ERS

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

ERS INTERNAL AUDIT DIVISION

To provide independent and objective assurance on the effectiveness of controls and operations to meet ERS' strategic directions.

Internal Audit Risk Assessment & Proposed FY22 Annual Audit Plan

August 25, 2021

FROM THE AUDIT DIRECTOR

We are pleased to submit the Internal Audit Risk Assessment and Proposed Internal Audit Plan (Plan) for Fiscal Year 2022.

The Texas Internal Auditing Act (Texas Government Code 2102) requires that a risk-based annual audit plan be developed and approved by the Board of Trustees. The Plan is designed to provide coverage of key risks, given the existing staff and approved budget. Key risks were determined based on a systematic approach incorporating management input, Internal Audit analysis and ERS' strategic objectives.

Continuous evaluation of the Plan, based on risks identified, timing of ERS' initiatives and staff availability could result in modifications to the Plan during the year. Amendments to the approved Audit Plan deemed significant will be coordinated with the Executive Director and submitted to the Audit Committee Chair for review and approval.

Sincerely,

Anthony Chavez, CIA, CGAP, CRMA
Director, Internal Audit Division

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AUDIT PLAN OVERVIEW

The annual internal audit plan is developed based on ERS' audit universe, stakeholder input and an assessment of risk and exposures affecting ERS. The objective of a risk-based audit plan is to identify and prioritize operational functions that present the greatest risk to meeting agency objectives and goals. In assessing risk ratings for each auditable unit, Internal Audit focuses on the inherent risk of each function. *Inherent risk is the susceptibility of not meeting agency objectives assuming there are no mitigating controls.* Consideration of mitigating controls in addressing key inherent risk was evaluated based on prior period audit engagements, discussions with senior management and industry knowledge. *See Appendix A* for a detailed description of the Audit Plan methodology.

The Chief Audit Executive must establish a risk-based audit plan to determine the priorities of the Internal Audit Activity, consistent with organization's goals. (IIA Standard 2010—Planning)

KEY TAKEAWAYS AND REVISIONS

In addition to overall risk rating of individual audit units, the following factors had a significant influence on the inclusion of individual engagements in the final Proposed Audit Plan:

- Areas of limited or no prior year audit coverage
- General market conditions
- Communication and discussions held during Board of Trustee meetings

No significant reviews were incorporated into the audit plan methodology or audit universes.

Internal Audit performs multiple types of audit engagements that provide various levels of service and assurance. Each engagement type has unique performance and reporting requirements to comply with audit standards. Standard project engagement types include:

AUDITS (75%) - Nature and scope of the engagement determined by Internal Audit; Highest level of assurance; Deliverable: Report for public distribution

CONSULTING (15%) - Nature and scope of engagement subject to agreement with audit customer; No assurance provided; Deliverable: report or memo with limited distribution.

AGREED UPON PROCEDURES (5%) - Specific procedures agreed to between management and Internal Audit to perform and report on the results; Lowest level of assurance; Deliverable: Report or memo for public distribution

INFORMAL CONSULTING (5%) - Ad-hoc assistance; Subject matter expert input ; Deliverable: Verbal discussions or memo to management.

Internal Audit is an independent, objective assurance and consulting activity that is guided by a philosophy of adding value and improving the operations of the Employees Retirement System (ERS).

Internal Audit assists ERS in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organization's risk management.

