

Public Agenda Item #11a

Presentation, Discussion and Consideration of
Audit Committee Agenda items:

Internal Audit Reports

December 2, 2016

Tony Chavez, Director, Internal Audit Division

Incentive Compensation Audit

Tony Chavez, Director, Internal Audit Division
Beth Gilbert, Internal Auditor

Incentive Compensation Audit



Audit Objective: To determine if recommended incentive compensation awards were in accordance with ERS' Incentive Compensation Plan ("ICP" or "Plan")

Scope: Plan Year 2016 incentive compensation awards recommended to ERS' executive office for approval.

Scope Area	Sub-Objective(s)
ICP Participant and Development	<ul style="list-style-type: none">• Are controls present to ensure participants are eligible and meet minimum requirements to receive the award?• Are controls present to ensure performance goals developed in accordance with ICP guidelines?
ICP Award Calculations	<ul style="list-style-type: none">• Are controls present to ensure the accuracy of recommended awards?• Are controls present to ensure recommended awards align with ICP directives?

Plan Year 2016 Award Highlights



\$2.58 million – Awards submitted for approval

\$6.15 million – Maximum awards possible

69 – Participants recommended to receive ICP

Plan Year 2016 Key Changes



Plan Development:

- Human Resources Division primary owner for Plan implementation
- All participants have a discretionary goal weight of 25%
- All participants have a minimum Total Trust Fund weight of 25%

Award Calculations:

- Finance Division performs award calculations
- Investments implemented a qualitative scoring tool for discretionary goals earned

Incentive Compensation Audit



Overall Assessment		Satisfactory
Scope Area	Result	Rating
ICP Award Calculation	Based on audit scope areas reviewed internal controls are effective to ensure accuracy of award calculations.	Satisfactory
ICP Participation and Development	Observation 1: Continue to ensure sufficient and relevant information provided to executive management in a timely manner. (Significant)	Needs Improvement

Hedge Funds Absolute Return Directional Growth Audit

Tony Chavez, Director, Internal Audit Division
Jonathan Puckett, Internal Auditor

Hedge Funds Audit



Audit Objective: *To determine whether the Hedge Fund investment program is effectively designed and operating to meet ERS' investment goals and objectives.*

Background:

- The program's value added return is **primarily derived from strategy selection**
- Three portfolios: Absolute Return (risk reduction), Direction Growth (return-seeking), Special Situations (return-seeking)
- Hedge fund managers are compensated through management and performance fees

Audit Objectives / Scope Areas:

- Investment Selection
- Ongoing Operations
- Performance Reporting

Related Audit:

- 2015 Financial Opinion Audit—Performed by the State Auditors Office, which covered valuation of hedge funds.

Investment Selection



Sub Objective: Are individual investments aligned with the hedge fund strategic plan?

- *Determined if details of approved hedge fund strategies aligned with strategic plan*
- *Identified sub-strategies and target range allocations that are essential to program execution*

Sub Objective: Are investment fees competitive with industry standards?

- *Reviewed fee structures of funds versus industry standard rates – 2% management fee and 20% incentive fee*

Sub Objective: Is investment liquidity consistent with hedge fund management's targets?

- *Program identified liquidity target since policy not specific. Audit reviewed actual liquidity profile versus target.*

Ongoing Operations



Sub Objective: Are quantitative risk characteristics of hedge funds monitored at both the fund and portfolio level?

- *Observed risk committee meeting and materials*
- *Reviewed the program's monitoring activities of key performance metrics*

Sub Objective: Do hedge fund investments remain within the parameter constraints and allocations as set by the Board of Trustees?

- *Reviewed performance for any indication of style drift*

Sub Objective: Are investment fees managed in accordance with contractual rates?

- *Recalculated fees to determine if third party administrator charged the correct fees*

Performance Reporting



Sub Objective: Do benchmarks reflect the goals and objectives of the hedge fund program?

- *Reviewed current goals and benchmarks vs best practices*
- *Met with Albourne (hedge fund consultant) and obtained survey of other pension funds' benchmarks*

Sub Objective: Is hedge fund performance accurately provided to stakeholders?

- *Reviewed August 2015 and August 2016 board meeting slides and noted issues with accuracy of data*
 - *No material differences noted*

Hedge Funds Audit



Overall Assessment		Satisfactory
Scope Area	Result	Rating
Investment Selection	Based on the audit scope areas reviewed, internal controls are effective, efficient and sustainable, and fully address significant risks related operational execution and regulatory compliance.	Satisfactory
Performance Reporting	Observation #1: Certain information provided to key decision makers and stakeholders is not accurate. (Moderate)	Satisfactory
Ongoing Operations	Observation #2: Monitoring of performance versus peer group hedge funds not performed. (Moderate)	Satisfactory

