

# **Audit Committee Meeting**

**September 2012**



Teacher Retirement System of Texas  
1000 Red River Street, Austin, Texas 78701-2698

**TEACHER RETIREMENT SYSTEM OF TEXAS  
BOARD OF TRUSTEES  
AUDIT COMMITTEE  
  
MEETING AGENDA**

**September 14, 2012 – 8:00 a.m.  
TRS East Building, 5<sup>th</sup> Floor, Boardroom**

- 1. Approve Minutes of June 8, 2012 Audit Committee Meeting**
  - Mr. Christopher Moss, Chair
  
- 2. Receive State Auditor’s Office Report on Planned Audit of TRS’ Comprehensive Annual Financial Report for Fiscal Year 2012** - Ms. Angelica Ramirez and Mr. Greg Adams, State Auditor’s Office
  
- 3. Receive Internal Audit Reports**
  - A. Audit of External Private Markets (EPM) Investments – Mr. Hugh Ohn and Mr. Rich Hall; Mr. Tom Wagner, Deloitte & Touche, L.L.P.
  - B. Quarterly Testing of Compliance with the Investment Policy Statement (Agreed-Upon Procedures) – Mr. Hugh Ohn and Ms. Dinah Arce
  - C. Testing of Information Systems Support Change Management Process (Agreed-Upon Procedures) – Mr. T.A. Miller, Ms. Christi Holman, Mr. Billy Lowe, and Ms. Lih-Jen Lan
  - D. Quarterly Testing of Information Security (Agreed-Upon Procedures)
    - Ms. Lih-Jen Lan
  - E. Quarterly Testing of Benefit Payments (Agreed-Upon Procedures)
    - Ms. Amy Barrett
  
- 4. Receive Status of Prior Audit and Consulting Recommendations**
  - Ms. Amy Barrett
  
- 5. Consider Recommendation to the Board of Trustees Regarding Proposed Revisions to the Internal Audit Charter** – Ms. Amy Barrett
  
- 6. Consider Recommendation to the Board of Trustees Regarding the Proposed Audit Plan for Fiscal Year 2013**
  - A. Options for Employer Audits for Fiscal Year 2013 – Ms. Karen Morris
  - B. Proposed Audit Plan for Fiscal Year 2013 – Ms. Amy Barrett
  
- 7. Receive Internal Audit Administrative Reports** – Ms. Amy Barrett
  - A. Results of Quality Assurance and Improvement Program Self-Assessment
  - B. Quarterly Internal Audit Status Reports
  
- 8. Evaluate the Performance of the Chief Audit Executive and Consider a Recommendation to the Board of Trustees Regarding the Performance Appraisal and Compensation of the Chief Audit Executive** – Mr. Brian Guthrie

**TAB 1**



**TEACHER RETIREMENT SYSTEM OF TEXAS  
AUDIT COMMITTEE MEETING  
June 8, 2012**

The Audit Committee of the Teacher Retirement System of Texas met on Friday, June 8, 2012 in the 5<sup>th</sup> floor Board room. The following persons were present:

**TRS Board Members**

Christopher Moss, Audit Committee Chair  
Eric C. McDonald, Audit Committee Member  
Nanette Sissney, Audit Committee Member  
Todd Barth, Audit Committee Member  
Anita Smith Palmer, Audit Committee Member  
R. David Kelly, Board Chair  
T. Karen Charleston, Board Member  
Joe Colonna, Board Member

**TRS Staff**

Brian Guthrie, Executive Director  
Ken Welch, Deputy Director  
Amy Barrett, Chief Audit Executive  
Hugh Ohn, Director, Investment Audit & Compliance  
Jan Engler, Manager, Internal Audit  
Lih-Jen Lan, Information Technology Manager, Internal Audit  
Dinah Arce, Senior Auditor, Internal Audit  
Terry Harris, Senior Investment Compliance Specialist, Internal Audit  
Dorvin Handrick, Senior Information Technology Auditor, Internal Audit  
Brian Gomolski, Senior Investment Auditor, Internal Audit  
Toma Miller, Risk, Control, & Compliance Specialist, Internal Audit  
Stephen Henry, Intern, Internal Audit  
Amy Morgan, Chief Information Officer  
Jerry Albright, Deputy Chief Investment Officer  
Sylvia Bell, Director, Administrative Center, Investments  
Jase Auby, Chief Risk Officer, Investment Division  
James Nield, Senior Investment Manager, Investment Division  
Ashley Baum, Chief of Staff to the Chief Investments Officer, Investment Division  
David Veal, Chief of Staff to the Chief Investments Officer, Investment Division  
Conni Brennan, General Counsel  
Charmaine Skillman, Assistant General Counsel  
Mary Chang, Assistant General Counsel  
Jamie Michels, Manager, General Accounting  
Cindy Haley, Team Leader, Financial Reporting, General Accounting  
Arlene Caballero, Payroll/Benefits Coordinator, General Accounting

