



Audit Committee Meeting

March 7, 2018



Presented for Review and Approval

May 23, 2018

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**AUDIT COMMITTEE MEETING
EMPLOYEES RETIREMENT SYSTEM OF TEXAS
March 7, 2018
ERS Board Room
ERS Building – 200 E. 18th Street
Austin, Texas 78701**

TRUSTEES PRESENT

Catherine Melvin, Audit Chair
Doug Danzeiser, Board Chair
Cydney Donnell, Board Vice Chair
Ilesa Daniels, Member
I. Craig Hester, Member
Jeanie Wyatt, Member

ERS STAFF PRESENT

Porter Wilson, Executive Director
Catherine Terrell, Deputy Executive Director
Paula A. Jones, Deputy Executive Director & General Counsel
William S. Nail, Special Projects & Policy Advisor
Jennifer Chambers, Director of Government Relations
Tony Chavez, Director of Internal Audit
Diana Kongevick, Director of Benefit Contracts
Robin Hardaway, Director of Customer Benefits
Sharmila Kassam, Deputy Chief Investment Officer
Machelle Pharr, Chief Financial Officer
Gabrielle Schreiber, Director of Procurement and Contract Oversight
Chineque “DeeDee” Sterns, Director of Human Resources
Tom Tull, Chief Investment Officer
Kathryn Tesar, Director of Benefits Communications
Chuck Turner, Chief Information Officer
Keith Yawn, Director of Strategic Initiatives
Georgina Bouton, Benefit Contracts
Kelley Davenport, Executive Office
Christi Davis, Customer Benefits
Jo Freeby, Benefit Contracts
Beth Gilbert, Internal Audit
Ginger Grissom, Office of Procurement and Contract Oversight
Jahna Holms, Office of Procurement and Contract Oversight
Jennifer Jones, Office of Strategic Initiatives
Panayiotis Lambropoulos, Investments
Greg Magness, Internal Audit
Betty Martin, Investments
Karen Norman, Internal Audit
Travis Olson, Investments
Jonathan Puckett, Internal Audit
Alexis Reece, Office of Procurement and Contract Oversight
Michael Shoop, Investments
Carol Stueler, Office of Procurement and Contract Oversight

ALSO PRESENT

Nick Arnold, Humana
Lisa Collier, State Auditor’s Office
Hillary Eckford, State Auditor’s Office
Patricia Kolodzey, Blue Cross and Blue Shield of Texas
Fabienne Robin, State Auditor’s Office

Meeting of the ERS Board of Trustees Audit Committee

1. CALL TO ORDER

1.1 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 and called the meeting to order at 8:00 a.m.

2. MINUTES

2.1 Approval of the minutes to the December 13, 2017 ERS Audit Committee Meeting (ACTION) -

Move that the ERS Board of Trustees Audit Committee of the Employees Retirement System of Texas approve the minutes for its meeting held on December 13, 2017.

Motion by Craig Hester, second by Cydney Donnell.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

3. AUDIT ITEMS

3.1 Review of External Audit Reports (ACTION) –

Mr. Tony Chavez, Director of Internal Audit, introduced Ms. Hilary Eckford and Ms. Fabienne Robin from the State Auditor's Office (SAO). Mr. Chavez reported there are two deliverables associated with the financial opinion audit (Independent Auditor's Report and Report on Internal Controls over Financial Reporting and On Compliance and Other Matters as Required by Auditing Standards). The reports were submitted to the Legislative Audit Committee on December 29, 2017.

Ms. Eckford reported the SAO was engaged to issue an opinion on the Employees Retirement System's (System) financial statements for fiscal year 2017.

The Independent Auditor's Report dated December 20, 2017 reported ERS' basic financial statements for fiscal year 2017 were materially correct and presented in accordance with accounting principles generally accepted in the United States of America.

The Report on Internal Control stated ERS had material accounting errors in the financial statements for the systems' active and retiree insurance plans and that the System did not properly implement part of a new accounting standard. However the System corrected and disclosed all material errors previously omitted or recorded in error that the auditors brought to its attention before the financial statements were finalized.

Ms. Eckford stated that Governmental Accounting Standards Board (GASB) 74 is referring to the requirements for the ERS plan regarding Other Post-Employment Benefits (OPEB) affecting the financial statements for the plans. The only OPEB that concerns ERS is retiree health insurance, since there are no other benefits paid for by the state once a person retires. GASB 74 went into effect for fiscal year 2017.

GASB 75 affects the employers within those plans and what's being reported on their financial statements. GASB 75 will be in effect for fiscal year 2018 for the employers.

There being no further discussion, the Board then took the following action.

Move that the Audit Committee of the Employees Retirement System of Texas accept the financial audit reports as prepared by the State Auditor's Office and presented in this agenda item.

Motion by Cydney Donnell, second by Craig Hester.

