

1. Meeting of the ERS Board of Trustees' Audit Committee



December 11, 2018



Public Agenda Item # 1.1

*Call Meeting of the ERS Board of Trustees'
Audit Committee to order*



December 11, 2018

Public Agenda Item # 2.1

*Review and Approval of the Minutes to the August 29, 2018
ERS Audit Committee Meeting - (Action)*



December 11, 2018

Questions?
Action Item



Public Agenda Item # 3.1

Review of External Audit Reports



December 11, 2018

Tony Chavez, Director of Internal Audit

Texas State Auditor's Office Incentive Compensation Audit



Tony Chavez, Director of Internal Audit

Sarah Puerto, State Auditor's Office, Project Manager

Hillary Eckford, State Auditor's Office, Audit Manager



An Audit Report on Incentive Compensation at the Permanent School Fund, General Land Office, Employees Retirement System, and Teacher Retirement System

Overall Conclusion

- The Employees Retirement System (ERS) generally calculated and paid incentive compensation for its plan year ending August 31, 2017, in accordance with its policies and procedures.
 - However, ERS overpaid two employees a total of \$3,593 in incentive compensation because it did not apply the correct lengths of service according to its incentive compensation plan for the two employees' calculations.

Questions?



Public Agenda Item # 3.2

Review of Internal Audit Reports



December 11, 2018

Investment Management Fees Audit



Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Greg Magness, Auditor

Investment Management Fees Audit



Objectives

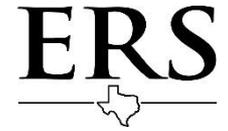
Audit Objective

To attest to the accuracy of reported annual management fees.

Program Objective

- 1) Verifying the reasonableness and accuracy of alternative investment management fees and investment advisor fees.
- 2) Accounting for the accuracy of all management fees paid for timely and accurate financial reporting.

Investment Management Fees Audit



Background

Management Fee

- A charge levied by a General Partner as compensation for managing the partnership (*Private Equity, Private Real Estate, Private Infrastructure*)
- A charge levied by an external Investment Advisor for managing a Public Equity investment fund (*Public Equity External Advisors, Hedge Funds*)

	FY2017	FY2016	FY2015
Reported Management/Investment Advisory Fees	\$100m	\$127m	\$90m

Investment Operations (Investments Division) and Investment Accounting (Finance Division) are responsible for processing and accounting of management fees

Investment Management Fees Audit

Results



OVERALL ASSESSMENT		Satisfactory
Scope Area	Results	Rating
Management Fee Processing	Investment Operations reviews the valuation of the investments to ensure Management Fees are based on fair value. Investment Operations re-calculates the Management Fees to ensure they are calculated according to contractual terms.	Satisfactory
Management Fee Accounting	Observation 2: Reconciliation Controls should be Refined to Identify Mis-classifications and Adjustments (Moderate)	Satisfactory
Management Fee Reporting	Observation 1: Presentation of alternative investment related costs should be evaluated. (Moderate)	Satisfactory

Investment Management Fees Audit



Observation #1

Presentation of alternative investment related costs should be evaluated. (Moderate)

	FY2017	FY2016	FY2015
Reported Management/Investment Advisory Fees	\$100m	\$127m	\$90m

