

# ERS

EMPLOYEES  RETIREMENT  
SYSTEM OF TEXAS

Internal Audit Annual Report  
Fiscal Year 2016

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**MISSION:**

Internal Audit provides independent and objective assurance on the effectiveness of controls and operations to meet ERS' strategic direction.

**PRINCIPLES:**



Integrity — work performed with honesty, diligence, and responsibility

Objectivity – impartial and unbiased attitude in audit work performed

Confidentiality - value and ownership of information respected and maintained

Competency - work performed with proficiency and due professional care

**VISION:**

- Relevant and beneficial audit results
- Sustainable and repeatable audit practices and procedures
- Meaningful Internal Audit indicators and measures
- Staff professional development and growth

## **I. Compliance Texas Government Code, Section 2102.015: Posting the Internal Audit Plan, Internal Audit Annual Report and Other Audit Information on the Internet Website**

House Bill 16 (83<sup>rd</sup> Legislature, Regular Session), signed by Governor Perry on June 14, 2013, amended the Internal Auditing Act to require state agencies and institutions of higher education, as defined in the bill, to post agency internal audit plans, internal audit annual reports, and any weaknesses or concerns resulting from the audit plan or annual report on the agencies' Internet Web site within 30 days after the audit plan and annual report are approved by the agencies' governing board or chief executive.

The Internal Audit Division meets the requirements by posting the approved documents at the following link: [http://www.ers.state.tx.us/About\\_ERS/Reports/Overview/](http://www.ers.state.tx.us/About_ERS/Reports/Overview/)

A detailed summary of weaknesses, deficiencies, wrongdoings, or others concerns raised by the audit plan or annual report and a summary of actions taken by ERS to address concerns, if any, that are raised by the audit plan or annual report is included in part II of this document.

## II. Internal Audit Plan for Fiscal Year 2016

Report Number	Title	Date	Status
2015-02	Procurement	12-2015	Report Issued
2015-04	BI Data Warehouse	02-2016	Report Issued
2016-01	Incentive Compensation Plan	11-2015	Report Issued
2016-02	GBP Procurement Follow-Up	04-2016	Report Issued
2016-05	Network Security (Cybersecurity)	07-2016	Report Issued
2016-06	Disability Retirements	07-2016	Report Issued
2016-IC-AUP-01	Investment Compliance AUP July – September 2015	11-2015	Report Issued
2016-IC-AUP-02	Investment Compliance AUP October – December 2015	01-2016	Report Issued
2016-IC-AUP-03	Investment Compliance AUP January – March 2016	04-2016	Report Issued
2016-IC-AUP-04	Investment Compliance AUP April – June 2016	07-2016	Report Issued
2016-02 Follow-Up	Status of Audit Recommendations	01-2016	Report Issued
2016-08 Follow-Up	Status of Audit Recommendations	07-2016	Report Issued

### Deviations from the approved FY2016 Audit Plan

One project was removed from FY2016 Audit Plan and another project was added.

Report Number	Title	Status
	Flexible Spending Accounts	Removed from Audit Plan
2016-04	Prescription Drug Program	Added to Audit Plan

Two projects were carried forward to the FY2017 Audit Plan.

Report Number	Title	Status
2016-03	Hedge Funds	Carried Forward to FY2017 Audit Plan
2016-04	Prescription Drug Program	Carried Forward to FY2017 Audit Plan

**Detailed summary of weaknesses, deficiencies, wrongdoings, or other concerns raised by the Audit Plan or Annual Internal Audit Report.**

Twice a year, Internal Audit reviews the management action plans identified within each audit report to ensure appropriate mitigating activity is being implemented or that executive management has accepted the risk. The results of the follow-up procedures are reported to the Board of Trustees and Executive Management in December and February of each year.

1) In FY2016, ERS Internal Audit Division completed six (6) audit projects with ten (10) observations identified.

- 08 Control Design<sup>1</sup>
- 02 Operating Effectiveness<sup>2</sup>

Most Management Action Plans for the above audits have FY2017 completion target dates.

2) ERS Internal Audit Division completed two (2) Follow-Up Audits reviewing Management Action Plan (MAPs) to determine if management addressed the risk identified. There were 10 total findings/observations from prior year's audit engagements reviewed.

