



Audit Committee Meeting

August 19, 2020



Presented for Review and Approval

December 8, 2020

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**AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
August 19, 2020**

The August 19, 2020 meeting of the ERS Board of Trustees Audit Committee was held by video conference call as authorized under Section 551.127 of the Texas Government Code. This meeting was conducted by videoconference in accordance with the governor's authorization concerning suspension of certain open meeting law requirements in response to the covid-19 (coronavirus) disaster. A quorum of the Board participated in the meeting remotely and could be heard and seen online by members of the public.

TRUSTEES PRESENT

Ilesa Daniels, Board Chair
I. Craig Hester, Board Vice Chair
Brian Barth, Member
Dr. James Kee, Member
Catherine Melvin, Member

ERS DIRECTORS PRESENT

Porter Wilson, Executive Director
Cathy Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director & General Counsel
Tony Chavez, Director of Internal Audit
Bernie Hajovsky, Director of Enterprise Planning

ERS STAFF PRESENT

Kelley Davenport, Executive Office
Tressie Landry, Internal Audit
Ricardo Lyra, Investments
Bruce Marton, Information Systems
Karen Norman, Internal Audit
Roger Nooner, Benefits Communications

ALSO PRESENT

Jason Ostroski, CLA
Brittany Smith, CLA

Meeting of the ERS Board of Trustees Audit Committee

1. Call Meeting of the ERS Board of Trustees Audit Committee to Order

Ms. Catherine Melvin, Chair of the Audit Committee of the Employees Retirement System of Texas (ERS), noting a quorum was present, called the meeting to order at 8:00 a.m. on Wednesday, August 19, 2020 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 6:33 p.m. on Monday, August 10, 2020, as required by Chapter 551 Texas Government Code, referred to as the Open Meetings Law.”

2. Review and Approval of the Minutes to the May 20, 2020 ERS Audit Committee Meeting – (ACTION)

Chair Catherine Melvin opened the floor for a motion on the approval of the minutes from the May 20, 2020 ERS Audit Committee meeting.

Move that the Audit Committee of the Employees Retirement System of Texas approve the minutes to the meeting held on May 20, 2020.

Motion by Jim Kee second by Craig Hester

Final Resolution: Motion Carries

Aye: Craig Hester, Brian Barth, Ilesa Daniels, Jim Kee, Catherine Melvin

3. Review of External Audit Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Mr. Jason Ostroski and Ms. Brittany Smith with CliftonLarsonAllen (CLA). CLA is the new financial statement auditor for ERS as selected by the Board of Trustees in May 2020. Mr. Chavez noted that audit work has begun and this meeting is an opportunity to provide an update and introduce the team, give further background on the financial statement audit, and highlight key audit focus areas.

Mr. Ostroski said that they would provide a brief overview of the audit plan and introduce themselves to the Trustees. The auditors report to the Audit Committee and noted the beginning of the audit is an excellent time for questions or input from the committee members.

All of the CLA team members are part of the State and Local Government Pension team which is dedicated to working with state and local government pensions. Ms. Smith introduced herself noting she also works with another Texas pension plan and has significant experience in using data analytics in the audit approach.

Mr. Ostroski explained the scope of the audit includes ERS' financial statements as of August 31, 2020, noting that the financial statements are included in the Comprehensive Annual Financial Report (CAFR). The CAFR is a powerful document that includes information related to investment performance, valuations, and required supplementary information. A very useful schedule included in the CAFR is the net pension and net other post-employment benefits (OPEB) liabilities which highlights the overall performance of the fund and allows the reader to track the Trust's funding progress and trends over a 10 year period.

Also included in the scope is an audit of ERS' Governmental Accounting Standards Board (GASB) 68 and 75 schedules, which are used to report to participating employers the information they need to report their net pension and net OPEB liabilities and provide their auditors with evidence of the amounts.

CLA will also provide a report on internal controls over compliance and financial reporting, which is required by governmental auditing standards. CLA is conducting the audit in accordance with governmental auditing standards so this report will be included. At the conclusion of the audit, CLA will report back to the Committee and provide written communication that will include audit communications required to the governing body.

Mr. Ostroski then described the audit methodology which includes four phases:

1. Planning and strategy
2. Preliminary fieldwork
3. Final fieldwork
4. Reporting

COVID-19 has presented some challenges to the auditing process, especially during a transition of auditors, but Mr. Ostroski noted that so far those challenges have been met and, as a firm, they have been able to complete several December 31 audits.

