

1. Meeting of the ERS Board of Trustees Audit Committee

December 10, 2019



Public Agenda Item #1.1

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

December 10, 2019

Public Agenda Item #2.1

*Review and Approval of the Minutes to the August 21, 2019
ERS Audit Committee Meeting - (Action)*

December 10, 2019

Questions?
Action Item

Public Agenda Item #3.1

Review of External Audit Reports

December 10, 2019

Tony Chavez, Director of Internal Audit

Hillary Eckford, State Auditor's Office, Audit Manager

Morgan Burandt, State Auditor's Office, Project Manager

Incentive Compensation at Selected Agencies



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

Overview

Employees Retirement System (ERS)

ERS calculated and paid incentive compensation in accordance with most of its policies and procedures for plan year 2018. However, ERS should strengthen controls over its calculation and review process.

- ERS awarded a total of \$5,148,363 in incentive compensation to 76 employees.
- Chapter issue rating was Low. Our audit identified strengths that support ERS's ability to administer the program and the issues identified do not present a significant risks that would negatively affect the ERS ability to administer the program.



An Audit Report on

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

SAO Report No. 19-048
August 2019

Recommendations

ERS should:

- Strengthen controls over its incentive compensation calculation and review process to include a review of the accuracy of performance calculations and reliability of source data.
- Develop and implement a process to communicate and document the approval of changes it makes to its performance calculation methodologies.
- Update its incentive compensation policies and procedures to reflect its current processes.

Questions?

Public Agenda Item #3.2

Review of Internal Audit Reports

December 10, 2019

Tony Chavez, Director of Internal Audit

Tressie Landry, Manager, Internal Audit

Greg Magness, Project Lead, Internal Audit

Profit Sharing

Profit Sharing Audit

Strategic Alignment



Strategic Alignment: Administer and manage trust assets innovatively to achieve target returns within risk tolerances. (ERS Strategic Plan)

Strategic Principle: Prudently invest in securities in order to maximize the probability that members, retirees, and beneficiaries are provided the benefits they have been promised at a reasonable and predictable cost. (ERS Investment Policy)

Program Objective: To actively manage, track, and report profit share distributed in plan investments.

Profit Sharing Audit

Background - Criteria



- ERS is required to calculate, track, and report profit share, by asset class.
 - Based on Best Practices
 - No GASB requirements
 - Informal control activities prior to requirement

Profit Share – Agreed share of profits resulting from the realization of an investment. Only earned on performance in excess of contractually agreed upon performance.

Texas Government Code defined profit share to include
Incentive Fees and Performance Fees

Profit Sharing Audit

Background – Best Practices



Profit share is one of the best ways to align the interests between a General Partner and Limited Partners

Source: ILPA

Three (3) guiding principles of an effective private equity partnership are:

- Alignment of Interest – General Partner and Limited Partners
- Governance – Agreement to the assumptions for the investments
- Transparency – Detailed information provided on the investments

Profit Sharing Audit

Profit Share



	FY17	FY18	FY19
Profit Share	\$ 65,498,503	\$ 64,782,987	\$ 58,619,679

FY17 - FY18 reported amounts include adjustments identified during audit engagement. See observation #1

FY19 - Amounts to be reported in FY19 CAFR.

Profit share is based on performance
Better performance results in larger distributions

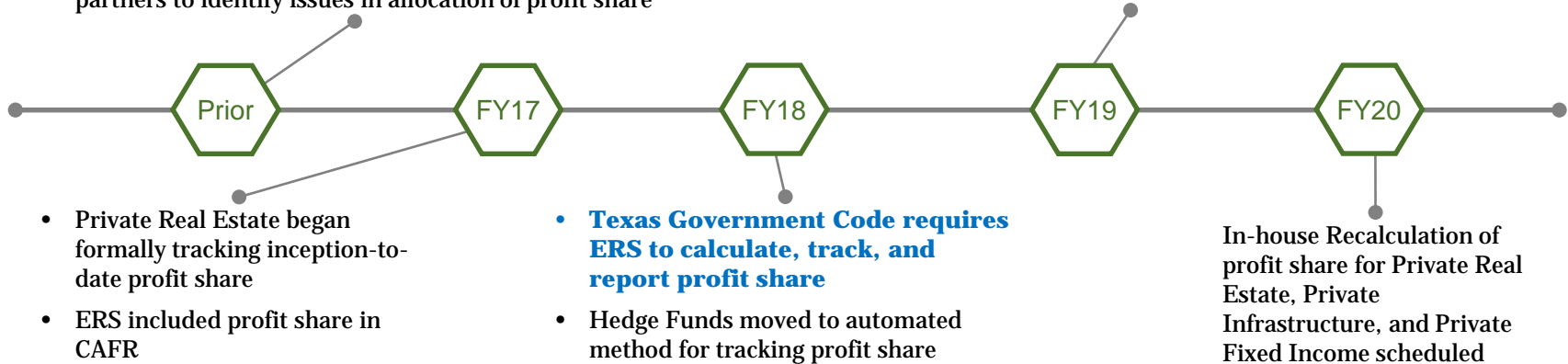
Profit Sharing Audit

Background - Historical Perspective



- Hedge Funds manually tracked profit share for ad hoc reporting (2012)
- Private Real Estate maintained profit share for ad hoc reporting (2015)
- ERS relied on independent audits of investment partners to identify issues in allocation of profit share