Prescription Drug Program Audit

Tony Chavez, Director, Internal Audit Division
Karen Norman, Internal Auditor

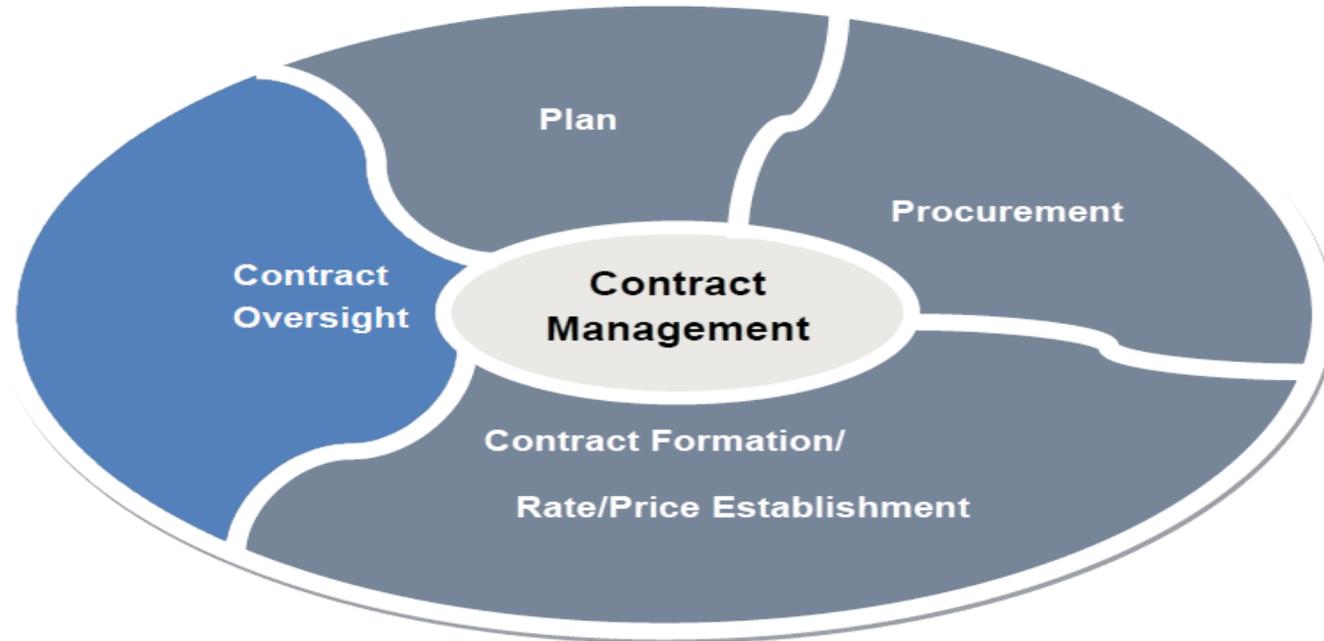
Prescription Drug Program – Information Flow



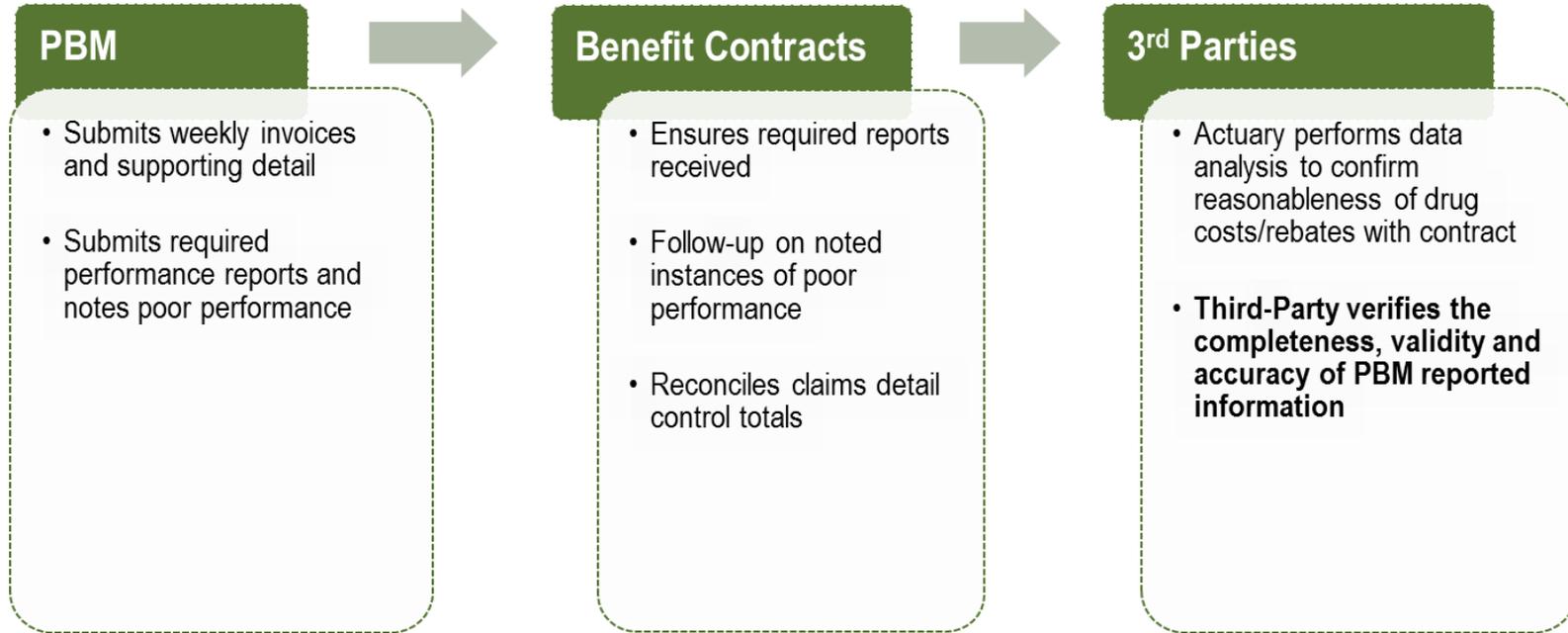
Audit Objective: *To determine if contract administration and oversight of the Prescription Drug Program ensures member benefits are properly delivered.*