Mr. Ostroski noted that the auditors have the responsibility to express an opinion on whether the financial statements are fairly and materially stated according to generally accepted accounting principles, as prescribed by GASB. A significant factor in this opinion is materiality, which is an important concept in the auditor's approach. It underpins the whole planning approach as well as the substantive approach around how CLA samples data and considers significant accounting processes and account balances. CLA applies professional judgment in developing materiality.

In considering materiality, there's quantitative and qualitative considerations. CLA looks at who will use the financial statements and then ultimately develop an amount for materiality, that's based on a calculation that uses benchmarks, typically total assets or revenue for pensions. CLA uses the materiality number to develop the risk assessment and identify significant account balances and processes.

If errors are found during testing, the materiality level is used to determine how those errors are communicated and what kind of opinion the auditors issue (modified or unmodified). An unmodified opinion would mean that the financial statements are not materially misstated in accordance with GASB. It is important to note there is a difference between reasonable assurance and absolute assurance. With a risk-based audit approach, we do not provide absolute assurance over the financial statements, rather reasonable assurance.

Ms. Smith reviewed significant processes and key risks identified:

1. Investments and Investment Income
 - a. Investments - Alternative/Non-Custodial Investments – SIGNIFICANT RISK
 - b. Investments - Publically traded/Custodial
2. Contributions/Member Testing
 - a. Employer and Member
 - b. Data Analytic procedures over contributions
3. Benefit Payments
 - a. Annuity, lump sum benefit payment and claim testing
 - b. Data analytic procedures over benefit payments
4. Actuarial information (including Total Pension Liability, Net Pension Liability, Total OPEB liability and Net OPEB Liability) and Related Disclosures – SIGNIFICANT RISK
 - a. Demographic and informational testing over employer census data
 - b. Data analytic procedures over census files
5. Financial Statement Process

Ms. Smith noted the difference between Non-Custodial and Custodial investments as the Custodial Bank having actual possession of the funds for investments whereas, non-custodial investment funds are held by the fund managers.

Dr. Kee asked if CLA would perform formal benchmarking, to which Mr. Ostroski and Ms. Smith noted that while they do not do formal benchmarking, they will use their knowledge of other pension systems to identify any best practices.

For the significant risk areas of alternative investments and actuarial information, CLA has already met with several ERS investment staff to understand their processes. Some key audit procedures will include:

- For alternative investments:
 - Selecting a sample of fund managers to confirm their investments balances to ensure the reporting is matching to ERS' custodial bank
 - Obtain audited financial statements of these investment funds and perform a recalculation to ensure ERS' share of the total investment fund matches to what is recorded in the financial statements
- For actuarial information:
 - Work with state agencies to test the census data they have in their systems to validate accurate reporting to ERS
 - Employ an auditor specialist, Foster and Foster, an actuarial firm to review actuarial reporting. This is different than the audit of the actuary that is performed by the ERS Board of Trustees in that this review is more focused on a financial statement reporting as opposed to the methodology and is more focused on the accounting valuation rather than the funding valuation.

Mr. Hester noted the importance of the census data and asked to confirm that Ms. Smith stated earlier that they would review the entire census database. Ms. Smith confirmed that they would perform analytics and reasonableness testing on the entire census database, but would only test a sample of census data with the agencies.

Mr. Ostroski noted that the last part of the audit were the GASB 68 and 75 schedules, which will start in March 2021 for the August 31, 2020 year end. He then asked for questions or comments.

Ms. Melvin assured CLA that they will have free and full access to records and resources necessary to conduct the audit.

This agenda item was presented for information and discussion purposes only. There was no further discussion or questions and no action was taken.

4. Review of Internal Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Ms. Karen Norman and Ms. Tressie Landry to discuss completed internal audit reports.

The first audit is of the Private Equity with two main scope areas of portfolio management and investments and an overall rating of satisfactory (internal controls were in place).

Ms. Norman began with a discussion of the investment cycle: developing an investment philosophy (planning), investing (execution), and governance (evaluating).

The investment selection process is the review and approval of potential investments into the ERS portfolio. Due diligence of the potential fund drives this process. ERS' depth and breadth of information reviewed results in a comprehensive investment packet for the asset class investment committee to review and confirm the investment. Then investments are continuously monitored, ensuring they perform as expected.

Mr. Chavez noted that the due diligence was an area that is performed very well. Three observations were reported for this audit:

1. Additional information communicated in Annual Asset Class Review would improve clarity (Significant)

Investment Returns - Two key controls related to communication are the annual asset class review and the quarterly summary board reports. The annual summary includes the use of appropriate benchmarks at the aggregate portfolio level. When evaluating performance, it is a framework, not necessarily just one benchmark, rather a combination of several benchmarks determined by what question you are trying to answer. The audit identified that the private equity asset class uses best practices as it relates to their portfolio benchmarks, including peer comparisons to direct peers, overall private equity peers and a public market equivalent.