**TRS Staff** (cont'd)

Ardtria Griffin, Leave/Benefits Coordinator, General Accounting  
Scot Leith, Manager, Investment Accounting  
Janet Bray, Director, Human Resources  
Mike Debbs, Senior HR Analyst, Human Resources  
Liz Oliphint, Manager, Benefit Processing  
Mike Rehling, Manager, Benefit Processing  
Jay LeBlanc, Director, Risk Management & Strategic Planning  
David Powell, Intern, Executive Division

**Other Attendees**

Leroy DeHaven, Texas Retired Teachers Association  
Tom Rogers, Austin Retired Teachers Association  
Steven Huff, Reinhart Boerner Van Deuren s.c.  
Angelica Ramirez, State Auditor's Office  
Amadou Ngaide, State Auditor's Office  
Rene Hernandez, Protiviti  
Joe Wojkowski, Protiviti  
Jeff Lambert, State Street Bank  
Mark Schafer, State Street Bank  
Stephen Kim, State Street Bank

Audit Committee Chair Christopher Moss called the meeting to order at 8:00 a.m. with a quorum of committee members present.

**1. APPROVE MINUTES OF APRIL 20, 2012 AUDIT COMMITTEE MEETING**

Mr. Todd Barth moved that the proposed minutes of the April 20, 2012 Audit Committee meeting be approved. Ms. Anita Smith Palmer seconded the motion, and the minutes were unanimously approved as presented.

**2. RECEIVE REPORT FROM THE STATE AUDITOR'S OFFICE ON THE AUDIT OF INCENTIVE COMPENSATION**

Mr. Amadou Ngaide presented the results of the State Auditor's Office audit of the incentive compensation plan at TRS. Mr. Ngaide stated that the report concluded that TRS calculated and paid incentive compensation in accordance with the plan. One recommendation was made regarding the establishment of a performance target for the trade management group. Management agreed to implement the recommendation.

**3. RECEIVE REPORTS ON COMPLETED INTERNAL AUDIT PROJECTS**

**A. Audit of Employee Compensation, Payroll, and Position Control**

Ms. Jamie Michels gave an overview of the payroll processes and controls at TRS.

Ms. Dinah Arce presented the results of the audit. She stated that there were no significant findings and two recommendations were made. The first one proposed that Human Resources develop written procedures that incorporate processes for payroll and ensure job descriptions are updated and personnel action forms are accurate. The second recommended the development of guidance for exempt employees on requesting payment of compensatory time. Management has agreed to both recommendations.

#### **B. Audit of Investment Risk Management**

Mr. Hugh Ohn gave a brief overview of the objectives of the Investment Risk Management Audit and stated that auditors from Protiviti were engaged to provide outside expertise to the project.

Mr. Rene Hernandez and Mr. Joe Wojkowski, both of Protiviti, discussed the results of the audit and explained the recommendations that were made. The audit found that management controls were operating effectively to achieve the business objectives, but there were opportunities to improve controls related to investment risk measuring and reporting activities. Management has agreed to the recommendations.

#### **C. Quarterly Testing of Compliance with the Investment Policy Statement (Agreed-Upon Procedures)**

Mr. Hugh Ohn presented the results of the compliance testing of the Investment Policy Statement. He stated that only one exception was found this quarter and that it was a carryover issue from the previous quarter. Management has taken action to mitigate the risk going forward.

#### **D. Quarterly Testing of Information Security (Agreed-Upon Procedures)**

Ms. Amy Barrett stated that this quarter's information security testing focused on access permissions to four high risk systems in the Investment Management Division. She noted a few exceptions were found and immediately corrected.