Management Fee - Fees paid to General Partner for managing the partnership

- Set amount
- Recalculated
- Often returned

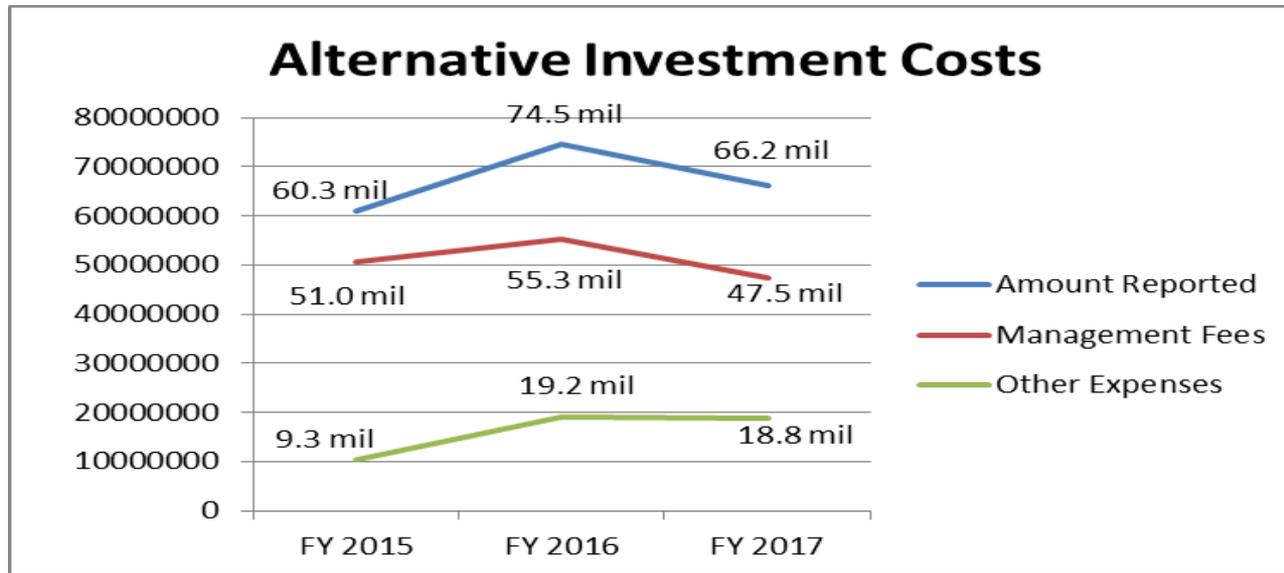
Other Fees – Amounts paid to the General Partner to reimburse for expenses incurred in creating / operating the partnership

- Billed as incurred
- Recorded
- Usually not returned

Investment Management Fees Audit



Observation #1



FY2017 numbers adjusted for overstatements reported in Observation #2

Percentage of Other Expenses in Management Fees Reported: FY 2015 -15.4% FY 2017-28.3%

Investment Management Fees Audit



Observation #1

- No specific accounting guidance on how to report
- Does the current presentation promote the understandability of information contained in the financial statements?

The Investment Accounting team will be reporting the Other Expenses in a column separate from the Management Fees in the 2018 Comprehensive Annual Financial Report.

Investment Management Fees Audit

Observation #2



Reconciliation Controls should be Refined to Identify Mis-classifications and Adjustments (Moderate)

1. An \$8.4m capital call was mistakenly categorized as a management fee. Based on a review of all management fee amounts, this appears to have been a random error
2. Two errors totaling \$1.4m (net of \$165k) resulted from unique situations that are not likely to re-occur

Management and Investment Advisory Fees are reported as net of investment values so the errors identified did not materially affect the financial statements

Investment Management Fees Audit



Observation #2

- Reconciliations occur, but errors were still made
- Investment Operations and Investment Accounting should review procedures to ensure reconciliations are made at the appropriate level

Investment Operations and Accounting have changed their reconciliation procedures to ensure that directives are properly accounted for.

In addition, other reconciliations have been added to ensure accurate and complete information is reported relating to management fees.

Questions?



Real Assets – Infrastructure Audit



Tony Chavez, Director - Internal Audit

Jonathan Puckett, Auditor

Real Assets – Infrastructure Audit



Background

- **Audit Objective:** To determine if investments in infrastructure are in accordance with ERS Investment Policy
- **Audit Sub-Objectives:**
 - Investment Selection
 - Ongoing Operations
 - Performance Reporting
- **Scope:** The audited period covered *Private Infrastructure investments made between August 2015 and December 2017.*

Real Assets – Infrastructure Audit

Background



Private Infrastructure is a subset of the alternative investment class, the Portfolio was created in FY14 and included 3 legacy investments.

