



## Audit Committee Meeting

March 10, 2021

# ERS

EMPLOYEES  RETIREMENT  
SYSTEM OF TEXAS

**Presented for Review and Approval**

**August 25, 2021**

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**AUDIT COMMITTEE MEETING  
EMPLOYEES RETIREMENT SYSTEM OF TEXAS  
March 10, 2021**

The March 10, 2021 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, 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 members of the Board participated in the meeting remotely and will be visible and/or audible to the public.

**TRUSTEES PRESENT**

Brian Barth, Audit Committee Chair  
Craig Hester, Board Chair  
Catherine Melvin, Board Vice-Chair  
Ilesa Daniels, Member  
Dr. James Kee, 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  
Machelle Pharr, Chief Financial Officer  
DeeDee Sterns, Director of Human Resources  
Chuck Turner, Chief Information Officer

**ERS STAFF PRESENT**

Kelley Davenport, Executive Office  
Tiffani Jenkins, Benefits Communications  
Lanesia Jones, Investments  
Tressie Landry, Internal Audit  
Bruce Martin, Information Systems  
John Streun, Investments

**ALSO PRESENT**

Jason Ostroski, CliftonLarsonAllen LLP

## **Meeting of the ERS Board of Trustees Audit Committee**

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

Mr. Brian Barth, 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, March 10, 2021 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 11:39 a.m. on Monday, March 1, 2021, as required by Chapter 551 Texas Government Code, referred to as the Open Meetings Law.”

### **2. Review and Approval of the Minutes to the August 19, 2020 ERS Audit Committee Meeting – (ACTION)**

Chair Brian Barth opened the floor for a motion on the approval of the minutes from the December 8, 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 December 8, 2020.

**Motion** by Craig Hester second by Catherine Melvin

Final Resolution: Motion Carries

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

### **3. Review of External Audit Reports**

Tony Chavez, Internal Audit Director, introduced Jason Ostroski, Principal from CliftonLarsonAllen, LLP (CLA), the accounting firm that conducted the financial statement audit of ERS' Annual Consolidated Financial Report.

Mr. Ostroski introduced himself as the engagement Principal and informed the Committee that he would review the results of the 2020 financial statement audit. In addition to the auditor's opinion, they issued other required communications and reports that will be included in his review.

#### Audit Results and Procedures:

Mr. Ostroski reported that CLA issued an unmodified opinion of the financial statements, meaning the statements are fairly presented in conformity with U.S. Generally Accepted Accounting Principles (GAAP).

Limited procedures (no opinion issued) were performed on the management discussion and analysis, required supplemental information, the introductory, investment, actuarial or statistical sections of the ACRF. The checklist for the Government Finance Officers Association is reviewed and CLA ensured all required components were included in those sections and reviewed for consistency throughout the report.

CLA performed limited procedures and reported an “in-relation to” unmodified opinion on the supplemental information and additional schedules contained in the financial section including a schedule of administrative expenses, investment expenses and payments to consultants. The in-relation to opinion was unmodified. This opinion is not directly issued, but rather is an opinion of these supplemental schedules “in relation-to” the financial statements as a whole.

#### Other Communications

A report on Internal Control over Financial Reporting, Compliance and Other Matters, which is required by Governmental Auditing Standards was issued. No material weaknesses, significant deficiencies or material findings were reported with compliance with laws, regulations or other matters.

Other information required by Government Auditing Standards is included in information provided to each Audit Committee member. These required communications include:

- *The responsibilities of auditors and management* – the auditor’s responsibility is to issue an opinion on whether the financial statements are reported fairly in accordance with the U.S. GAAP and management is responsible for the presentation of the financial statements
- *Significant Accounting Policies* – one significant account policy implementation was Governmental Accounting Standards Board (GASB) statement 84. GASB 84 impacted agency funds, which are funds held by ERS on behalf of another party, by removing the agency fund designation. This change can be seen on the financial statements by comparing the FY19 and FY20 balance sheet and income statements – in FY19 agency funds were included as a separate column, but in FY20 they have been included in the governmental funds. The amounts are insignificant, but the presentation change is significant.
- *Any audit adjustments or passed adjustments* – none were identified for FY20
- *Management judgments and accounting estimates* –
  - Valuation of alternative investments is one of the significant management judgments and accounting estimates
  - Actuarial information, assumptions and methods used – Mr. Hester asked for Mr. Ostroski’s comments on the long term rate of return used by ERS and in Mr. Ostroski’s opinion the ERS long term rate of return is within the range of industry standards
- *Other information* – management was very cooperative, no disagreements with management, management did not consult with other accountants on the application of GAAP or GAAS, no major issues were discussed with management prior to retention and management made required representations to CLA.