- 10 Control Design
  - 07 of 10 were Fully Implemented
  - 03 of 10 were Partially Implemented

<sup>1</sup> Choose Control Design when there is an error in the way the process is set-up or nothing is in place.

<sup>2</sup> Choose Operating Effectiveness when there is a process in place but the process is not working efficiently or effectively.

### III. Consulting Services and Nonaudit Services Completed

The *International Standards for the Professional Practice of Internal Auditing* define consulting services as advisory in nature and at the specific request of an engagement client. The nature and scope of consulting engagements are subject to agreement with the engagement client.

#### Service Organization Control (SOC) reports

In fiscal year 2016, Internal Audit reviewed Service Organization Control (SOC) reports for compliance with Statement on Standards for Attestation Engagements No. 16 – *Reporting on Controls at Service Organizations*.

Specifically we performed the agreed upon procedures to assist management in its review of the service providers SOC report. Internal Audit did not perform review procedures to determine if the service organization control objectives and the related control activities are relevant to ERS nor did we perform procedures to identify any control gaps that may affect ERS’ business objectives. Information provided was intended solely for the use of ERS management, and was not intended to be and should not be used by anyone other than the specified party.

<b>Deliverable</b>	<b>Title</b>	<b>Date</b>	<b>Objective</b>
Memorandum	Minnesota Life Insurance Company	10/26/2015	Reviewed the vendor SOC report for compliance with Statement on Standards for Attestation Engagements No. 16.
Memorandum	Empower Retirement, Defined Contribution Plan Record Keeping System	01/06/2016	Reviewed the vendor SOC report for compliance with Statement on Standards for Attestation Engagements No. 16.
Memorandum	CareMark RX, Pharmacy Benefit Management System	02/01/2016	Reviewed the vendor SOC report for compliance with Statement on Standards for Attestation Engagements No. 16.
Memorandum	Wells Fargo Institutional Retirement & Trust	07/07/2016	Reviewed the vendor SOC report for compliance with Statement on Standards for Attestation Engagements No. 16.
Memorandum	United HealthCare Report on Claims Administration Processing	8/24/2016	Reviewed the vendor SOC report for compliance with Statement on Standards for Attestation Engagements No. 16.

### Allegations of Fraud, Waste and Abuse

In fiscal year 2016, Internal Audit continued to assist in compiling, tracking, and coordinating with the Chief Compliance Officer to determine the proper delegation and disposition of the final results of internal and external allegations of wrongdoing. Trends identified are reported to the Board of Trustees annually. In addition, three fraud investigations were completed but no wrongdoing was identified.

### Informal Consulting

Internal Audit also provided input and guidance as a subject matter expert related to risk and control self-assessments. This included methodology for measuring inherent risk to assist divisions in identifying those areas of most importance. Internal Audit did not develop or implement any specific control activities nor assume any management responsibility. No formal deliverable was prepared.

#### **IV. External Quality Assurance Review (Peer Review)**

**REPORT ON THE  
EXTERNAL QUALITY ASSURANCE REVIEW  
OF THE EMPLOYEES RETIRMENT SYSTEM OF  
TEXAS**

**INTERNAL AUDIT DIVISION**

*October 31, 2013*



**PERFORMED BY  
AMY BARRETT  
CHIEF AUDIT EXECUTIVE  
TEACHER RETIREMENT SYSTEM OF TEXAS**

**TOM MCGAHA  
SENIOR INTERNAL AUDITOR  
TEXAS DEPARTMENT OF INSURANCE**

**KENT HEATH  
INTERNAL AUDITOR  
TEXAS COMMISSION ON ENVIRONMENTAL QUALITY**

**PERFORMED IN ACCORDANCE WITH THE  
STATE AGENCY INTERNAL AUDIT FORUM  
PEER REVIEW POLICIES AND PROCEDURES**

## OVERALL OPINION

Based on the information received and evaluated during this external quality assurance review, it is our opinion that the Employees Retirement System of Texas (ERS) Internal Audit Division receives a rating of "pass with deficiencies" and is in material compliance with the Institute of Internal Auditors (IIA) *International Professional Practices Framework* and Code of Ethics, the United States Government Accountability Office (GAO) *Government Auditing Standards*, and the Texas Internal Audit Act (*Texas Government Code*, Chapter 2102) with exceptions identified in the report. This opinion, which is the middle of the three possible ratings, means that policies, procedures, and practices are in place to implement the standards and requirements necessary for ensuring the independence, objectivity, and proficiency of the internal audit function, with the exception of the deficiencies noted.