Scope Area	Sub-Objectives
Financial	<ul style="list-style-type: none">• Are drug claims processed in accordance with Plan design?• Are drug costs accurately submitted for reimbursement?• Are financial guarantees determined and received in accordance with contract provisions?
Performance	<ul style="list-style-type: none">• Are members receiving benefits in accordance with the Master Benefit Plan Document?• Are deliverables submitted timely and accurately in accordance with contract provisions?• Is vendor performance accurately reported?• Is vendor performance appropriately evaluated and communicated to key stakeholders?

Contract Management Overview



Prescription Drug Program – Oversight



Summary Results



Overall Assessment		Needs Improvement
Scope Area	Result	Rating
Financial	Observation 1: Controls over accuracy of key information used to manage and evaluate the PBM are not effective. (Significant) Observation 3: Consider additional division control activities to enhance third-party review work. (Moderate)	Needs Improvement
Performance	Observation 1: Controls over accuracy of key information used to manage and evaluate the PBM are not effective. (Significant) Observation 2: PBM performance results should be consistently maintained and communicated. (Significant) Observation 3: Consider additional division control activities to enhance third-party review. (Moderate)	Needs Improvement

Controls over accuracy of information used to manage and evaluate the PBM are not effective.



Key Control – Third Party Reviewer verifies the completeness, validity and accuracy of PBM reported information

Incomplete Population

93,000 – Claims not included in the third-party review

\$4 Million – Expenses (not accounted for) paid by ERS

Limited Claims Testing

\$63,000 – Prescriptions paid by ERS for non-members

ERS Review

Performance Guarantees not tested

Performance results should be consistently maintained and communicated



- Communication of decisions
- Historical accuracy is not maintained

Monthly Administrative Performance Report (MAPR) Heat Map Summary
HealthSelect Prescription Drug Plan
Caremark Rx, L.L.C.
Fiscal Year 2015

DESCRIPTION		09-2014	10-2014	11-2014	12-2014	01-2015	02-2015	03-2015	04-2015	05-2015	06-2015	07-2015	08-2015
ACCT. MGMT.	Provide reports - Monthly, Qly, Annual	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
	Ensure participant satisfaction												Pending
	Provide quality communication materials	Not Met	Not Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
	Provide written notice of change(s)	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met	Met
	Attend annual enrollment meetings										Met	Met	
CUST. SRVC.	Respond to written correspondence	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Answer calls w/in 30 seconds	88%	87%	95%	94%	96%	94%	88%	92%	92%	93%	90%	92%
OPERATIONS	Process paper claims reimbursement	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Adjudicate pharmacy claims	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Ensure dispensing accuracy	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Ensure dispensing protocol Rx	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Ensure dispensing non-protocol Rx	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Process & mail ID cards correctly	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
SYSTEMS & DATA MGMT.	Ensure system availability	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Ensure website availability	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Process eligibility file timely, accurately	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Provide notification of file errors	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Resolve errors timely, accurately	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
	Process system and code changes	1 instance	Met	2 Instances	Met	Met							

Consider additional division control activities to enhance third-party review



Investment Compliance

July 1 – September 30, 2016

Tony Chavez, Director, Internal Audit Division
Beth Gilbert, Internal Auditor
Jonathan Puckett, Internal Auditor

Investment Compliance Procedures



Securities Lending –

- Program temporarily suspended since February 2016
- Program is restricted to only ETFs which has caused audit flags for diversification limits through September 2016.

Questions?