



# Audit Committee Meeting

August 23, 2017



Presented for Review and Approval

December 13, 2017

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
August 23, 2017  
ERS Board Room  
ERS Building – 200 E. 18th Street  
Austin, Texas 78701**

**TRUSTEES PRESENT**

I. Craig Hester, Chair  
Doug Danzeiser, Vice-Chair  
Ilesa Daniels, Member  
Cydney Donnell, Member  
Brian Ragland, Member  
Jeanie Wyatt, 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  
Jennifer Chambers, Director of Government Relations  
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  
Tom Tull, Chief Investments Officer  
Chuck Turner, Chief Information Officer  
Keith Yawn, Director of Strategic Initiatives  
Anthony Curtis, Investments  
Kelley Davenport, Executive Office  
Juli Davila, Investments  
Liz Geise, Benefits Communications  
Beth Gilbert, Internal Audit  
Betty Martin, Investments  
John McCaffrey, Investments  
Karen Norman, Internal Audit  
Travis Olson, Investments  
Jonathan Puckett, Internal Audit  
Mari Queller, Finance  
Susie Ramirez, Executive Office  
Robert Sessa, Investments  
Leighton Shantz, Investments

**ALSO PRESENT**

Mary Grace Bilby, Self  
Kristen Doyle, Aon Hewitt Investment Consultants  
Ryan Falls, Gabriel, Roeder, Smith & Co.  
Seth Hutchinson, Texas State Employees Union  
Bob May, Texas Pension Review Board  
Michael McCormick, Aon Hewitt Investment Consultants  
Catherine Melvin, Texas Department of Public Safety  
Joe Newton, Gabriel, Roeder, Smith & Co.  
Avery Saxe, Legislative Budget Board  
Trevor Simmons, Legislative Budget Board  
Steve Voss, Aon Hewitt Investment Consultants  
Brian Thomas, Weaver

## 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 –

Mr. Craig Hester, Chairman of the Board of Trustees of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 8:02 a.m. and read the following statement:

“A public notice of the ERS Board of Trustees meeting containing all items on the proposed agenda was filed with the Office of the Secretary of State at 2:41 p.m. on Monday, August 14, 2017, 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 to consider agenda items. Mr. Hester turned the meeting over to Mr. Brian Ragland, Chair of the Audit Committee.

### 2. MINUTES

#### 2.1 Approval of the minutes to the May 17, 2017 ERS Audit Committee Meeting (ACTION) -

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes to its meeting held on May 17, 2017.

**MOTION** by Cydney Donnell, second by Craig Hester

Final Resolution: Motion Carries

Aye: Brian Ragland, Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt

### 3. AUDIT ITEMS

#### 3.1 Review of Internal Audit Reports –

Mr. Ragland recognized Mr. Tony Chavez, Director of Internal Audit to discuss several audit items with the board.

Revenue Processing: Karen Norman, Internal Auditor, was project lead on the engagement and presented the results to the Board. An audit of Finance's revenue process was performed to determine if contributions from state agencies were collected and reported accurately. The two scope areas were retirement and insurance contributions. The overall assessment given during this audit was satisfactory with two observations; Finance should review monitoring and reporting requirements for alignment with program objectives and to continue coordinating with other state agencies for increased efficiencies.

Ms. Norman noted that during Fiscal Year 2016, \$4.9 billion in contributions were received by ERS. ERS bills agencies based for the number of employees who are enrolled in the insurance programs. The number of employees is based on our benefits enrollment system and the billing is based on the rates set by the Board. After the billed amounts are received, general accounting reconciles what was billed to the agency to what was actually received.

Retirement contributions are set by statute and not determined by ERS. The contribution amount is based on a member's pensionable earnings, which can change throughout their employment. The ERS system does a check for reasonableness per person based on the established contribution percentages. Finance has identified areas for improvement and has been working alongside other agencies to increase efficiencies where possible. In 2016, members of the Finance division staff began working with staff at the State Comptroller of Public Accounts to implement a direct deposit process for the contributions that ERS receives. ERS has wanted a streamlined electronic process for a long time, as the current system involves numerous paper checks. System changes have been implemented by the Comptroller and ERS

began getting electronic deposits in March for some programs. All contributions are expected to be via direct deposit in December, eliminating the manual process.