- In-house Recalculation of Private Equity profit share began
- Private Real Estate formalized reconciliation procedures for reporting profit share
- First profit share with Public Equity Advisor



Profit Sharing Audit

Results



OVERALL ASSESSMENT		SATISFACTORY
SCOPE AREA	RESULTS	RATING
Profit Share Formation	Portfolio Managers negotiate the terms and methodology for calculating profit share. Office of General Counsel reviews contract to ensure terms match those negotiated.	SATISFACTORY
Profit Share Reporting	Observation 1: Continue to perform process improvements to ensure accuracy of profit share reported. (Moderate) Observation 2: Improve communication and information sharing amongst profit share reporting process owners. (Moderate)	SATISFACTORY

Profit Sharing Audit

Control Framework - Verification



Asset Class	Verification Methodology
Hedge Funds	External recalculation performed by ERS' Hedge Fund consultant and provided on a quarterly basis.
Private Real Estate	Internal verification of profit share reported to supporting documentation performed by Private Real Estate Portfolio Team as received.
Private Equity	Internal recalculation performed by Investment Accounting Section (Finance Division) as received.

Investment Accounting is scheduled to begin recalculating profit share in Private Real Estate, Private Infrastructure, and Private Fixed Income in FY20

Profit Sharing Audit

Observation 1 – Continue Process Improvements



- Private Real Estate
 - Continue reconciliation process to ensure completeness of reporting
- Hedge Funds
 - Automated upload to tracking system
 - Agreed upon reporting timeframe to ensure completeness

Asset Class	FY17 - over/(under) reported	FY18 - over/(under) reported
Private Real Estate	\$ (2,163,623)	\$ (3,234,874)
Hedge Funds	\$ (1,300,553)	\$ (101,945)

Profit Sharing Audit

Observation 2 – Improve Communication



- Formalize follow-up procedures when variances are identified
 - Inform Portfolio Managers of profit share distributed, including variances
 - Possible attestation by Portfolio Manager accepting GP's calculations

Costs matter and need to be effectively managed. Decisions to invest cannot be made without considering costs, and costs must be actively and prudently managed whenever possible to maximize investment returns.

Source: ERS Investment Policy

Profit Sharing Audit

Observation 2 – Improve Communication



- Provide assistance to Finance when building the model for recalculation
 - Accountant only receives a copy of executed contract
- Provide additional Investor-level reporting to Finance for recalculation
 - Private Equity and Real Estate require additional transparency
- Ensure tracking system is complete through follow-up
 - Investments Operations updates tracking system

Questions?

Public Agenda Item #3.3

Review of Internal Audit Administrative Items

December 10, 2019

Tony Chavez, Director of Internal Audit

Tressie Landry, Audit Manager

Sonya Etheridge, Director of Internal Audit of the Texas Facilities Commission

Andrea Focht-Williams, Senior Internal Auditor of the Texas Municipal Retirement System

Annual Audit Performance and Quality Review

Annual Audit Performance and Quality Review – *Reports*



- 1) **Quality Assessment and Improvement Program** - Required monitoring, assessing, and reporting of compliance with Audit Standards
 - a) *External Quality Assurance Review*

- 2) **Internal Audit Annual Report** - Required reporting of internal audit plans, annual reports, and any weaknesses or concerns resulting from audit activity

- 3) **Internal Audit Performance Measures** – Control to evaluate the effectiveness of audit processes and procedures

Annual Audit Performance and Quality

Review – *External Quality Assurance Review*



- Government Auditing Standards require external peer reviews conducted by independent reviewers every three years
- Conducted under standards and guidelines published by the Texas State Agency Internal Audit Forum (SAIAF)
- Ratings:
 - a) Pass/Generally Conforms
 - b) Pass with Deficiencies/Partially Conforms
 - c) Fail/Does Not Conform

Annual Audit Performance and Quality

Review – *External Quality Assurance Review*



Team

- Sonya Etheridge – Internal Audit Director, Texas Facilities Commission, Certified Internal Auditor (CIA), Certified Public Accountant (CPA)
- Andrea Focht-Williams – Senior Internal Auditor, Texas Municipal Retirement System, Certified Public Accountant (CPA), Certified Fraud Examiner (CFE), Certified Investments and Derivatives Auditor (CIDA)

QAR Process:

- Review of policies and procedures
- Review of Internal Audit self-evaluation
- Interviews with Board and Audit Committee Chairs, Executive Office, Senior Management and Internal Audit staff
- Review of three engagements (report and work papers)

Annual Audit Performance and Quality Review – *External Quality Assurance Review Results*



- **Pass/Generally Conforms:** *Internal Audit's processes and procedures have been properly designed to ensure compliance with audit standards.*
- **Best Practices:**
 - Articulates the level and extent of risk when communicating results
 - Mid audit update (Scope Meeting) with stakeholders and program owners
 - Staff attend relevant and timely training