We found that the Internal Audit Division is independent, objective, and able to render impartial and unbiased judgments on the audit work performed. The staff members are qualified, proficient, and knowledgeable in the areas they audit. Individual audit projects are planned using risk assessment techniques; audit conclusions are supported in the working papers; and findings and recommendations are communicated clearly and concisely.

The Internal Audit Division is well managed internally. In addition, the Division has effective relationships with the ERS Board of Trustees (Board) and is well respected and supported by management. Interviews conducted during the quality assurance review indicate that management considers Internal Audit a useful part of the overall agency operations and finds that the audit process and report recommendations add value and help improve the agency's operations.

## ACKNOWLEDGEMENTS

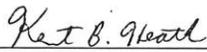
We appreciate the courtesy and cooperation extended to us by the Internal Auditor, Internal Audit staff, Board Members, the Executive Director, Chief Operating Officer, and the senior managers who participated in the interview process. The feedback from the interviews provided valuable information regarding the operations of the Internal Audit Division and its relationship with management.

  
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Amy Barrett  
Chief Audit Executive  
Teacher Retirement System of  
Texas  
SAIAF Peer Review Team Leader

10/31/13  
Date

  
\_\_\_\_\_  
Tom McGaha  
Senior Internal Auditor  
Texas Department of Insurance  
SAIAF Peer Review Team Member

10/31/13  
Date

  
\_\_\_\_\_  
Kent B. Heath  
Internal Auditor  
Texas Commission on Environmental Quality  
SAIAF Peer Review Team Member

10/31/13  
Date

## **V. Internal Audit Plan for Fiscal Year 2017**

### **Introduction**

The Texas Internal Auditing Act (Texas Government Code) requires that a risk-based annual audit plan be developed and approved by the Board of Trustees. The Plan is designed to provide coverage of key risks, given the existing staff and approved budget. Key risks were determined based on a systemic approach incorporating management input, Internal Audit analysis, and ERS' strategic objectives.

Continuous evaluation of the Internal Audit Plan, based on risks identified, timing of ERS' initiatives, and staff availability may result in modifications to the Internal Audit Plan during the year. Significant modifications to the Internal Audit Plan will be coordinated with the Executive Director and submitted to the Audit Committee Chair for review and approval.

### **Audit Plan Approach**

The annual internal audit plan is developed based on ERS' audit universe, stakeholder input, and an assessment of risk and exposures affecting ERS. Throughout the year Internal Audit advances its understanding of ERS strategic objectives and initiatives through attendance at strategic planning meetings, and division presentations/training. Auditors also gain an understanding of industry trends and current environmental risks through discussions with industry personnel, review of trade publications, and attending relevant external training. On a periodic basis the audit universe and associated risk measurement tools are updated to reflect current strategies and the direction of the agency.

ERS' audit universe is divided into two separate and distinct groupings to better assess and measure risks associated with core business objectives. The first group, Member Services (Retirement, Group Benefits, Operations and Information Resources), relates to ERS core business objectives of providing retirement and benefit programs to state employees, retirees, and their dependents. The second group, Investments, core business relates to the ERS goal of earning investment returns on a long-term basis to support ERS member services.

For the FY 2017 the Audit Universe was significantly revised including the development of specific risk criteria for Information Systems and incorporation of a framework to better evaluate cybersecurity risk and objectives. The framework is divided into five core functions with each containing distinct security objectives.

For each auditable unit (program process or investment strategy), Internal Audit utilized risk criteria tailored for each audit universe, auditor professional judgement and feedback from Stakeholders to measure the inherent risk by impact and likelihood that it would affect ERS goals or objectives. This allowed Internal Audit to identify those areas that were high risk and impact to ERS' strategic directions to be carried forward to the fiscal year 2017 audit plan. In addition key operational functions that were assessed lower risk ratings were also carried forward to the fiscal year 2017 audit plan because periodic review was deemed necessary and appropriate.

