



## Audit Committee Meeting

December 13, 2017



Presented for Review and Approval

March 7, 2018

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
December 13, 2017  
ERS Board Room  
ERS Building – 200 E. 18th Street  
Austin, Texas 78701**

**TRUSTEES PRESENT**

Catherine Melvin, Audit Chair  
Doug Danzeiser, Board Chair  
Cydney Donnell, Board Vice Chair  
Ilesa Daniels, Member  
I. Craig Hester, 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  
Bernie Hajovsky, Director of Enterprise Planning Office  
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 Investment Officer  
Kathryn Tesar, Director of Benefits Communications  
Chuck Turner, Chief Information Officer  
Keith Yawn, Director of Strategic Initiatives  
Kelley Davenport, Executive Office  
Juli Davila, Investments  
Christi Davis, Customer Benefits  
Beth Gilbert, Internal Audit  
David Lacy, Office of General Counsel  
Nancy Lippa, Office of General Counsel  
Greg Magness, Internal Audit  
Betty Martin, Investments  
Karen Norman, Internal Audit  
Jamey Pauley, Enterprise Planning Office  
Jonathan Puckett, Internal Audit  
Susie Ramirez, Executive Office  
Tanna Ridgway, Investments  
Leighton Shantz, Investments

**ALSO PRESENT**

Cynthia Jumper, Texas Tech University Health Science Center  
Sara Puerdo, State Auditor's Office  
Michael Clayton, 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 –

Mr. Doug Danzeiser, 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 8:00 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 10:21 a.m. on Friday, December 1, 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. Danzeiser turned the meeting over to Ms. Catherine Melvin, Chair of the Audit Committee.

### 2. MINUTES

#### 2.1 Approval of the minutes to the August 23, 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 for its meeting held on August 23, 2017.

**Motion** by Cydney Donnell, second by Jeanie Wyatt.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

### 3. AUDIT ITEMS

#### 3.1 Review of External Audit Reports –

Ms. Melvin recognized Mr. Tony Chavez, Director of Internal Audit. Mr. Chavez introduced Ms. Sara Puerto and Mr. Michael Clayton from the State Auditor's Office (SAO). Ms. Puerto reported that the objective of the Incentive Compensation audit of Plan Year 2016 was to determine whether the Employees Retirement System of Texas (ERS) calculated and paid incentive compensation in accordance with policies and procedures. The SAO reported that ERS did calculate and pay its Plan Year 2016 incentive compensation in accordance with its policies and procedures. There were no errors noted by SAO.

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

#### 3.2 Review of Internal Audit Reports –

Mr. Tony Chavez, Director of Internal Audit, reported that the objective of the Incentive Compensation Audit was to determine if recommended incentive compensation awards were in accordance with ERS' Incentive Compensation Plan (ICP). Mr. Chavez noted the scope was for Plan Year 2017 awards recommended to ERS' executive office for approval. There were two scope areas reviewed: 1) ICP Participation and Development, and 2) ICP Award Calculations. The overall assessment was satisfactory. Internal controls are effective to ensure eligible participants' performance goals are in accordance with the Plan. Internal controls are effective to ensure accuracy of award calculations.

Mr. Chavez stated key changes implemented over the past few years include designating the Human Resources division as the primary owner of the ICP, having the Finance division calculate the ICP awards, an independent third-party to review the accuracy of recommended awards and verify compliance with the plan, and developing a qualitative scoring tool for Investment Division management to document the discretionary percentages are earned.

In Plan Year 2017 there were 71 participants recommended to receive ICP awards. Awards submitted for executive approval totaled \$5.30 million of the maximum \$7.03 million possible.

Ms. Donnell asked how the payments are made. Mr. Chavez responded that award payment is based on 50% from Plan 2017, 25% from Plan 2016 and 25% from Plan 2015. Mr. Porter Wilson clarified the extended payment period is designed to retain staff. Staff must be employed and in good standing on the date each payment is made.

Mr. Chavez introduced Mr. Jonathan Puckett, Internal Auditor, to discuss the securities lending section of the investment compliance review. Mr. Puckett reported that there were three instances unresolved for more than three business days where counterparties were below the 100% collateralization limit. One of the three was caused by differences between the way the borrowing broker calculated collateral and the industry norm. The other two instances were due to rights that were issued on securities that were lent out, which increased the effective loans outstanding. The borrowers were unaware at the time and therefore did not count the rights in their calculation of collateral that was due.

Ms. Donnell asked if this is something that My Compliance Office system can flag and allow ERS to catch before it happens. Mr. Leighton Shantz, Director of Fixed Income, responded the flags are spotted the next day. He said that he does not consider the items of consequence to the Trust or to the Board. Mr. Shantz also reported that in this particular issue, the borrower does not recognize it until the rights actually are attached and settled, which is the industry norm, but there was an announcement date prior to the record date, so the lending agent correctly attaches them on the announcement date rather than on the settlement date.

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

*3.3 Executive Session - In accordance with Section 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; or 2) a security audit. Thereafter, the Board may consider appropriate action in open session.*

Audit Committee Chair, Catherine Melvin stated it was 8:17 a.m. on December 13, 2017 and the Board of Trustees' Audit Committee, a committee of the whole, will meet in executive session in accordance with Section 551.076, Texas Government Code, to deliberate: 1) the deployment, or specific occasions for implementation, of security personnel or devices; or 2) a security audit. Thereafter, the Board may consider appropriate action in open session.

