, Director of Internal Audit, introduced Tressie Landry, ERS Internal Auditor, to present on the Internal Audit Charter (Audit Charter). The ERS Audit Charter is the governing document that defines Internal Audit's purpose, authority and responsibilities.

Ms. Landry stated that the charter provides the audit committee's delegation of authority through the internal audit director to have unfiltered access to the agency in order to perform work. The authority of the internal audit director is also enhanced by the organizational structure of the internal audit division, At ERS, the Director of Internal Audit has direct accountability to the board and administrative accountability to the executive director. The purpose of the annual review is to comply with audit standards, inform and prompt discussion and reinforces roles and responsibilities to the agency. In looking at the proposed changes, staff made one minor change to add the responsibility of the annual review of the charter by the internal audit director to the charter.

The audit committee charter was originally created at the suggestion of a peer review of the internal audit function. The charter was first introduced in December 2014. Ms. Landry reported that the Audit Committee Charter is designed to lay out the purpose, authority, and responsibility of the audit committee, with the key responsibility being the hiring and directing of the internal audit director.

Mr. Danzeiser proposed Section 2, last bullet be modified to be "Resolve any disagreements between management and the external auditors", removing the stipulation that the Audit Committee only had authority to resolve disagreements in relation to financial reporting.

There were no further discussion; the Board then took the following action.

Move that the Audit Committee of the Employees Retirement System of Texas accept the revised Internal Audit Charter and the revised Audit Committee Charter including suggestions made by Mr. Danzeiser as presented in this agenda item.

Motion by Cydney Donnell, second by Doug Danzeiser.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Catherine Melvin, Jim Kee

4. ADJOURNMENT/RECESS

4.1 Adjournment of the ERS Board of Trustees Audit Committee.

There being no other items, the ERS Board of Trustees' Audit Committee adjourned at 8:40 a.m.

4.2 Recess of the ERS Board of Trustees. Following a temporary recess, the Board of Trustees will reconvene its meeting with the Investment Advisory Committee to take up the following Board of Trustees and Investment Advisory Committee agenda items.