Investment Type	Committed Capital	Total Investments	Net Asset Value (08/31/18)	Average Deal Size
Legacy Investments	\$150 million	3	\$38 million	\$50 million
Pre 2017 Allocation Investments (No Legacy)	\$791 million	19	\$507 million	\$44 million
Post 2017 Allocation Investments	\$430 million	6	\$13 million*	\$72 million
Total	\$1,371	28	\$558 million	\$51 million

* Investments are less than a year old and not all capital has been called by the General Partner, making the net asset value low.

Real Assets – Infrastructure Audit

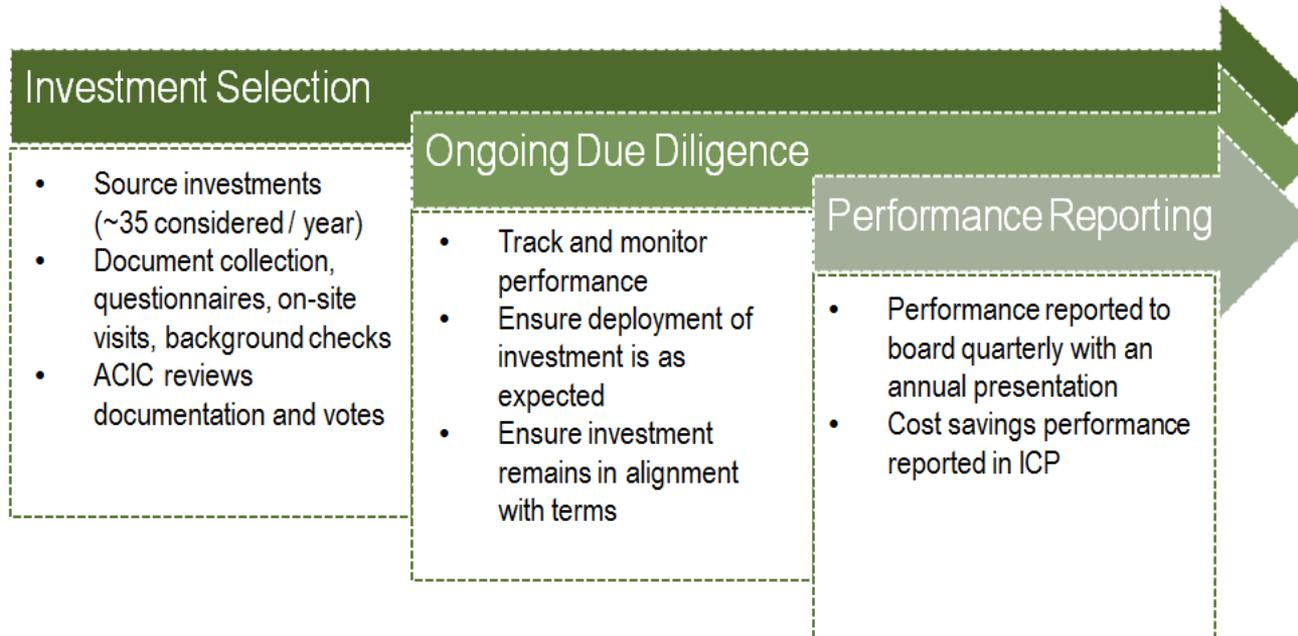
Results



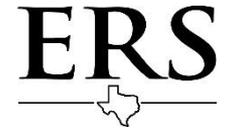
OVERALL ASSESSMENT		Satisfactory
Scope Area	Results	Rating
Investment Selection	Asset Class Investment Committee (ACIC) reviews Investment Recommendation Memo for all investments.	Satisfactory
Ongoing Operations	Ongoing due diligence materials are reviewed as they are received by Infrastructure team. Checklist completed to document completion of review of ongoing due diligence materials.	Satisfactory
Performance Reporting	Observation #1— Key information unavailable to support performance incentive benchmarks. Observation #2—Select Infrastructure ICP goal attributes do not align with ERS' Incentive Compensation Plan objectives.	Needs Improvement

Real Assets – Infrastructure Audit

Highlights



Real Assets – Infrastructure Audit



Background – Infrastructure Incentive Compensation

Infrastructure incentive compensation is a measurement of ERS private infrastructure portfolio blended economics against industry market economic fund terms. – 2016 Incentive Compensation Plan