### **4. RECEIVE STATUS OF PRIOR AUDIT AND CONSULTING RECOMMENDATIONS**

Ms. Amy Barrett gave a brief overview of the outstanding audit recommendations. She stated that all outstanding significant recommendations have been implemented. Internal Audit staff has met with the executives in charge of implementation of all remaining items and feels that appropriate progress is being made. Two recommendations from a human resources consulting project in fiscal year 2010 have been substantially implemented and will no longer appear on the quarterly report. The new human resources director is reviewing what has been done to date to see if there are any future improvements needed. The audit committee directed internal audit staff to incorporate an audit of human resource issues identified in the prior consulting engagement once management has had an opportunity to implement planned changes.

## **5. RECEIVE REPORTS AND OBTAIN INPUT ON INTERNAL AUDIT PROJECTS IN PROGRESS**

### **A. Survey of Public Pension Funds**

Ms. Barrett gave an overview of the results of two surveys conducted by Internal Audit to gain more information regarding employer audits conducted at other pension plans. One survey was of public pension plans that conduct employer audits and the second survey was of public pension plans that do not conduct employer audits. Different options for employer audits will be developed and will address compliance and liability issues as well as resources required for these projects. These options will be presented at the September audit committee meeting. In addition, the audit committee directed internal audit staff to provide information in September on incentives employers have for not following plan rules and the effects on the trust related to financial, legal, and compliance matters.

### **B. Audit Plan for 2013**

Ms. Barrett discussed the audit project universe and the projects currently scheduled for fiscal year 2013. Ms. Barrett requested feedback on whether the proposed audit areas addressed the concerns of committee members or if they wanted other audit areas covered. The proposed audit plan will be presented to the audit committee and the board of trustees in September 2012 for approval.

## **6. RECEIVE REPORTS ON INTERNAL AUDIT ADMINISTRATIVE ACTIVITY**

Ms. Barrett reviewed several standard administrative reports including the status of the audit plan. Ms. Barrett stated she is confident that all audit projects planned for the current fiscal year will be completed. Lastly, Ms. Barrett introduced Stephen Henry, the Internal Audit summer intern.

The meeting adjourned at 9:16 a.m.

Approved by:

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Christopher Moss  
Chair, Audit Committee  
Board of Trustees  
Teacher Retirement System of Texas

**TAB 2**



## **Audit Committee Meeting Agenda**

### **Financial Statement Audit of the Teacher Retirement System**

#### **For the Fiscal Year Ended August 31, 2012**

### **INTRODUCTION AND AUDIT TEAM MEMBERS**

State Auditor's Office Audit Team:

- Angelica M. Ramirez, CPA (Audit Manager)
- Gregory Scott Adams, CPA, MPA, CGFM, Project Manager
- Mary Ann Wise, CPA, CFE, Assistant Project Manager
- New and returning team members

### **PURPOSE AND SCOPE OF THE AUDIT**

- To determine whether the Teacher Retirement System's (System) fiscal year 2012 financial statements are materially correct in accordance with U.S. generally accepted accounting principles.
- To review internal controls to the extent necessary to express an opinion on the financial statements.
- To test financial transactions and note disclosure information.
- To test compliance with laws and regulations for which noncompliance would have a direct and material effect on financial statements amounts.
- To detect and report any fraud and/or illegal acts that are material to the financial statements.

### **REPORTING TIME LINE**

- Independent auditor's report (opinion on the financial statements) – November 13, 2012 (estimated).
- Report on internal controls and on compliance and other matters (required for audits performed in accordance with generally accepted government auditing standards) – November 2012.
- Report to the Legislative Audit Committee – November 2012.

### **ADMINISTRATIVE AND OTHER MATTERS**

- Audit work will be conducted in two phases; interim work July 16 – August 24, and substantive work October 1 – November 13.
- Auditors will coordinate their work through the internal audit liaison but will still have direct access to records, employees, and external service providers.
- Internal Audit will provide direct assistance through the performance of selected audit procedures as agreed upon between the State Auditor's Office and Internal Audit.
- The State Auditor's Office is independent to conduct the audit of the System's fiscal year 2012 financial statements. The State Auditor's Office conducts all projects in an environment of full independence; that is, free of any personal, external, or organizational impairment.