After the executive session, Ms. Melvin stated it was 9:17 a.m. on December 13, 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.

*3.4 Review of Internal Audit Administrative Items - (ACTION)*

Internal Audit reviews and proposes any necessary revisions to the Internal Audit Charter on an annual basis. Mr. Chavez introduced Ms. Beth Gilbert, Internal Auditor, to present recommended revisions. Ms. Gilbert reported that the International Professional Practices Framework, Standard 1000, requires the Chief Audit Executive to periodically review the internal audit charter and present it to senior

management and to the Board for approval. Revisions were made to comply with revised professional audit standards and to document the Internal Audit Director's supervision of the Investment Compliance function.

Mr. Wilson noted that ERS has extended an offer for an investment compliance officer and hopes to have the new hire on board on January 2, 2018.

There being 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 as presented in this agenda item.

**Motion** by Craig Hester, second by Jeanie Wyatt.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

### 3.5 Review of Audit Administrative Items - Annual Performance

#### Internal Audit Annual Report

Mr. Tony Chavez, Internal Audit Director, presented the Annual Internal Audit report stating that it is statutorily required by Texas Government Code, Chapter 2012. Report guidelines and content are prescribed by the Texas State Auditor's Office. The report provides a summary of internal audit activities including FY 2017 internal audit plan results, consulting and non-audit services completed, FY 2018 internal audit plan, external audit services procured in FY 2017, and reporting suspected fraud, waste & abuse.

#### Quality Assurance Improvement Program

Government Auditing Standard 3.82a requires each audit organization to establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements.

The external peer review performed in October 2016 was led by Amy Barrett, Chief Audit Executive, Teacher Retirement System of Texas. Ms. Barrett presented the results to the Board in December 2016. The objective of the external peer review was to determine whether the internal audit function is in compliance with professional auditing standards, Texas Internal Auditing Act, and Internal Audit Code of Ethics. ERS Internal Audit Division received the highest rating of "Pass/Generally Conforms."

Mr. Chavez addressed the status of the improvement opportunities which are all fully implemented. The formal independence assessment was reported annually in August. The self-review of quality assurance activities will be reported each December. Working paper documentation is regularly evaluated to ensure an efficient and effective process is in place. Mr. Chavez continuously evaluates the need for a full-time internal IT auditor; however, he determined current IT co-source resources are optimal and appropriately compliment current internal resources.

Mr. Chavez reported that internal assessments must include ongoing monitoring of the performance of the internal audit activity and periodic self-assessments or assessments by other persons within the organization with sufficient knowledge of internal audit practices. The FY 2017 self-assessment opportunities are to continue to identify key risks, increase the timeliness in meeting established milestones, continue to improve communication of audit findings, and documenting/organizing audit evidence to support audit results. Mr. Chavez said he plans to re-emphasize the risk assessment process during the audit planning phase.

### Internal Audit Performance Measures (FY 2017)

Mr. Chavez discussed the Internal Audit Performance Measures for FY 2017. Mr. Chavez stated that the Audit Committee is responsible for reviewing the effectiveness of the internal audit function including conformance with audit standards. Performance measures help assess the effectiveness, efficiency and sustainability of the internal audit function. Mr. Chavez reported that the FY 2017 performance measure were presented for review and discussion at the December 2016 Audit Committee meeting.

Mr. Chavez reminded the board that the Internal Audit strategic goals are to enhance professional practices, enhance performance management and accountability, and grow people management.

Mr. Chavez discussed his team's accomplishments in the last five years included hiring all four members of the audit team, revising the Audit Universe based on core business functions and specific risk criteria, implementing of automated audit management software, revising the audit report format, establishing audit ratings, and developing/implementing the quality assurance improvement program to make sure professional standards are followed.

Ms. Wyatt asked if there are any considerations to shortening and clarifying the investment policy. Mr. Chavez noted that the Board and executive office would have significant input on the revision of the Investment policy. One of the duties of the Investment Compliance Officer will be reviewing the policy for compliance issues.

FY 2018 initiatives include coordinating with process owners to develop an overall program objective if one does not exist, utilizing preliminary milestone meetings with process owners to gather input on program risks and challenges, and greater evaluation of audit sub-objectives to ensure alignment with program objective.

All staff are certified as a certified internal auditor, a certified government audit professional, or both. Mr. Chavez provided the board with 2017 highlights and stated one employee attended the State Agency Internal Audit Forum Internal Audit Leadership Development Program. The Internal Audit division hosted a team of University of Texas interns, and Beth Gilbert was the Marketing committee chair and the Exhibits and Sponsorship committee co-chair for the IIA Southern Regional Conference held in Austin in September 2017. The 2018 initiatives include training in ERS' core business functions.

Mr. Chavez then announced to the Board the recommended FY 2018 performance measure revisions, including reducing the number of days from end of field work to when the draft report is sent to the executive director, percent of audits within the audit engagement budgeted hours and audit staff attending 16 hours (40%) of required annual training.

Ms. Donnell commended the audit team for their continued improvement including tone at the top, audit ratings, the revised report format, and vastly improved audit reports.

Ms. Melvin commended the Audit team for embracing a spirit of continuous improvement and quality assurance.

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

## **4. ADJOURNMENT**

### 4.1 Adjournment of the ERS Board of Trustees Audit Committee

The ERS Board of Trustees Audit Committee adjourned at 9:50 a.m.