Annual Audit Performance and Quality Review – *Strategic Plan*



1. Enhance Professional Practices
2. Enhance Performance Management and Accountability
3. Grow People Management

2019 Strategic Objectives:

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

Annual Audit Performance and Quality Review – *Enhance Professional Practices*



- External QAR – Confirmation of Internal Audit’s control framework
- Consulting engagements communication and documentation
- Continue to formalize the process
 - Timeliness of work paper review
 - Data validation and analysis
 - IT System risks



**ERS Internal
Audit Division**

Annual Audit Performance and Quality Review – *Enhance Performance Management*



- Stakeholder Survey
 - Successes:
 - Perception within ERS
 - Address significant areas
 - Areas for Improvement:
 - Recommendations to address root cause
 - Information technology proficiency
- FY19 Continuous Improvement Activities
 - Program Primer
 - Improved audit work paper development



Annual Audit Performance and Quality Review – *Grow People*



- Skills Assessment
 - Alignment between self-assessments and Director assessments
 - Ethical, Know the Standards, Know the Business
 - Continue emphasis on results and solutions
- Training
 - Association of Public Pension Fund Auditors Conference
 - Private Equity Accounting and Fee Validation
 - Private Equity Learning & Development
 - Auditing IT Governance
- Professional Development
 - Internal Audit Leadership Development Program
 - UT Interns

Core Competencies:

- Improvement and Innovation
- Internal Audit Delivery
- Critical Thinking
- Persuasion and Collaboration
- Communication
- Business Acumen
- Governance and Risk Management
- IPPF (Audit Standards)
- Internal Audit Management
- Ethics

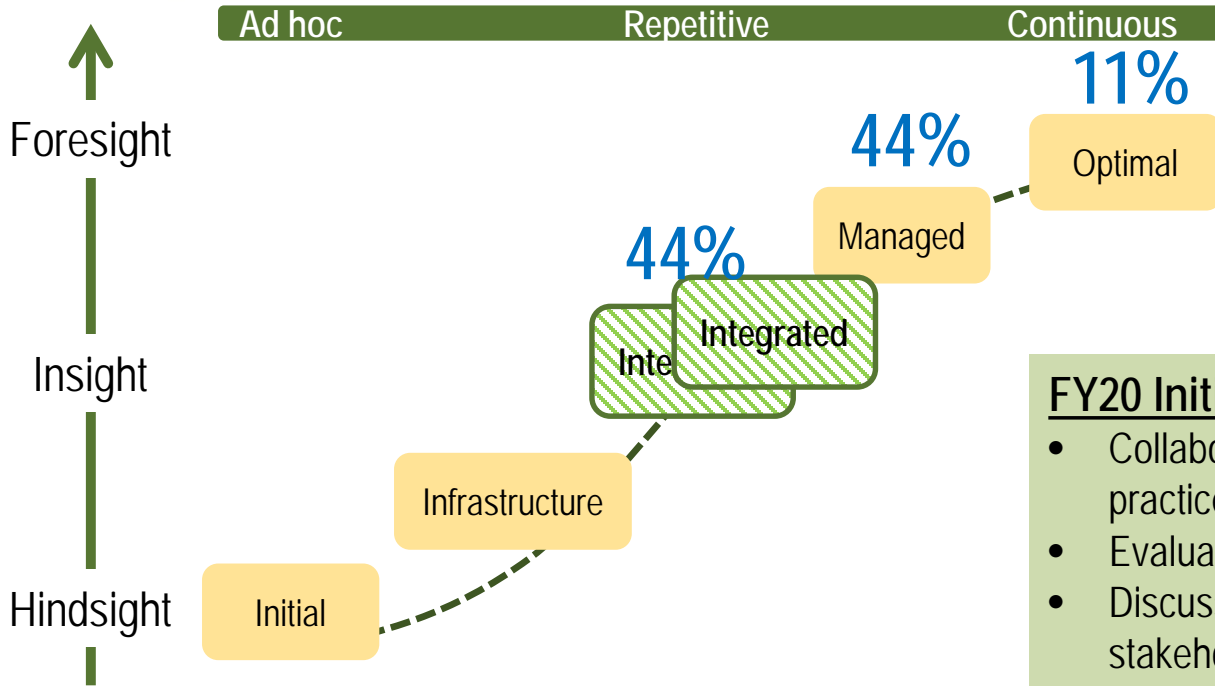
Annual Audit Performance and Quality Review – *2019 Performance Measures*



- Continue to provide quality results
- Continue to increase business acumen
- Maintaining productivity
- Increased efficiency on standard audits
- Efficiency on complex/advance audits continues to be a challenge



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



FY20 Initiatives:

- Collaborate with process owners on best practices/peers/criteria
- Evaluate data request methods
- Discuss audit rating methodology with stakeholders for input

Questions?

Public Agenda Item #4.1

Adjournment of the ERS Board of Trustees Audit Committee Meeting

December 10, 2019