The second observation is to review monitoring and reporting requirements for alignment with program objectives. Reports should be periodically reviewed for accuracy. Mr. Hester asked to define the variance thresholds as stated on page 7, exhibit A. Ms. Machel Pharr, Chief Financial Officer responded that the current threshold at that time was \$5. The variances have been less than 1% for the year.

Procurement Cards: Mr. Chavez stated the objective of this audit was to determine whether purchases were completed in accordance with policies and procedures regarding procurement card use. The overall assessment was satisfactory. The three scope areas are the procurement card usage, the procurement card payments and the procurement card users. The procurement cards provide an alternative payment process for goods and services allowing for cost savings and timely purchases. The ERS Office of Procurement and Contract Oversight (OPCO) made over 99% of the \$172,000 in procurement card purchases in Fiscal Year 2016. In Fiscal Year 2017 as of March 31, 2017, OPCO's purchases totaled \$91,500. The remainder of the purchases were made in other divisions by staff using the new procurement card process. Expanding authority and responsibility to other agency users allowed OPCO personnel to address other purchasing priorities. Mr. Chavez reported that 11 additional cardholders were added in eight divisions in FY17. New cardholders are limited to purchases for training and conferences.

Investment Compliance AUP: Ms. Beth Gilbert, Internal Auditor, noted that there was one instance of a pre-trade request that was improperly approved and subsequently executed. Upon notice, the position was reversed immediately.

Mr. Jonathan Puckett, Internal Auditor, reported that the exception report incorrectly identified an instance where an investment was made in a company associated with a prohibited country. The company that appeared to violate the compliance rule is no longer on the prohibited list; therefore the exception noted was false because the Custodian was relying on an outdated list of prohibited companies to ensure that the Custodian is always operating with an updated list. The list originates from the Comptroller's Office and procedures have been established within Internal Audit to ensure that the list is updated with the custodian.

For securities lending, Mr. Puckett noted one instance where the counterparty was below the 100% collateralization limit for more than three business days. The borrowing broker calculates collateral differently from the industry norm. The borrowing broker calculated the collateralization limit after accounting for expected returns for the day. This methodology is considered reasonable. Ms. Donnell asked why investments keep having exceptions. Mr. Puckett noted that most of these instances were corrected very soon before the instance hit the three-day threshold.

Status of Audit Recommendations: Ms. Gilbert informed the board that the audit recommendations are performed biannually and there are four different statuses:

Implemented,  
Partially Implemented,  
No-Action Taken, and  
Executive Management Acceptance of the Risk.

Ms. Gilbert noted that management of the responsible area conduct a self-assessment of their progress on the audit recommendation and then internal audit staff members review and analyze supporting documentation to corroborate the self-assessment. The audit work was not performed to verify the effectiveness of management actions implemented to determine if the controls were working as intended.

Ms. Gilbert highlighted the Disability Retirement audit. Internal Audit's observation was that existing monitoring activities provided limited assurance for continued participation in the disability

program. In response, Customer Benefits added an annual letter to disability participants to confirm proof of earnings. Customer Benefits also revised the initial disability retirement application to require members to certify their understanding that they may be subject to re-evaluation. Staff believed that additional monitoring would require a full-time employee and a business determination was made that the cost outweighed the benefit.

This agenda item was presented for discussion and informational purposes only. No action was taken.

3.2 Review of Internal Audit Administrative Items: Internal Audit Risk Assessment & Proposed Fiscal Year 2018 Annual Audit Plan (ACTION) –

Mr. Chavez presented the risk-based internal audit plan. The process was similar to what has been done in previous years: identify risks, measure those risks, prioritize those risks, and then select and develop the proposed audit plan for approval.

This year a separate IT (Information Systems) Audit Universe was added because these technology engagements have their own unique risks. This was in coordination with the Information Systems Division and Chief Information Officer. This year's plan also incorporated legislative interest and the Sunset review recommendations into the risk assessment process.