The use of the public market equivalent benchmark essentially answers the question, “Was the decision to allocate capital to private investments a good one?” This is a relevant benchmark that is a best practice for private equity investments. Because there is additional risk in private investments, it is also a best practice to add a premium to this benchmark when using it for private investment benchmarking.

ERS used the public market equivalent with a premium as the policy benchmark until March 2019, when the board approved the use of a public pension peer benchmark as the policy benchmark. ERS still uses and presents the public market equivalent as a benchmark, however, the premium has been removed. ERS would have exceeded the benchmark even if the premium was included.

In summary, overall the private equity asset class is aligned with best practices and uses a framework for evaluating performance. However, it is general practice to include a premium when using the public market equivalent benchmark. The questions raised by this observation are (1) should there be a premium on the public equivalent benchmark? And if so, (2) what should that premium be?

Mr. Ricardo Lyra, Director of Private Equity, said that the official benchmark was changed to the peer benchmark, so the change wasn't to remove a premium from the official benchmark it was to change the official benchmark. The public equity equivalent benchmark will continue to be presented and a decision can be made whether a premium should be added back to the benchmark.

Sub-Component Level - Mr. Chavez continued that the audit reviewed the performance at the portfolio level, but review at the sub-component level can identify which investments were the performance drivers. Two key questions are did ERS make good decisions within the portfolio across strategies, sectors, geographies, and vintages and select good fund managers (General Partners)? Best practices suggest a pooled performance attribution process which segments the portfolio by different attributes such as investment type or strategy. Again, this is to provide additional information to the Board on where the performance attribution originates from.

Portfolio Management - Ms. Norman reviewed the tactical plan for the asset class. The tactical plan sets the amount of committed dollars that can be invested each year and is approved annually by the Board. It is a roadmap for the upcoming year and a breakout between strategies of how the allocation may be used to maintain the diversification of the portfolio. In line with the hybrid investment philosophy which outlines ranges for diversification and allows flexibility to access opportunities presented after the tactical plan has been approved.

Diversification of investments is how risk is managed and measured and the investment guidelines state the portfolio will diversify by various strategies like geography, industry, lifecycle, and capital structure. However, the annual overview does not include reporting current diversification to targeted allocations, and including this would promote transparency of investments selected in the recent years. Additional information such as trending over multiple years of the strategy allocations would promote transparency.

Portfolio Cost – The annual review provides information related to private equity term, management fees and profit shares, as well as forecasts of cost savings based on negotiated fees. However, the actual total expenses and profit shares are not included (they are included in the Comprehensive Annual Financial Report for ERS). To improve transparency, these actual expenses should be disclosed in the annual review of the asset class.

2. Private Equity investment classification process should be improved (Moderate)

Classification of investments is important because ERS sets forth different diversification metrics and uses these diversifications as a risk management tool. The audit compared ERS' investment classifications with those used by Burgiss', a research quality database that tracks private capital funds and classifies investments into categories. Of the 114 investment classifications 86 did align. The comparison showed differences in investments that have a mixture of asset classes or strategies, such as investments in both buyouts and venture capital.

Included in the report is a recommendation to develop a rules-based methodology of classifying investments to promote a repeatable, consistent, and more objective investment classification process. The recommendation is not to use the Burgiss methodology, but rather to develop one that is suitable to the needs of ERS.

Another area for improvement in investment classification is the definition of secondary investments. ERS Investment Guidelines state that secondary partnerships can include any of the other private equity strategies. Most of the investments that ERS classified as secondaries were classified differently by Burgiss because they do not have a category for secondaries, they classify the investment by the type of investment. Again, the recommendation is not to use the Burgiss methodology, but to develop a standardized taxonomy to ensure consistency.

3. ICP Private Equity goals and procedures not fully developed

Incentive compensation plan (ICP) metrics include a floor for when the award will start paying for performance and a maximum performance level that is a risk control, so staff do not take on too much risk. The observation in the ICP relates to the established max performance level.

Currently, the range where ERS starts awarding performance is when the benchmark is greater than the median, or 50 percentile up to the 37.5 percentile. One hundred percent of the award is achieved at the 37.5 percentile and the 37.5 percentile equates to better performance than 63% of the peer groups. Note: the industry top quartile usually starts at 25 percentile or higher. The recommendation is to provide further information for the utilization of the 37.5 percentile as the max performance level.