- Beginning with 2016 ICP, discretionary goal award capped at 25% weight
- In response, an infrastructure quantitative ICP goal was developed - 50% weight
- A cost-savings goal based on negotiated management fee rate
- Formalized through approved memo from Infrastructure Portfolio Manager to management
- Non Board approved benchmark as delegated by approved ICP

Real Assets – Infrastructure Audit

Performance – Infrastructure Incentive Compensation



ICP Plan Year	One-Year Performance	Three-Year Performance	Maximum Award	Actual Award	Eligible Participants
2017	180%	194%	\$211,286	\$211,286	9
2016	210%	214%	\$197,818	\$197,818	9
2015	N/A	N/A	\$155,047	\$155,047	1

Real Assets – Infrastructure Audit



Calculation – Infrastructure Incentive Compensation

$$\text{Infrastructure ICP Performance} = \frac{(\text{Benchmark Fee} - \text{Avg. Negotiated Fee})}{(\text{Benchmark Fee} - \text{Target Fee})}$$

Benchmark Fee – Determined by staff’s assessment of private infrastructure portfolio blended economics against industry market economic fund terms.

Target Fee – Calculation based on portfolio mix of Funds vs. Direct/Co-investments (70/30 mix)

Plan Year	Benchmark Fee	Target Fee
2018	1.70%	1.19%
2017	1.75%	1.23%
2016	1.75%	1.23%

Negotiated Mgmt. Fee = Infrastructure ICP Performance

1.75% Fee = 0%

0% Fee = 333%

3.5% Fee = -333%

Real Assets – Infrastructure Audit



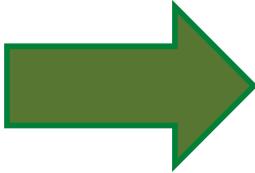
Observation #1

Key information unavailable to support performance incentive benchmarks.

Benchmark Fee



Industry / market economic fund terms



ERS economics that would adjust the market economic fund terms



ERS Infrastructure Fund Negotiated Management Fees* (2016-2017)

Median – 1.50%

Mean – 1.29%

Range – 0.75% - 1.60%

*Figures represent nominal fees negotiated without being weighted by commitment amount.

Real Assets – Infrastructure Audit

Observation #1

Target Fee (1.23%) = Benchmark (1.75%) x Portfolio fund ratio target (70%)

Direct / Co-investments



Lower Avg. Management Fee

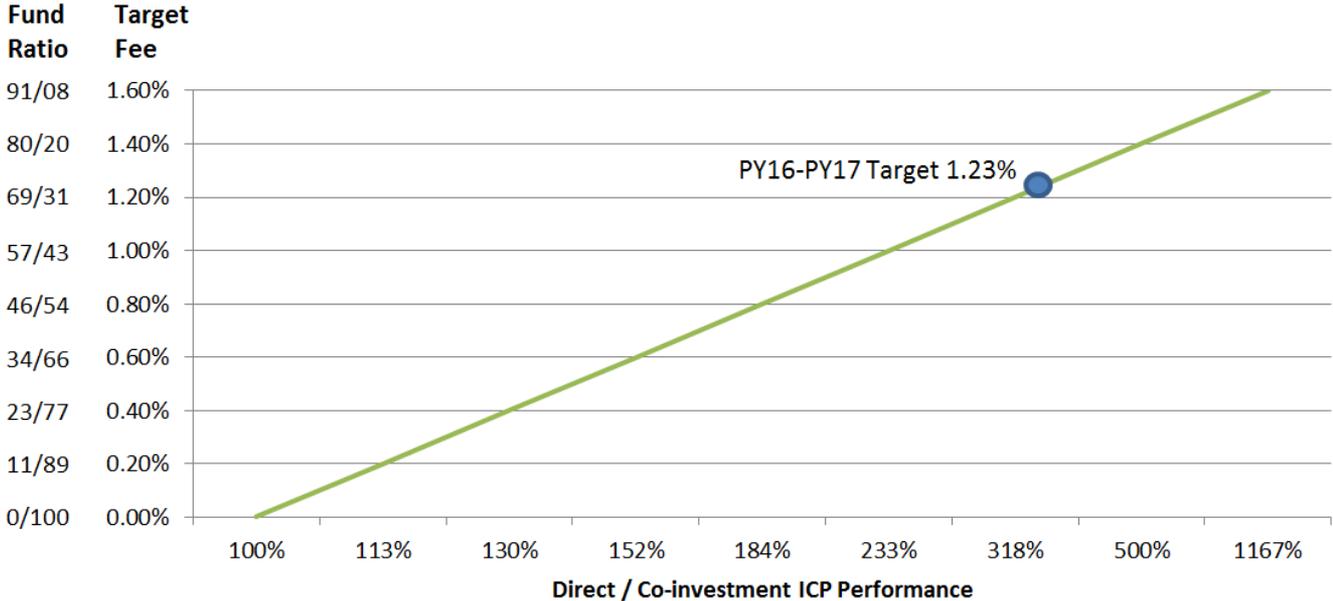
	Portfolio Mix (Funds/Co-investments)
Target Mix	70% / 30%
PY17	52% / 48%
PY16	41% / 59%