## **Internal Audit Plan**

The Board of Trustees approved the Internal Audit Plan for Fiscal Year 2017 on August 16, 2016. The Internal Audit Plan consists of twelve risk-based, value-adding activities for the fiscal year. The audit activities (including FY2016 Audits carried over) consist of three (3) types of activities and coverage:

### **Audits**

- Nature and scope of engagement determined by Internal Audit
- Highest level of assurance
- Deliverable: Report for public distribution

### **Agreed Upon Procedures**

- Specific procedures agreed to between management and Internal Audit to perform and report on the results
- Lowest level of assurance
- Deliverable: Report/memo for public distribution

Consulting (Advisory)

- Nature and scope of engagement subject to agreement with audit customer
- No assurance provided
- Deliverable: Report or memo with limited distribution

The Internal Audit Division will provide the results of audit activities to the Audit Committee and Board of Trustees at the request of the Audit Committee Chair.

**Approved Audit Plan FY2017**

<b>Title</b>	<b>Type</b>	<b>Budgeted Hours</b>
Ethics Program	Audit	350
Procurement Cards	Audit	350
Contract Management – HealthSelect*	Audit	750
Revenue Processing – State Agency Contributions	Audit	500
Standard Retirements	Audit	750
Privacy Incident Response	Audit	750
Incentive Compensation	Audit	200
Investment Compliance Review	Consulting (Advisory)	750
Investment Governance	Consulting (Advisory)	500
Quarterly Investment Compliance Procedures	Agreed Upon Procedures	500
2016 Financial Audit Opinion	Audit	80
Pension Actuary Review	Audit	40

\*Contract management

## Contingency List

A contingency list of two (2) activities is also included in the internal audit plan. These risks were ranked as “high” but were not included in the fiscal year 2016 Internal Audit Plan. This provides for additional coverage if the above activities are completed prior to the conclusion of the fiscal year.

Title	Type
HealthSelect Denial Process	Audit
Global Credit High Yield	Audit

## VI. External Audit Services Procured in Fiscal Year 2016

Audit Engagement	Vendor
The Audit of ERS' Fiscal Year 2015 Financial Statements	Texas State Auditor's Office
Schedule of Employer Allocation and the Collective Pension Amounts including:	
1) Independent Auditor's Report and 2) Report on Internal Control Over Financial Reporting and on Compliance and Other Matters.	Texas State Auditor's Office

## VIII. Reporting Suspected Fraud and Abuse

ERS has a responsibility to state employees, retirees, and the public to maintain the highest ethical standards when conducting business. Individuals are encouraged to report in good faith any suspected fraud, waste, abuse, or ethics policy violation in connection with programs administered by ERS.

ERS complies with the requirements of Article IX, *Section 7.09, Fraud Reporting, General Appropriations Act* General Appropriations Act (83<sup>rd</sup> Legislature, Conference Committee Report) by:

- Enforcing the ERS Fraud policy to minimize the impact of potential or actual fraudulent acts at ERS by deterring such activity or detecting it as early as possible
- Alerting all ERS employees that there are reporting mechanisms that are easy, safe and secure using:
  - ERS Public website
  - ERS Internal Focal Point Website (Intranet)
  - Direct contact with Internal Audit
  - State Auditor's Office Hotline
- Alerting the public that there are reporting mechanisms that are easy, safe, and secure using:
  - ERS Public website at  
[https://www.ers.state.tx.us/three\\_column\\_template.aspx?menuid=2147483675&pageid=2147483685](https://www.ers.state.tx.us/three_column_template.aspx?menuid=2147483675&pageid=2147483685)
  - Direct contact with the Director, Internal Audit Division or Chief Compliance and Ethics Officer
  - State Auditor's Office Fraud Hotline telephone number is listed on the ERS Public Website at  
[https://www.ers.state.tx.us/three\\_column\\_template.aspx?menuid=2147483675&pageid=2147483685](https://www.ers.state.tx.us/three_column_template.aspx?menuid=2147483675&pageid=2147483685)

ERS complies with the requirements of Texas Government Code, Section 321.022 *Coordination of Investigations* by submitting *Reasonable Cause to Believe* report(s) to the State Auditor's Office if applicable.

The Director, Internal Audit Division coordinates the *SAO Hotline Complaints* with his Texas State Auditor's Office designated contact.