FY 22 PROPOSED ANNUAL INTERNAL AUDIT PLAN

CORE BUSINESS	ENGAGEMENT OBJECTIVE
INVESTMENTS	**Private Real Estate**[1] **—** *To determine if investments in private real estate are in accordance with ERS Investment Policy. (AUDIT)* **Public Equity—Externally Managed —***To determine if investments in externally managed public equity are in accordance with ERS Investment Policy. (AUDIT)*
MEMBER SERVICES	**Dental Insurance**[1] **-** *To determine if contract management over the dental insurance program ensures member benefits are properly delivered. (AUDIT)* **Budgeting**[2]*— To evaluate the planning and managing of ERS Operating Budget. (AUDIT)* **ERS Performance Measure Management—***Determine whether ERS is accurately reporting its performance measures to the Automated Budget and Evaluation System of Texas (ABEST) and whether adequate controls exist over the collection, calculation, and reporting of its performance measures. (AUDIT)* **Contact Center***—Determine whether the member services delivered via the contact center are delivered timely and accurately. (AUDIT)* **Pension Forecasting**[1]*— To determine if the methodology and assumptions for Pension valuations are reasonable and internally consistent. (AUDIT)*
INFORMATION SYSTEMS	**Security Monitoring & Event Analysis**[1]*—To determine if policies and processes ensure the effective and efficient use of information technology to meet ERS strategic goals and objectives. (AUDIT)* **Cyber Security Framework***— Review the cyber security framework to ensure proper security mechanisms are in place and compliant with relevant regulations or best practices. (AUDIT)* **Disaster Recover***— Determine if processes and procedures are designed to ensure the continuance of key business functions in the event of a disruption. (AUDIT)*
ENTERPRISE	**Financial Opinion Audit***—To opine on whether ERS' fiscal year 2021 annual financial statements are free from material misstatement and in conformity with generally accepted accounting principles. (AUDIT)*

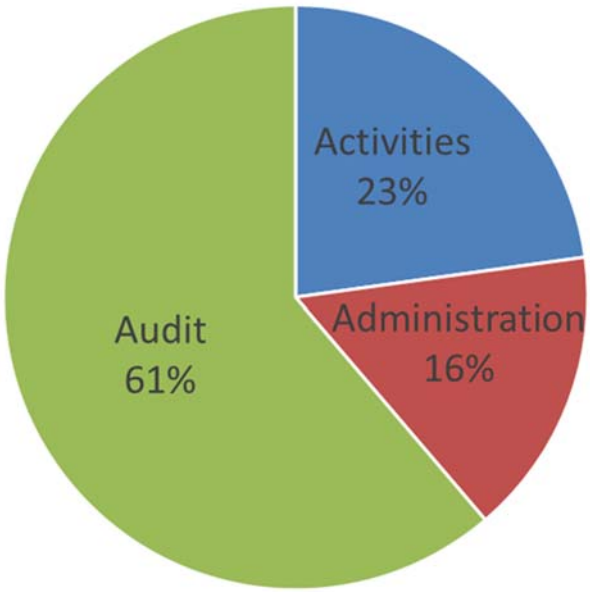
[1] Audit began in FY21 and carried forward to FY22 Audit Plan

[2] FY21 carryover, audit was not started

OPERATING BUDGET

Internal Audit is allocated five (5) full-time equivalent (FTE) audit positions with an operating budget of approximately $1.2 million which includes **$234,000** for required financial audit work. Based on FTEs and co-source audit resources, estimated available audit hours are **9,300.** Internal Audit is required by laws and professional audit standards to conduct certain activities on an annual and/or periodic basis (see IA Major Activities). Those activities are also included in the estimated audit hours.

Resources (employees and operating budget) are adequate to complete the projects listed in the proposed FY22 Annual Audit Plan.



FY22 INTERNAL AUDIT MAJOR ACTIVITIES

Risk Assessment & Annual Audit Plan	Assess and update ERS Audit Universe and corresponding risk ratings. Develop the FY23 Annual Internal Audit Plan in coordination with the Board and Executive Office.
Internal Audit Quality Assurance Improvement Program Review	Conduct an annual self-assessment of Internal Audit's compliance with professional auditing standards.
Annual Internal Audit Report	Prepare annual report of audit activities in accordance with statutory requirements for submission to required agencies.
Status of Audit Recommendations	Report on the implementation status of Management Action Plans (MAPs) to address prior audit observations and recommendations.
External Audit Liaison and Oversight	Coordinate audits and other activities between external regulatory agencies and ERS.
Fraud, Waste & Abuse	Coordinate tracking, disposition, and reporting instances via ERS' public website, ERS' Intranet and SAO Hotline Complaints.