Mr. Hester commented that he really liked the opportunity to review and comment on the draft Internal Audit Plan.

There being no further discussion, the Board then took the following action.

Move that the Board of Trustees for the Employees Retirement System of Texas approve and adopt the proposed Fiscal Year 2018 ERS Internal Audit Plan as listed in Exhibit A of this agenda.

**MOTION** by Doug Danzeiser, second by Cydney Donnell

Final Resolution: Motion Carries

Aye: Brian Ragland, Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt

3.3 Review of Internal Audit Administrative Items: Internal Audit Independence Affirmation (ACTION) –

Mr. Chavez reported that the Internal Audit Director is required to report annually to the Board and by statute, Internal Audit is required to follow the standards of both the Institute of Internal Audit standards and the Government Auditing standards. When assessing independence, ERS uses the Government Auditing Standards Conceptual Framework for Independence. This framework includes asks the audit team to identify threats to independence, evaluate the significance of the threats identified both individually and in the aggregate, and then apply any safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

Mr. Chavez stated that Internal Audit is independent in accordance with Charter provisions. The internal audit activity is free from interference by any element of the organization, including matters of audit selection, scope, procedures, frequency, timing or report content.

Internal Audit staff has affirmed that they are free from personal or external impairments that would impact the auditor's opinions, conclusions, and recommendations. Internal Audit established proper safeguards for non-audit services that might impact independence. To improve investment governance, an investment compliance officer is scheduled to be added in Fiscal Year 2018. The position will be responsible to ensure investment activities comply with applicable statutes, regulations, Board policies and investment guidelines. The position will report to the Director of Internal Audit. With the

addition of this position to the audit team, the audit charter was reviewed to determine the need for additional safeguards.

The proposed safeguards that were discussed included 1) continued acceptance or ownership of risks by management, 2) amend and seek Board approval of the Internal Audit Charter to include the director's additional responsibilities and compliance staff responsibilities, 3) clearly define roles and responsibilities of internal audit and investment compliance, including separate staff and segregation of duties, 4) periodic independent reviews of the effectiveness of the compliance program, and 5) including evaluation results from the compliance function in the Internal Audit annual risk assessment. Ad hoc engagements will not be performed based on compliance results unless requested by the Board or executive management. With proposed safeguards, the proposed Investment Compliance Officer can report to the Director of Internal Audit.

Mr. Chavez stated a white paper written by Ms. Gilbert is available if the Board would like further information on the research completed. Mr. Ragland mentioned that his agency has a similar structure.

Mr. Danzeiser asked about the audit capabilities and Mr. Chavez responded by stating that Internal Audit will still be able to perform audits, but will not conduct an audit review over the compliance function and all the procedures that the investment compliance officer will perform.

There being no further discussion, the Board then took the following action.

Move that the Board of Trustees for the Employees Retirement System of Texas approve and adopt the proposed safeguards related to the reporting of the Investment Compliance Officer to the Director of Internal Audit.

**MOTION** by Cydney Donnell, second by Craig Hester

Final Resolution: Motion Carries

Aye: Brian Ragland, Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt

#### **4. EXECUTIVE SESSION**

##### 4.1 Executive Session –

Mr. Ragland stated it was 8:37 a.m. on August 23, 2017 and the Board of Trustees will meet in Executive Session in accordance with Session 551.076, Texas Government Code, the Audit Committee of the Board of Trustees, a committee of the whole of the Board, will meet in executive Session to deliberate: (1) the deployment, or specific occasions for implementation, of security personnel or devices; and (2) a security audit. Thereafter, the Board may consider appropriate action in open session.

After the executive session, Mr. Ragland stated it was 9:30 a.m. on August 23, 2017. The Board is now in Open Session. No action, decision, or vote was taken by the Board while in Executive Session.

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

#### **5. ADJOURNMENT**

##### 5.1 Adjournment of the ERS Board of Trustees Audit Committee –

The ERS Board of Trustees Audit Committee adjourned at 9:31 a.m.