TAB 3

**TAB 3A**

# AUDIT OF EXTERNAL PRIVATE MARKETS (EPM) INVESTMENTS

August 29, 2012

## TRS Internal Audit Department

<b>Business Objectives</b>	To invest in private equity and real asset funds (including co-investments) to generate long-term rate of return in excess of policy benchmark and provide diversification	To ensure that private markets investments are recorded at fair value in accordance with industry valuation standards	To establish long-term strategic partner network (SPN) relationship with private markets investment firms
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>Investments not fitting strategy</li> <li>Selecting no or less qualified managers/funds</li> <li>Fund strategy or style drift</li> <li>Liquidity risk</li> <li>Lack of transparency</li> </ul>	<ul style="list-style-type: none"> <li>No audits on funds or no timely receipt of audit report</li> <li>Inaccurate net asset value (NAV) reported</li> <li>General Partner's (GP) valuation policies not covered by due diligence</li> </ul>	<ul style="list-style-type: none"> <li>Unqualified or less qualified firms selected</li> <li>Improper/undue influence</li> <li>Final selection not supported by evaluations</li> <li>Lack of transparency</li> <li>Legal risk</li> </ul>
<b>Management Controls</b>	<ul style="list-style-type: none"> <li>Investment Policy Statement (IPS)</li> <li>Due diligence</li> <li>Internal Investment Committee (IIC) approval</li> <li>Semi-annual portfolio review</li> </ul>	<ul style="list-style-type: none"> <li>Monitoring of GP audited financial statements</li> <li>Reconciliation of values between State Street/GP</li> <li>Due diligence checklists</li> <li>Investment staff's ongoing monitoring</li> </ul>	<ul style="list-style-type: none"> <li>Appropriateness of evaluation/selection criteria</li> <li>Investment staff's due diligence</li> <li>Internal and external legal counsel's assistance</li> </ul>
<b>Controls Tested</b>	<ul style="list-style-type: none"> <li>Staff's due diligence</li> <li>Consultant's prudence letter</li> <li>Verification of manager in Premier List</li> <li>Semi-annual portfolio review</li> </ul>	<ul style="list-style-type: none"> <li>Review of annual financial statements</li> <li>Reconciliation to the partner capital statements</li> <li>Performance of Investment staff's initial due diligence</li> <li>Identification of variances</li> </ul>	<ul style="list-style-type: none"> <li>Policies and procedures, including evaluation criteria</li> <li>Supporting documentation for evaluation results</li> <li>Consultant's input</li> <li>Confirmation with Legal Services staff</li> </ul>
<b>Results</b>	<ul style="list-style-type: none"> <li>Management controls are operating effectively.</li> <li>An opportunity to preclude Trustee's non-compliance with prohibited investments under Ethics Policy exists.</li> </ul>	<ul style="list-style-type: none"> <li>Management controls are operating effectively.</li> <li>Opportunities to improve or modify the controls related to the valuation procedures exist.</li> </ul>	<ul style="list-style-type: none"> <li>Management controls are operating effectively.</li> <li>An opportunity to improve the investment approval process exists.</li> </ul>
<b>Recommended Actions</b>	<ul style="list-style-type: none"> <li>Identify information for Trustees to preclude non-compliance with Ethics Policy requirement on prohibited investments.</li> </ul>	<ul style="list-style-type: none"> <li>Reconcile partner capital statements with audited financial statements.</li> <li>Consider discontinuing the Valuation Committee.</li> </ul>	<ul style="list-style-type: none"> <li>Obtain IIC approval for investment proposals requiring Board action.</li> </ul>
<b>Management Responses</b>	<p>Agree – Legal Services and Investment Management Division (IMD) will identify information on which Trustees may rely for ethics compliance.</p>	<p>Agree – Management will</p> <ul style="list-style-type: none"> <li>Perform reconciliations.</li> <li>Discuss Valuation Committee future in the next committee meeting.</li> </ul>	<p>Agree – IMD will follow the approval procedures of the IIC Charter, effective immediately.</p>

Legend of Results:



Red - Significant to TRS  
Yellow - Other Reportable Issue



Orange - Significant to Business Objectives  
Green - Positive Finding or No Issue



August 29, 2012

Audit Committee, Board of Trustees  
Mr. Brian Guthrie, Executive Director

## EXECUTIVE SUMMARY

We have completed the audit of **External Private Markets (EPM) Investments**, as included in the *Fiscal Year 2012 Audit Plan*. As part of this project, Internal Audit engaged an external service provider (Deloitte & Touche) to obtain additional expertise. Business objectives related to the EPM investments that are covered as part of this project are as follows:

- To invest in private equity and real asset funds (including co-investments) to generate a long-term rate of return in excess of policy benchmark and provide portfolio diversification
- To ensure that private markets investments are recorded at fair value in accordance with industry valuation standards
- To establish long-term strategic partner network (SPN) relationship with private markets investment firms

Based on our audit results, we determined that management controls are operating effectively to achieve business objectives. We did not identify any significant issues. However, we identified opportunities to enhance or modify controls regarding Trustee's compliance with the Ethics Policy, valuations of private markets investments, and the investment approval process. Specifically, we recommend that:

- Legal Services work with IMD staff to identify the information for Trustees to preclude non-compliance with the Ethics Policy regarding private markets prohibited investments.
- Investment Accounting reconcile the net asset value from the partner capital statement with annual audited financial statements for all TRS private markets investments
- TRS management consider discontinuing the operation of the Valuation Committee
- The proposed investments requiring Board action be approved by the Internal Investment Committee (IIC), as required by the recently adopted IIC Charter.

Results of our procedures are presented in more detail in the **Results and Recommendations** section (page 8). The audit objective, scope, methodology and conclusion are described in **Appendix A** (page 14).

## BACKGROUND

### Private Markets Investments

Unlike the securities traded in public markets, such as stocks and bonds, private markets investments represent a variety of illiquid investments. Illiquidity means that the investments generally cannot be sold at short notice and require a long-term investment horizon and capital commitment. The major categories of private markets investments include private equity, real estate, and infrastructure.

In addition to illiquidity, private markets investments show the following characteristics:

- **Lack of transparency** – Information about private equity, such as investment strategies, investment holdings, investment performance, is not publically available. Information is scarce, non-systemic, and difficult to obtain.
- **Potential for higher returns** – Private markets investments have the potential to offer investors higher returns. Such higher returns, however, are compensating investors for a higher degree of illiquidity and less transparency surrounding these investments.
- **Additional diversification** - Private markets investments have different return characteristics from traditional asset classes. Their returns are less correlated with traditional equity and fixed income securities, mitigating undue portfolio risk.
- **Longer-term horizon** – Private markets investments are relatively illiquid, typically with lock-up investments periods, with an average life of 10 – 12 years. Long-term investors such as pension funds do not require a high level of liquidity, and therefore, can benefit from the “liquidity risk premium.”

### External Private Markets (EPM) Group

At TRS, private markets investments are managed by the External Private Markets (EPM) group. This group consists of 22 professionals with numerous advanced degrees and certifications and a wide array of prior experience. The current organization chart for this group is shown in **Appendix B** (page 16).

The primary business objective of the EPM group is to make investments that generate a long-term rate of return in excess of the return of the policy benchmark for each authorized Private Markets investment strategy as outlined in the Investment Policy Statement (IPS). To achieve this objective, the EPM group identifies investing opportunities, performs due diligence, and monitors performance of investments made. In addition to the regular responsibilities for managing investments in private equity and real assets, the EPM group is also responsible for managing the Emerging Manager Program. This program, which started based on the Rider included in the Fiscal Years 2010-2011 Appropriations Act, provides growing opportunities for qualified emerging fund managers.

The investment process for private markets investments includes such steps as strategic planning, manager certification, review and approval by the Internal Investment Committee (IIC), continuous monitoring, and reporting. See **Appendix C** (page 17) for a summary of the private markets investment process.

## Selection of Strategic Partner Network (SPN) Firms

In 2010, the EPM group started seeking to establish long-term Strategic Partnership Network (SPN) relationships with highly qualified private markets firms with primary goals of reaching global access to multiple private markets assets, establishing firm-to-firm relationships (rather than a single fund-based relationship), increasing alignment of long-term interest, improving strategic planning and research capabilities, and lowering overall fees. This task of selecting SPN was completed when the Board of Trustees (Board) approved hiring of two firms (based on the Investment Management Division's recommendation), with an allocation of \$3 billion to each firm, in November 2011.

## TRS Private Markets Investments

The TRS Board, through the Investment Policy Statement (IPS), established a long-term target asset allocation of 27% to private markets investments. The Board allowed that this allocation could range from 12% to 37%. As of June 30, 2011, the net asset value of TRS private markets investments was \$25.7 billion which represented approximately 23.6% of the total Trust investments.

