Audit Committee Meeting

March 11, 2020

ERS
EMPLOYEES RETIREMENT
SYSTEM OF TEXAS

Presented for Review and Approval

May 20, 2020

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AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
March 11, 2020
TRS Board Room, E513
TRS Building - 1000 Red River Street
Austin, Texas 78701

TRUSTEES PRESENT
Catherine Melvin, Audit Chair
Brian Barth, Member
Ilesa Daniels, Member
I. Craig Hester, Member
Jim Kee, Member

ERS DIRECTORS 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
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director of Procurement and Contract Oversight
Dee Dee Sterns, Director of Human Resources
Kathryn Tesar, Director of Benefits Communications
Tom Tull, Chief Investment Officer
Chuck Turner, Chief Information Officer
Keith Yawn, Director of Strategic Initiatives

ERS STAFF PRESENT
Jason Avants, Information Systems
Georgina Bouton, Group Benefits
Kelley Davenport, Executive Office
Juli Davila, Investments
Pablo de la Sierra, Investments
Aaron Ismail, Internal Audit
Tressie Landry, Internal Audit
Greg Magness, Internal Audit
Betty Martin, Investments
Roger Nooner, Benefits Communications
Jonathan Puckett, Internal Audit
Susie Ramirez, Executive Office
Tanna Ridgway, Investments
Mary Jane Wardlow, Executive Office
Ariana Whaley, Executive Office

ALSO PRESENT
Ann Bishop, Texas Public Employees Association
Adrienne Cabrera, Office of the Governor
Michael Clayton, State Auditor's Office
Ryan Falls, Gabriel Roeder & Smith
Joe Newton, Gabriel Roeder & Smith
Kelley Ngaide, State Auditor's Office
Tom Nun, Great–West Life & Annuity Insurance Company
Colleen McGlamry, UnitedHealthcare
Rick Villarreal, Community First Health Plan

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 Board of Trustees 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. 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 8:37 a.m. on Tuesday, March 3, 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 December 10, 2019 ERS Audit Committee Meeting – (ACTION)

Ms. Melvin opened the floor for a motion on the approval of the minutes from the December 10, 2019 ERS Audit Committee meeting.

The Board then took the following action:

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes to the meeting held on December 10, 2019.

Motion by Craig Hester, second by Jim Kee
Final Resolution: Motion Carries
Aye: Craig Hester, Doug Danzeiser, Ilesa Daniels, Catherine Melvin, Jim Kee

3. Review of External Audit Reports

Mr. Tony Chavez, Director of Internal Audit, introduced Kelley Ngaide and Michael Clayton with the State Auditor's Office (SAO) to present the results from the Fiscal Year 2019 Financial Statement Opinion Audit. There were two deliverables associated with this report including the independent auditor's report, which was an unqualified opinion, and a report on ERS' internal controls. It was also noted that the State Auditor's Office provided a memo to the legislative audit committee that summarizes the results of work performed. This is included in exhibits A, B, and C of the State Auditor's Office deliverables.

Mr. Clayton described his role in the audit as the audit manager and Ms. Ngaide's role as the project manager. The auditors' issued an unqualified opinion, which means they determined that the financial statements as presented were materially correct and were reported in accordance with generally accepted accounting principles. This also means that the report as stated was not misleading to the reader of financial statements.

For their opinion, they looked at the key parts of the system, any benefit system operations, including investments, benefits, and also insurance. That included verifying that the state and member contribution amounts were accurately stated, looking at the payments to retirees and insurance companies to ensure those were correct as well, and also looking at investment balances, asset balances recorded on the financial statement, as well as investment and income accounts to determine if those were accurately stated in the financial statement.

Ms. Ngaide reviewed the three deliverables:

- the Financial Statement Opinion, dated December 20, 2019, noting the SAO issued an unqualified opinion for the Fiscal Year 2019 financial statements,
- the report on Internal Control over Financial Reporting and on Compliance and Other Matters, dated December 20, 2019 required for audits performed in accordance with generally accepted government auditing standards, noting that the majority of the internal controls tested were operating effectively. However, there was a significant error in an entry in the fiduciary funds which was corrected before the financial statements were issued and
- the Report to the Legislative Audit Committee, which is the oversight body of the State Auditor's Office, noting that the report summarizes the results of the previous two reports.

Ms. Melvin requested that Chief Financial Officer Machelle Pharr provide more information on the error. Ms. Pharr confirmed that there was an error of $440 million. The error resulted from consolidating portfolios at the end of the year. They recorded receivables, transactions, and payments in the investment accounting system, which created an interface to the general ledger. These were included in the financial statement because it was the end of the year.