The question related to the illiquidity premium is applicable to the ICP calculations since it is used as a benchmark in calculating awards. Previously, there was a 300 basis point premium and it was calculated on a time weighted return and not the internal rate of return. The ICP benchmark is currently calculated on the internal rate of return, which was listed as a reason for excluding the premium; however supporting information for the reason for the changes was not identified.

Mr. Chavez reviewed a chart that provided the historical performance benchmarks for max performance benchmark, actual performance and the realization percentage, noting that even with a premium of 300 basis points, performance awards would have been awarded at 100% due to the level of performance.

The next report is the Status of Audit Recommendations, presented by Ms. Tressie Landry.

Ms. Landry said the methodology to follow-up on audit recommendations begins with the process owners making a self-assessment of the implementation status of each recommendation. Internal Audit then performs a review and either agrees or disagrees with the self-assessed status level. Status levels include: implemented, partially implemented, no action taken, and management acceptance.

This report includes 11 recommendations from eight audit reports. Three recommendations were partially implemented and eight are implemented.

The first partially implemented recommendation is from the Revenue Processing Audit and is a continuing issue related to the implementation of the Centralized Accounting Payroll Personnel System (CAPPS). CAPPS is a state-wide effort to combine all state agencies on a new centralized payroll system operated by the Comptroller of Public Accounts. During implementation for a few state agencies, there were some system issues that caused reporting errors to ERS. A team of internal and external resources have been working on solutions and corrections for quite some time. This issue is expected to continue for a significant time, and will continue to be included in the report until it is resolved. The system errors require ERS staff to do additional manual work to ensure that annuity payments are correct.

The solutions thus far have included manual corrections to system issues for the smaller agencies with work on a systemic fix for larger agency still in progress. There will also need to be corrections to data for the errors.

The other two partially implemented recommendations are from the HealthSelect of Texas® Denial Process Report and the Temporary Worker Contract Management Report. These two recommendations are awaiting finalization of some procedures and require additional time.

Ms. Landry addressed a question from Ms. Melvin, stating that process owners may implement procedures or changes that are different than what is included in the recommendation, especially if processes change over time. Internal Audit reviews to determine whether the risk was addressed by the changes made.

This agenda item was presented for information and discussion purposes only. There was no further discussion or questions and no action was taken.

5. Review and Consideration of Audit Administrative Items: Internal Audit's Proposed Fiscal Year 2021 Audit Plan – (ACTION)

Mr. Chavez presented the proposed Fiscal Year 2021 Internal Audit Plan. Internal Audit is required to have a risk based annual audit plan. The plan starts with the audit universe and risks are assessed and prioritized as it relates to each program. Available audit resources are applied to finalize the plan.

The program risks are generally not going to change from year to year, so sometimes a major factor in the prioritization is the time since the last audit. That and the impact of COVID-19 were the two major factors that impacted the prioritization this year.

These priorities are always coordinated with the Audit Committee and the executive office as well as input from the division directors. External interests are also considered.

For FY21 there is estimated to be 9,300 hours to apply to audit projects, which is a factor in deciding how many projects can be completed in the year.

There being no questions, the Board of Trustees took the following action:

Move that the Board of Trustees Audit Committee of the Employees Retirement System of Texas approve and adopt the proposed Fiscal Year 2021 ERS' Internal Audit Plan as listed in Exhibit A of the agenda item.

Motion by Brian Barth second by Craig Hester

Final Resolution: Motion Carries

Aye: Craig Hester, Brian Barth, Ilesa Daniels, Jim Kee, Catherine Melvin

6. Review of Audit Administrative Items: Annual Internal Audit Independence Assessment

Mr. Chavez presented the annual internal audit independence assessment. Internal Audit is required to follow both the governmental auditing standards and professional internal audit standards, of which one is the requirement to maintain independence.

Internal Audit follows a conceptual framework to identify any threats to independence and evaluate the significance of those threats. If any are identified, there are several safeguards available to reduce or eliminate the threat.

Mr. Chavez formally communicated that the Internal Audit Division is free from threats of independence at both an individual and organizational level. There are safeguards in place for the non-audit services performed by the office to prevent impacts to independence.

This agenda item was presented for information and discussion purposes only. There was no further discussion or questions and no action was taken.

7. Adjournment of the Board of Trustees Audit Committee Meeting

The Audit Committee meeting adjourned at 9:37 a.m. on Wednesday, August 19, 2020.