Real Assets – Infrastructure Audit



Observation #1

Target Fee - Direct / Co-investments impact on ICP Performance



Real Assets – Infrastructure Audit



Observation 2

Select investments included in the ICP goal calculation do not align with ERS' Incentive Compensation Plan objectives.

- 3 legacy investments from FY13 included in ICP
 - Total commitment \$150 and each with a zero percent negotiated management fee
- 2 investments with negative investment performance contributed positive incentive compensation performance
 - Negative investment performance not attributable to normal investment life-cycle

ICP Goal Directives:

- *Directly tied to a participant's actual performance*
- *No incentive shall be applied retrospectively for past performance*
- *Incentivize achievement of the highest level of performance*
- *Asset class performance goals must include rationale so that it can be independently verified by Internal Audit and/or an external auditor*

Source: 2016 ICP

Questions?



Public Agenda Item # 3.3

Review of Internal Audit Administrative Items



December 11, 2018

Annual Audit Performance and Quality Review



Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Annual Audit Performance and Quality Review – *Reports*



- 1) **Internal Audit Annual Report** - Required reporting of internal audit plans, annual reports, and any weaknesses or concerns resulting from audit activity
- 2) **Quality Assessment and Improvement Program** - Required monitoring, assessing, and reporting of compliance of the internal activity with Audit Standards
- 3) **Internal Audit Performance Measures** – Control to evaluate the effectiveness of audit processes and procedures

Annual Audit Performance and Quality Review –

Key Takeaways



- Processes in place to ensure conformance with audit standards
- Improved collaboration with process owners to better align program objectives and associated risks
- Continue to improve and pursue opportunities to improve business acumen
- Significant decline in audit efficiency

Annual Audit Performance and Quality Review – *Audit Efficiency*



- First full fiscal year with current staff levels
- Concurrently 3 – 4 audits being performed
- Led to decline in timeliness of reviews
- Led to delays in final report when additional work or documentation determined to be required



The Auditor VI position formally designated as an Audit Manager

Annual Audit Performance and Quality Review –

Audit Roles



Audit Manager

- Initial review of audit work papers to confirm sufficient evidence has been gathered and organized in accordance with audit standards and division policy to support audit results
- Provide feedback and assist project leads in the completion of audit engagements

Audit Director

- Second level review of milestone deliverables and key work papers that support audit findings
- Ensure audit program and results align with ERS strategic/business goals and objectives
- Ensure appropriate audit ratings determined based on level of risk and impact to ERS

Annual Audit Performance and Quality Review – *Audit Manager*



Tressie Landry, CIA

Audit Manager

17 years of
professional
experience



- Project Manager, Tx Health and Human Services Commission
- Senior Auditor, U.S. Dept. of Veterans Affairs
- Senior Manager, Myers and Stauffer
- Budget Analyst, City of Oklahoma City
- Senior Accountant, Chesapeake Energy
- Senior Auditor, Tx State Auditor's Office