ERS Finance was made aware of the error and reversed it so that it would not be reflected in the financial statements. They have modified their procedures to make sure that any similar items in the future, such as intercompany transactions, are eliminated before they produce financial statements. They are also reviewing underlying guidance given to the custodian bank as to how they recorded those as receivables and payables.

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

4. Review of Internal Audit Reports

Mr. Chavez introduced the first report, an Information Technology (IT) Governance Review, which was performed as an advisory or consulting project. These engagements are similar to an internal audit report, but any observations do not require a management response, nor are they color coded by severity. In addition, Internal Audit collaborates more with division owners on the scope areas and review procedures for these types of projects. Mr. Chavez introduced Tressie Landry, audit manager, and Jonathan Puckett, audit lead.

Mr. Puckett thanked Chuck Turner, Chief Information Officer, and others throughout the agency for providing their input and assistance in this review. The objective for this review was to determine if policies and processes ensure the effective and efficient use of information technology to meet ERS' strategic objectives. In every audit or project that Internal Audit performs, program objectives of the business unit are identified. Information Systems provided their program objective for IT governance, which is to understand the risk / controls used to achieve IT objectives to help ensure that they are aligned with business objectives.

IT governance is how an organization uses information technology to meet its strategic objectives. Information technology and an organization's strategic objectives go hand-in-hand.

Mr. Puckett noted that in the background section on page three of the report, there are some best practices that IT governance should focus on. These best practice attributes include:

- Aligning IT strategies with organizational objectives and goals,
- Identifying and managing risk,
- Optimizing IT investments so that ERS gets value as an agency,
- Managing IT resources efficiently and
- Defining, measuring, and reporting performance through meaningful metrics

The results of the review show that IT governance at ERS is adequately established to allow for management to achieve its stated goals and objectives. This result was established by reviewing the best practices previously mentioned and determining if ERS has addressed each of those best practices. To do this, Internal Audit reviewed governance procedures that are currently in place:

- Annual project meetings, project planning meetings, and budget meetings,
- Weekly directors' meetings,
- Meetings with Information Systems business analysts and division leadership,
- Project manager meetings with business analysts and
- Data governance council monthly meetings.

Internal Audit looked at each best practice and determined if any of the current procedures address each of those.

All ERS's current IT governance processes address the first best practice attribute. For each of the remaining best practices, there is at least one IT governance process that addressed each except for the

last one, which is defining and reporting performance metrics. For this best practice, it was noted improvements could be made.

One observation was reported for this project, which was that identifying and improving communication of strategic metrics would provide insight into the effectiveness of IT governance.

Dr. Kee began a discussion on the attribute of optimizing IT investments. Mr. Puckett summarized that annual project and budget meetings, as well as meetings between business analysts and division leaders, inform management on the effectiveness of IT investments. Mr. Chavez added that individual project plans include metrics for why a new system or change to a system is necessary, how it will improve the program, and how success will be measured.

Mr. Puckett continued, noting the Information Systems (IS) Division does track some performance metrics, but it has not identified which metrics are critical or strategic and how to report each of those. One challenge to this process is the substantial amount of data available to the IS Division that could be used for these metrics. In addition, there is a large number of performance metrics suggested in best practices.

Mr. Puckett presented an example of performance metrics suggested in best practices. It listed 45 different areas of data governance, and there is one or more performance metrics for each of those. In order to narrow the relevant metrics, Internal Audit surveyed division directors, Executive Office, and IS management on how they would prioritize different information systems activities related to four different areas of IT governance. Each of the activities in the survey were tied to specific performance metrics that were found in best practices.

Every surveyed staff member responded, including all directors, executive office member, and IS management. The results of the survey, also found on page five of the report, lists the key takeaways and suggested metrics for each IT governance area based on the results of the survey:

- Strategy - IS should support each division to perform its best
- People and Resources -IS should complete critical tasks with adequate resources
- Infrastructure – employees should have optimal tools so that they can do their jobs with minimal disruptions
- IT Service - IS timely resolves issues and prevents cybersecurity threats

Internal Audit's recommendation is to use the survey results to identify which performance metrics work best for ERS and how often IS should report these metrics. These metrics should contain certain attributes, such as definitions, calculation methodologies, targets, and reporting frequencies.

Mr. Hester inquired about responsibility for the IT Governance process. Mr. Wilson noted that ERS would look to Mr. Turner and his team to help the agency identify risk, and that ERS has recently engaged in an enterprise risk management assessment with the assistance of an external consultant. One of the areas that they focused on was IT and systems risk, because so much of what ERS does is tied to systems and applications. The assessment identifies the top business applications and programs that ERS uses to conduct business, and the accompanying controls, along with disaster recovery plans and operational continuityprocesses. It is something that ERS is looking at in a much more structured and formal way right now, but it's something that happens organically within the organization, probably led by ERS' IT team.