Mr. Ostroski reviewed the data analysis performed during the audit which included an analysis of 2019 and 2020 benefit payments, trend analysis, comparing census data to benefit payments and searched for significant payment swings. In future years, CLA will expand the types of analysis performed.

#### 2020 GASB 68/75 Schedule Update

GASB 68 and 75 schedules essentially allocate the net pension liability, as well as net other postemployment benefits (OPEB) liability, to participating employers (state agencies and institutions of higher education). This is audited by ERS’ auditor and provided by ERS to the employing agencies so that their auditors can rely on the allocation of the pension and OPEB liabilities to that agency. CLA expects to issue their opinion report on these schedules in April 2021.

#### Conclusion

Mr. Ostroski summarized his presentation stating the audit process overall went very well, even given the challenges of remote working. Catherine Melvin inquired if there was any additional information that the Audit Committee members should know or consider. Mr. Ostroski noted that there were some minor best practices that were shared with the Chief Financial Officer (CFO), Machel Pharr, but nothing significant enough to bring to the attention of Committee members.

Ms. Melvin asked Ms. Pharr to comment on the experience of new auditor, noting the State Auditor’s Office has performed the audit for several years. Ms. Pharr stated that it was challenging working with a new auditor during a time of required remote work and initially there were some delays, but the team and auditors were able to work through those and get the auditors the information and access they required. There were also some procedural changes that were unique to CLA, especially with communication to state agencies, but the steps seemed to strengthen the agencies’ understanding of their responsibilities to employee benefits as an employer.

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

#### **4. Review of Internal Reports**

##### Internal Public Equity

Mr. Chavez presented the results of the Internal Public Equity audit by introducing the size of the global public equity portfolio in the total ERS Trust. Global public equity represents 42% of the total Trust, of which 73% of that is internally managed. This internally managed portfolio was the subject of this engagement.

Internal audit aligned this engagement with the “Support the retirement income security of members, retirees, and beneficiaries” strategic goal. The global public equity portfolio is a return-seeking asset class.

The objective of the audit was to determine if public equity investments managed internally by ERS’ Investments team members are in accordance with the ERS Investment Policy. There were two scope areas:

- Investment Management
- Governance

The overall assessment was satisfactory in Investment Management and a needs improvement in the Governance scope area where one observation was identified.

##### Investment Governance

A few years ago the Board amended the Investment Policy to move from a rules based policy to a principles based policy. Part of that revision included an investment governance structure where ERS Investment professionals report to the Board on monthly performance summaries, quarterly summaries and compliance, and annual asset class and Trust reviews. The annual asset class review was identified as a key control because it is the activity during the year where the investment team provide their results, insight and assessment of the performance of the asset class and summarizes all the information provided to the Board members during the year. This process also allows for feedback from the Board as a whole and is a conduit for advice on going forward and a time to discuss what the team is doing well and improvements going forward.

The annual asset class review is a best practice and does provide good information including:

- Short term investment performance (annual performance)
- Investment risks (tracking error) – the Board has established risk parameters and the investment team had controls to ensure they were within those parameters
- Portfolio implementation decisions and allocations
- Other information required to be reported by the Investment Policy such as portfolio costs

Observation – Annual review does not provide the Board/IAC with all information needed to facilitate a discussion of Global Public Equity’s *long-term performance* in meeting strategic objectives

Internal audit reviewed the ERS Strategic Plan, Investment Policy Statement, investment team Board/IAC meeting presentations and industry guidance to determine what long-term performance reporting would look like and what information should be included. Some of the key elements identified include:

- Long-term performance information presented based on a rolling average to mitigate the impact of short-term
- Internal versus externally managed fund performance
- Return performance attribution

From these key elements, a framework was developed with questions that, together, should be answered in the annual asset class review. These questions were aligned with the ERS Strategic Plan, Investment Policy Statement and best practices. These questions include:

1. How did the asset class contribute to supporting member retirement income security?
2. Was the decision to allocate capital to the asset class a good one?
3. Did Public Equity meet its investment objective?
4. How effective was the Public Equity investment strategy?
5. Did we make good allocation decisions across portfolios, sectors, geographies, and strategies (factor tilts)?
6. How effective was active management?