APPENDIX A—AUDIT PLAN METHODOLOGY

1) **Evaluate Audit Universe -** The audit universe represents all the functions, programs and activities available to audit (audit units). The audit universe is reviewed and updated to reflect changes in strategic directives or organization structure during the prior year. *(See Appendix B)*

2) **Review Risk Criteria -** For each audit universe, unique risk factors are used to assess risk. Risk factors are intended to align with current goals and objectives of ERS' core functions. Risk factors are weighted based on strategic goals, external landscape and emerging risks for the upcoming fiscal year. *(See Appendix C)*

3) **Gather Stakeholder Input -** Held discussions with members of management to solicit input over planned activity, challenges that may impact meeting goals and objectives and potential areas of interest from governing bodies.

4) **Risk Rate Audit Units -** Utilizing risk criteria, measure the inherent risk of each audit unit in meeting ERS' strategic missions.

5) **Analyze Risk Scores -** Review risk results by core business function, business objective/process and auditable unit. Discuss results with executive and senior management for reasonableness.

6) **Prioritize Auditable Units -** Narrow the list of potential audits deemed high value for ERS. Include key operational functions that were assessed lower risk ratings, but periodic review is deemed necessary and appropriate. Discuss results with Executive Management.

7) **Board Communication -** Communicate with Board results of the annual audit plan procedures. Incorporate feedback received regarding Board priorities into proposed audit plan.

Audit provides essential accountability and transparency over government programs. Given the current challenges facing governments and their programs, the oversight provided through audit activities is more critical than ever. Audits provide objective analysis and information needed to make decisions necessary to create a better future.

The Internal Audit Division's audit engagements are conducted in accordance with the United States Government Accountability Office's (GAO) Government Auditing Standards, the Institute of Internal Auditors' (IIA) International Professional Practices Framework, the Texas Internal Auditing Act (Texas Government Code, Chapter 2102) and Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2013 Framework.

APPENDIX B—AUDIT UNIVERSE

ERS Investments

Prior Audits (5 years) | External Audits | FY 2022 Audits

GOVERNANCE

Policy

- Asset Allocation
- Performance Measurement (Benchmarking)
- Incentive Compensation
- Investment Diversification Limits
- Investment Governance
- Tactical Planning

Management

- Investment Compliance
- Corporate Actions
- Proxy Voting

INVESTMENTS

Return Seeking

- Private Equity
- Private Infrastructure
- **Credit**
  - Internally Managed
  - Externally Managed
- **Real Estate**
  - Private RE
  - Public RE
- Opportunistic Credit
- **Public Equity**
  - Internally Managed
  - Externally Managed
  - Emerging Managers
  - Directional Growth
  - Special Situations
  - Trading

Risk Reduction / Liquidity

- Cash
- Rates
- Securities Lending
- Absolute Return (Hedge Funds)
- Texas Employees Group Benefits Program (Insurance Portfolio)

OPERATIONS

Financial

- Management Fees
- Profit Sharing
- Valuations
- Investment Accounting
- Investment Reporting

Services

- Investment Performance
- Trade Settlements
- Back Office Due Diligence
- Alternative Investment Fund Processing

Member Services

Prior Audits (5 years) | External Audits | FY 2022 Audits

STRATEGIC MANAGEMENT

Governance

- Strategic Planning
- Ethics & Compliance
- Public Information & Records Retention
- Legislative Reporting
- Business Continuity

Program Management

- Enterprise Risk Management
- Enterprise Planning
- Pension Forecasting
- GBP Rate Development & Analysis
- Insurance Forecasting

MEMBER PROGRAMS

Group Benefits

- **Health Insurance**
  - HealthSelect
  - Health Maintenance Organizations (HMOs)
  - Medicare Advantage
- Vision
- Appeals Administration
- Life Insurance
- Prescription Drug Program
- Disability Insurance
- Dental Insurance
- Flexible Spending Accounts
- Wellness
- Contact Center

Retirement

- Disability Retirements
- Deferred Compensation (Texa$aver)
- Retirement Account Withdrawals
- Standard Retirements
- Survivor Benefits
- Service Credits
- Qualified Domestic Relations Orders

OPERATIONS

Financial

- Budgeting
- Travel
- Financial Reporting
- Agency Accounting
- Procurement
- Member Program Accounting
- Purchasing

Support Services

- Facility Management
- Legal Services
- Communications
- Print Services
- Contracting
- **Human Resources**
  - Workforce Management
  - Personnel Administration
  - Employee Training
  - Temporary Workforce
- Benefit Coordinators
- Physical Security