Final Resolution: Motion Carries

Aye: Craig Hester, Cydney Donnell, Doug Danzeiser, Ilesa Daniels, Jeanie Wyatt, Catherine Melvin

Mr. Chavez then introduced Ms. Mabelle Pharr, ERS' Chief Financial Officer, to present the impact related to GASB 74. Ms. Pharr stated that the Texas Employees Group Benefits Program (GBP) is a single plan. A single fund was created to capture GBP appropriations. Prior to the issuance of GASB 43, all of the contributions went to this one fund, which was treated as an internal service fund or proprietary fund for purposes of GASB reporting. As a single plan, the GBP includes all members in one risk pool. The plan is pay-as-you-go and only asks for the funds needed to fund the program over the course of each biennium.

When GASB 43 was enacted, ERS needed to account for retiree health benefits separately from active employees in the Comprehensive Annual Financial Report. It also stated that, if those contributions are going to what is considered a qualifying trust for purposes of GASB, those would be reported as a fiduciary fund, but active members still need to be reported as an internal service fund.

Ms. Melvin asked Ms. Pharr if she has had an opportunity to discuss the proposed changes and any financial statement reporting impact with GASB, and Ms. Pharr responded that staff did talk to GASB about the potential procedure changes. GASB was in agreement that this would continue to qualify as a fiduciary fund for the State Retiree Health Account.

Ms. Pharr noted that staff determined that pharmaceutical rebates were not allocated appropriately between the Internal Service Fund and the Retiree Health Account. The SAO audit determined that the change in rebate allocation was treated as an error correction but should have been treated as an accounting estimate. GASB has different requirements for handling error corrections and accounting estimates. Error corrections require revisions to the correct current year plus prior years in which the error occurred. Accounting estimates are revised for the current year only.

Ms. Pharr reported that the GASB changes to OPEB reporting will affect many employers in the GBP since the program is classified as a cost-sharing multiple-employer plan. This requires ERS staff, along with the consulting health insurance actuaries, to develop allocation schedules that will tell the employers their proportionate share of the overall potential OPEB liability. Employers, such as community colleges and universities, along with a subset of state agencies, such as the Texas Department of Transportation, will have to report this figure on their financial statements. These liabilities are different for the State of Texas than pension liabilities, since the State has greater freedom to adjust these benefits in the future.

There was no further discussion or questions and no action was taken.

3.2 Review of Internal Audit Reports –

Mr. Chavez introduced Ms. Karen Norman, Internal Auditor, to present on Vendor Information Technology Oversight. Ms. Norman reported that Internal Audit performed an audit to determine if oversight of vendors ensures protection of ERS information. During planning and development, the Office of Procurement and Contract Oversight (OPCO) oversees the process with Information Systems subject-matter experts developing the vendor requirements. Ms. Norman reported that the contract managers through the divisions, monitor vendor performance and if any reports are submitted with IT information, the report may be sent to the Information Systems division for review.

The audit covered two scope areas, Planning and Development (selecting a vendor), and Oversight (after contract has been executed). The overall assessment was that it needs improvement. There were two observations: 1) due diligence activities may not always provide verification of key requirements, and 2) control activities have not been established to guide vendor IT oversight.

Key controls include subject matter expert involvement in creating requirements, requirements in confidentiality, integrity and availability, on-site visits to the vendor's data center, Service Organization

Control (SOC) report review, and contracts contain additional exhibits and requirements to align with the type of data that the vendor has available.

Mr. Hester asked if key controls are spelled out in the Texas Contract Management Guide. Ms. Norman said that the guide does provide requirements of how to perform a thorough review and perform additional steps like reviewing the SOC reports or the data center but not all requirements are specifically detailed.

Ms. Norman informed the Board that vendor oversight is important as it helps identify or distinguish any issues that may be occurring. Control activities have not been established to guide Vendor IT Oversight agency-wide. According to the Texas Contract Management Guide, as the risk associated with a particular vendor increases, the level and degree of oversight should be increased by a corresponding level. No agency-wide vendor IT risk framework or assessment has been rolled out to measure vendor IT risk.

The Texas Contract Management Guide provides different types of monitoring: Onsite inspections, report reviews and annual questionnaires. Internal Audit found ERS currently generally uses reports to monitor all types of vendors, particularly the data recovery plan tests, SOC reports and the data security annual attestation. ERS also often performs site visits for verification of information presented in the vendors' responses. Identifying elements that require further review and determining criteria for those reviews can help ERS better review vendor reports would be beneficial.

Ms. Norman reported that while key controls are present, current due diligence activities may not always provide verification of key vendor IT requirements. The report recommends to staff to identify all IT requirements that need verification and have mitigating controls when verification cannot occur.

The Internal Audit recommendation for observation #1 is that in order for vendor oversight to assess and mitigate IT risks, there should be an agreement on processes with set timeframes and measurements. The Internal Audit recommendation for observation #2 is that the due diligence process should be evaluated to prioritize the requirements needing verification and identify how verification can occur, including alternate procedures.