Skills
Summary



- Healthcare auditing
- Data analysis
- Coaching staff
- Easily understand technical issues
- Empathetic and open-minded listener

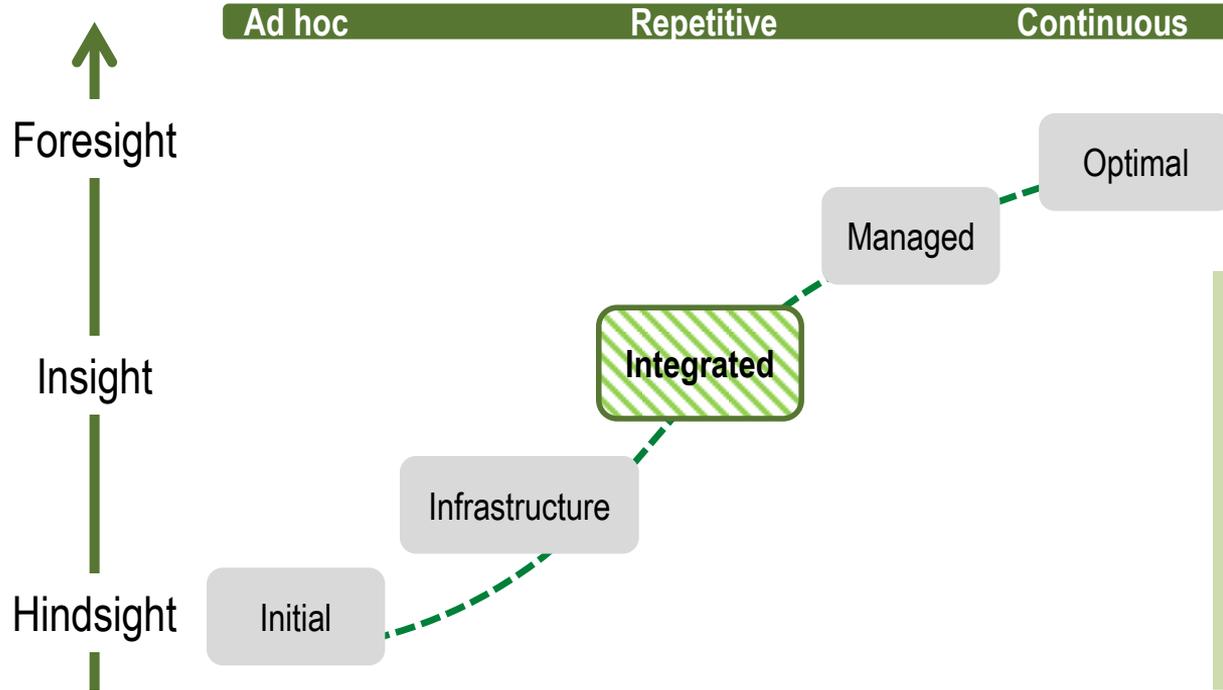
Annual Audit Performance and Quality Review – *FY19 Action Plan*



- 1) Designation of Audit Manager
 - Allow Director to lead select engagements
 - Allow Director greater focus on strategic activities
- 2) Formal audit talent assessment of the Internal Audit Division
 - Staff development (training needs, performance plans)
 - Identify skill gaps for individual audit engagements
- 3) Evaluation of current audit customer survey structure for continued viability
 - Maintain alignment with stakeholder expectations
 - Identify strengths and opportunities for improvement
- 4) Continual emphasis on audit work papers elements
 - Promote critical thinking and analysis
 - Ensure sufficiency of audit work planned



Annual Audit Performance and Quality Review – *Wrap-Up*



Strategic Objectives:

- Improve efficiency while maintaining quality
- Continue to advance audit function capabilities
- Groom staff for leadership roles (succession planning)
- Decrease reliance on individual(s)
- Continue to advance critical thinking to add value to the agency

Questions?



Public Agenda Item # 4.1

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



December 11, 2018