Mr. Chavez thanked Mr. Puckett and invited Ms. Landry to present on the status of audit recommendations.

Ms. Landry described the process used to follow up on audit recommendations and the implementation of management action plans. Periodically, Internal Audit asks the process owners to provide the status of management action plans to address audit report recommendations. Based on this information from the process owners, Internal Audit either reviews additional documentation or reviews control processes. Internal Audit does not re-audit the process, but assesses actions taken and whether those address the risks identified in the audit recommendation.

There are four different status levels: implemented, partially implemented, no action taken, and management has accepted the risk. For this period, there were four audit recommendations from three reports.

Ms. Landry highlighted the Real Assets - Infrastructure report, which had two recommendations. The first recommendation related to the retention of support documentation and more communication regarding the justification for the incentive compensation plan performance measures. Internal Audit found that the program area has increased the documentation for benchmarks, included additional information in the Incentive Compensation Plan Goal Memo, and changed the performance metrics. This was an instance where the performance metric was based on a cost savings metric. It has changed to a mix of a cost savings basis and a performance basis. The performance metric will continue to evolve as the portfolio matures so it will eventually be 100% performance-based.

Mr. Hester asked if that goal excludes the original investments, or legacy investments, that were originally included in the incentive compensation goal. Ms. Landry noted that the legacy investments are related to the second observation which also has a status of implemented. The legacy investments have been excluded from the performance target. Internal Audit reviewed the Plan Year 2020 ICP Goal Memo, and those were specifically excluded from the goal.

In addition to the specific recommendations, Internal Audit conducted a comprehensive review of all outstanding recommendations and added a new section of the report to show a summary of all outstanding recommendations.

Mr. Chavez presented the summary information and stated that this information is usually presented one audit at a time, however, Internal Audit wanted to provide trending and overall reports to show how well ERS has done in implementing management action plans over the past several years. This also allowed for an assessment over Internal Audit's own controls over the process to make sure it's doing everything it needs to do.

New graphs and information were added to the report that demonstrate that the division directors are implementing their management action plans. They also show that as more audits are completed, the work necessary to track management action plans has increased. Through this review process, there were some recommendations that were overlooked. Specifically, there were three in 2015 and two in 2016 that are past due their implementation dates. Two of them were partially implemented, and a review was completed, but Internal Audit didn't follow up to confirm if they were eventually fully implemented. Internal Audit reassessed its controls to make sure that they follow up with each management recommendation and action plan.

Internal Audit adjusted its controls to ensure that they timely evaluate all recommendations by making the log of recommendations accessible to all staff and assigning the updating tasks to all auditors. By the next Audit Committee meeting all these should be addressed and up to date. Internal Audit wanted to provide a bigger perspective on the status of all recommendations and not just on the individual engagements.

Generally, the reports the status of audit recommendations biannually, but is more specifically based on the implementation date provided by the process owner. Ms. Melvin inquired whether other recommendations are tracked and noted that it would be helpful to see all (external and internal) recommendations presented together.

In addition, Ms. Melvin asked if management action plans change over time, if Internal Audit strictly sticks to the original plan. Ms. Landry explained that when the auditor reviews the audit report, recommendation and management action plan, they are identifying the risk that was noted in the report and whether or not that risk has since been mitigated. If it was appropriate for actions other than those outlined in the management action plan to address the risk, then that is accepted as long as the original risk has been mitigated.

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

5. Review of Internal Audit Administrative Items

Ms. Landry presented the Internal Audit Charter. Internal Audit reviews the Internal Audit Charter on an annual basis. The purpose of the annual review is to outline the purpose, authority, and responsibility of the Internal Audit Director and the Internal Audit function and to inform new board members and prompt discussion. It's also an audit standard requirement that reinforces roles and responsibilities to the agency.

The authority of the internal audit director in the audit charter is enhanced by the reporting organizational structure in which the internal audit director has direct authority to the audit committee and administrative responsibility to the executive director.

Mr. Chavez added that no changes were identified in standards or in statute for this period and thus, Internal Audit has no recommended changes to the document. There is no action item, unless the board has any items that they wish to address in the audit charter.

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

6. Adjournment of the ERS Board of Trustees Audit Committee meeting. Following adjournment of the Audit Committee, the Board of Trustees will take up the remining Board agenda items.

The Audit Committee adjourned at 8:33 a.m. on March 11, 2020.