Information Technology

Prior Audits (5 years) | External Audits | FY 2022 Audits

BUSINESS APPLICATION

Member Services	Investments	Operations
PS Pension	Bloomberg	PS Financials
PS - Benefits	FactSet	PS Human Resources
BI Data Warehouse	n-Tier	Concur
	Eagle Investment Accounting System	Clarity

MANAGEMENT

Governance		Support Services	
IT Governance	Data Governance	Service Desk	Remote Connectivity
Asset Management	Cloud Management	Database Administration	Network Services
IS Acquisition	Project Prioritization	Mobile Devices	Website Administration

Information Technology

Prior Audits (5 years) | External Audits | FY2022 Audits

CYBER SECURITY

Detect

- Malware Protection
- Security Monitoring & Event Analysis
- Vulnerability Assessment

Recover

- Disaster Recovery Procedures

Respond

- Cybersecurity Incident Response
- Privacy Incident Response

Identify

- Privacy and Confidentiality
- Data Classification
- Critical Information Asset Inventory
- Enterprise Security Policy, Standards and Guidelines
- Control Oversight and Safeguard Assurance
- Information Security Risk Management
- Security Oversight and Governance
- Security Compliance and Regulatory Requirements Management
- Cloud Usage and Security
- Security Assessment and Authorization / Technology Risk Assessments
- External Vendors and Third Party Providers

Protect

- Enterprise Architecture, Roadmap & Emerging Technology
- Secure System Services, Acquisition and Development
- Security Awareness and Training
- Privacy Awareness and Training
- Cryptography
- Secure Configuration Management
- Change Management
- Contingency Planning
- Media
- Physical Environmental Protection
- Personnel Security
- Third-Party Personnel Security
- System Configuration Hardening & Patch Management
- Access Control
- Account Management
- Security Systems Management
- Network Access and Perimeter Controls
- Internet Content Filtering
- Data Loss Prevention
- Identification & Authentication
- Spam Filtering
- Portable & Remote Computing
- System Communications Protection

RISK	INVESTMENT RISK ATTRIBUTES	MEMBER SERVICES RISK ATTRIBUTES	INFORMATION SERVICES RISK ATTRIBUTES
STRATEGIC (Directive)	• Board/Management initiative • Asset allocation targets and ranges • Tactical planning and positioning (over/under weight) • High tracking error volatility • Legislative interest • Public perception • Investment literacy (complexity)	• Criticality to achieving mission • Board/Management initiative • Reputation loss if goals not achieved • Size of population served • Criticality of service/program provided • Legislative interest • Public perception	• Criticality data/system in achieving mission • Level of system availability required to achieve mission • System delivery direct to members • Reputation loss if goals not achieved • Size of population served • Legislative interest
OPERATIONAL (Implementation)	• Asset class maturity • Complexity of investment strategy • Market accessibility to meet tactical plans • Investment risk management complexity • Required expertise • Staffing levels/Turnover • Level of external management • Opportunity for personal gain, misuse/misappropriation;	• Service/Program complexity and maturity • Transaction volume • Required expertise • Staffing levels/Turnover • Level of external management in delivery services • Opportunity for personal gain, misuse/misappropriation	• System complexity and maturity • Required confidentiality of data/transactions • Transaction volume • Level of data ownership • Data origination (internal vs. external) • Staffing levels/turnover
FINANCIAL (Dollars)	• Percent of total fund balance • Frequency of valuation (market price) • Utilization of leverage as part of investment strategy • Liquidity • Risk for material financial misstatement • Corresponding incentive compensation	• Total program expenditures • Level of cost oversight of expenditures (direct payment vs. pass-through) • Market cost conditions and trends • Cost transparency • Risk for material financial misstatement	• Total direct cost of information system • Total cost for related program • Risk for material financial misstatement
REGULATORY (Mandates)	• Volume and complexity of regulatory requirements • Level of negative public perception from non-compliance • Potential loss of autonomy/stewardship from non-compliance • Severity of fines from non-compliance • Time since last audit • Prior audit observations • Potential for conflict of interest		