Mr. Hester commented that these questions should be recommended for all asset classes. In addition, asset class directors should be reporting during their annual asset class reviews:

1. Whether they are in line with the policy during the period of time and if not, why? Where there any deviations from the policy?
2. Rolling three-to-five-to-ten year rolling average performance reports
3. From asset allocation decisions, what allocation decisions were made in the previous year? Were there shifts between domestic and international, large cap and small cap, etc.?

Mr. Chavez noted that the annual review does include some information on the risk parameters and the asset allocation decisions. In summary for the observation, Internal Audit identified a lack of long-term performance information and charts or other data visualizations to improve the communication of performance results in the annual asset class review.

Example graphs were created by Internal Audit and included in the audit report to show possible answers to each of the listed questions in the framework and while they are based on information from the ERS custodian, they are not official investment reports and for illustration and discussion purposes.

Audit recommends the asset class director should:

- Identify key performance questions that address long-term performance in meeting strategic goals
- Develop corresponding charts and other data visualization to answer key performance questions
- Communicate and discuss performance results during annual asset class review

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

#### Status of Audit Recommendations

Mr. Chavez introduced Tressie Landry, Internal Audit Manager, to present the results of Internal Audit follow-up of prior audit recommendations.

Ms. Landry described the methodology to follow-up on prior recommendations, stating the auditor asks the process owner to provide an implementation self-assessment of either implemented, partially implemented, no action taken or management acceptance of the risk. The auditor may review documentation or perform limited testing to determine if they agree with the implementation rating. The area is not re-audited, but rather the determination is made whether the actions taken by management would address the risk presented in the audit finding.

This report includes three recommendations from three reports, which are listed below with the implementation status reported by management and agreed to by Internal Audit:

- Disability Retirements (2016-06) observation 1 – Implemented
- HealthSelect of Texas® Contract Management (2018-05) – observation 1 – Implemented
- Temporary Workers Contract Management (2019-02) – observation 1 – Partially Implemented with an expected implementation date after March 2021
- There were no further questions or discussion, and no action was required on this item.

## **5. Review, Discussion and Consideration of Internal Audit Administrative Items – (Action)**

Mr. Chavez asked Ms. Landry to review the Internal Audit Charter and Audit Committee Charter. We review the Internal Audit Charter to inform and prompt discussion, make changes necessitated by changes in audit standards and to reinforce the roles and responsibilities to the agency. The review this year did not identify any changes necessary to the document.

Next, Ms. Landry reviewed the Audit Committee Charter which establishes the purpose of the Audit Committee, the authority of the Committee to direct the Internal Audit Director to conduct audits and allows the Audit Committee to hire external auditors or consultants to investigate any matters within the authority of the Committee.

There is a suggested change to the Audit Committee Charter – the proposal is to remove the requirement for the Internal Audit Charter to approve each year due to the fact that there are few changes to the responsibilities or auditing standards that would necessitate the need to change the Charter.

Dr. James Kee asked for clarification on the impact of not making the recommended change and Mr. Chavez noted that the approval is documented via signatures and the change would eliminate the need for annual signatures on the document. Ms. Melvin confirmed that it is still the intent to review the Internal Audit Charter every year whether there are recommended changes.

**Move:** Move that the Audit Committee of the Employees Retirement System of Texas approve updates to the Internal Audit Charter and/or the Audit Committee Charter as discussed in this agenda item.

**Motion** by Craig Hester, second by Dr. James Kee  
Final Resolution: Motion Carries  
Aye: Brian Barth, Ilesa Daniels, Catherine Melvin

## **6. Adjournment of the Board of Trustees Audit Committee Meeting**

The Audit Committee meeting adjourned at 8:57 a.m. on Wednesday, March 10, 2021.