Ms. Melvin asked if Internal Audit identified any changes needed in contract language to ensure that the agency would be able to do such monitoring. Ms. Norman responded that contracts have standard language giving ERS the ability to review or audit all information.

Ms. Gabrielle Schreiber, Director of Procurement and Contracts Oversight (OPCO), reported that OPCO staff have been working with staff throughout ERS to determine if there is a need to deviate from the standard contract language for the particular solicitation. Work continues with the Information System division to determine if there are other controls that need to be put in place.

The next audit report, HealthSelect of TexasSM (HealthSelect) Denial Process, was presented by Mr. Jonathan Puckett, Internal Auditor. Mr. Puckett stated that the audit objective was to determine if medical and drug denials were handled in accordance with the master benefit plan documents. There were three scope areas: Third-Party Administrator (TPA) appeals, ERS appeals, and Stakeholder engagement. Overall assessment for the audit was satisfactory. For the first scope area, TPA appeals, internal audit had no reportable observations noted. For the second scope area, ERS appeals, internal audit reported two observations: intended governance over ERS appeals is unclear and key information that supports appeals decisions is not consistently documented. The third scope area, stakeholder engagement, had no reportable observations.

Mr. Puckett reported the audit included HealthSelect appeals received by ERS from September 1, 2015 through May 31, 2017.

Mr. Puckett provided background information on the HealthSelect denial process audit and stated that HealthSelect members have a right to appeal a denied benefits claim. The appeal process is a tiered approach. Once a claim is denied, a member may submit an appeal to the third-party administrator (TPA). If that appeal is denied, the member may appeal to ERS, and if ERS denies the appeal, a member may ask an independent review organization to review their claim.

ERS appeals are all reviewed by the Director of Benefit Contracts. Some appeals are also reviewed by a Grievance Review Committee (GRC), which consists of internal staff from several areas, including Office of the General Counsel, Benefit Contracts, Executive Office and Customer Benefits. The GRC provides an appeal decision recommendation to the Director of Benefit Contracts. Mediation may be available at any time after an eligible claim is denied.

Mr. Puckett provided a brief explanation on the claims and email statistics. Internal audit reviewed many appeal decision letters and noted that the denied appeal letters were thorough and contained key information for the members. The audit also concluded that appeal determinations were timely and sufficiently communicated to members. The appeals process was also adequately communicated to members and the information provided to management and the Board is accurate.

Mr. Danzeiser wanted to know if internal audit categorized the denials to see whether the drug plan was getting a higher proportion of denials versus the medical plan. Mr. Puckett responded the drug plan has a larger volume of appeals than the medical plan, however medical appeals make up the vast majority of total appeal dollars because medical claims have a larger associated cost than drug claims.

The audit report concluded that the intended governance over ERS appeals is unclear and that GRC's appeal approval authority should be clarified. The type of appeals subject to review by the GRC is not defined. The GRC members' intended roles and responsibilities are also not defined and the charter does not define different roles and responsibilities of the members of each division. In addition, meeting attendance requirements for GRC members are not clear.

The audit also identified areas where consistent and thorough documentation is not available, including key facts that support appeals decisions and the basis for overturned or approved appeals decisions. Mr. Hester asked if a review of the GRC charter has been completed and Mr. Puckett stated that the charter is being reviewed, with an expected implementation date of May 1, 2018.

Mr. Danzeiser reminded the Board that the TPA contract includes a clause that is based on their ability to control costs, which could provide an incentive to deny claims. He continued by saying it is very important for staff to carefully monitor the appeals process and to analyze the reasons for those reversals and see if there are large numbers of claim denials, or patterns that need to be further explored.

Mr. Chavez introduced Mr. Aaron Ismail, Investment Compliance Officer. Mr. Chavez reported on the results of the Investment Compliance Agreed Upon Procedures review. Mr. Chavez stated there were no issues with the portfolio compliance, personal trading and proxy voting. Securities lending had one issue related to the counterparty being below the 100% collateralization limit which was resolved within four days.

Ms. Beth Gilbert, Internal Auditor, reported on the status of audit recommendations. Implementation is based on an assessment provided by management. Internal audit reviews and analyzes the supporting documentation, but does not do independent audit work to verify the effectiveness of the management actions.

Ms. Gilbert highlighted the second observation of the Hedge Funds audit. Internal Audit recommended that the program develop a process to monitor the performance of individual funds against peer groups. An investment analyst was hired to oversee the peer review reporting process and preliminary reports were developed, but they need to be refined and improved. Staff also continues to research potential software or vendors that would allow for a greater automated report process.

This agenda item was presented for discussion and informational purposes only. No action was taken.

4. ADJOURNMENT

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

The ERS Board of Trustees Audit Committee adjourned at 8:56 a.m.