As of June 30, 2012, the number of private equity and real assets funds TRS invested in (including co-investments) was 124 and 110, respectively. These investments are executed in a limited partnership agreement (LPA) where a fund manager is designated as general partner while TRS as a limited partner. The general partner is responsible for day-to-day management of the fund, including identification of investment opportunities and preparation of financial reports of the funds. Limited partners are responsible for both providing funding and monitoring general partner's investing activities.

## Accounting and Reporting of Private Markets Investments

Accounting and financial reporting of private markets investments is performed by the custodian (i.e., State Street Bank). In other words, State Street Bank (SSB) is TRS' book of records for accounting and financial reporting purposes. Based on quarterly and annual financial reports prepared by general partners as well as records of fund transfers between general partners and TRS, SSB prepares monthly financial reports on fair values of TRS' partnership interest in private markets investments. Staff from both IMD's Investment Operations and Financial Division's Investment Accounting review and oversee the fair values reported by SSB. SSB is also responsible for measuring and reporting performance of private markets investments. See **Appendix D** (page 18) for the financial reporting process for private markets investments.

## BUSINESS OBJECTIVES, RISKS, AND CONTROLS

For the audit of External Private Markets Investments, we obtained information about the following three business objectives, as well as the related risks and the controls management established to mitigate these risks:

Business Objective	Inherent Risks (without considering controls)	Management Controls Established	Management Controls Tested
Invest in private equity and real asset funds (including co-investments) to generate a long-term rate of return in excess of policy benchmark and provide portfolio diversification	(1) Investments selected not fitting the portfolio or investment strategy	<ul style="list-style-type: none"> <li>▪ Investment Policy Statement</li> <li>▪ Investment staff's due diligence</li> <li>▪ Consultant's prudence letter</li> <li>▪ Internal Investment Committee (IIC) approval</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment staff's due diligence</li> <li>▪ Consultant's prudence letter</li> </ul>
	(2) Selecting managers or funds with inadequate qualifications, experience, or track records	<ul style="list-style-type: none"> <li>▪ Investment staff's due diligence</li> <li>▪ Consultant's due diligence</li> <li>▪ IIC approval</li> <li>▪ Premier List</li> </ul>	<ul style="list-style-type: none"> <li>▪ Existence of IIC approval</li> <li>▪ Verification of manager in the Premier List</li> </ul>
	(3) Fund strategy or style drift	<ul style="list-style-type: none"> <li>▪ Investment staff's ongoing monitoring</li> <li>▪ Advisory Board participation</li> <li>▪ Semi-annual portfolio review</li> </ul>	<ul style="list-style-type: none"> <li>▪ Annual meeting and Advisory Board meeting attendance</li> <li>▪ Semi-annual portfolio review</li> </ul>
	(4) No longer qualified managers remaining on the Premier List	<ul style="list-style-type: none"> <li>▪ Manager addition/ removal process as part of semi-annual portfolio review</li> <li>▪ Investment staff's ongoing due diligence</li> </ul>	<ul style="list-style-type: none"> <li>▪ Additions and removals processes for the Premier List</li> </ul>
	(5) Liquidity risk due to long-term lockup of TRS capital	<ul style="list-style-type: none"> <li>▪ Policy portfolio asset targets and allowable ranges</li> <li>▪ Annual capital plan</li> <li>▪ Annual forecast for capital calls and distributions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment staff's completion of annual forecast for capital calls and distributions</li> </ul>
	(6) Lack of transparency (e.g., no timely disclosure of investment strategies or portfolio holdings)	<ul style="list-style-type: none"> <li>▪ Position-based monitoring by a third party</li> <li>▪ Advisory Board participation</li> <li>▪ Periodic meetings with General Partners (GPs)</li> <li>▪ Semi-annual portfolio review</li> <li>▪ Contractual requirements for submission of audited annual and unaudited quarterly financial statement within a specified time frame</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment staff attendance to Advisory Board or annual meetings</li> <li>▪ Semi-annual portfolio review</li> <li>▪ Receipt of annual audited financial statements</li> </ul>
	(7) General Partner's (GP) non-compliance with limited partnership agreement (LPA)	<ul style="list-style-type: none"> <li>▪ Contractual requirements per LPA</li> <li>▪ Internal and external legal counsel review</li> <li>▪ Investment staff's ongoing monitoring</li> </ul>	<ul style="list-style-type: none"> <li>▪ Legal Counsel's involvements in negotiations and development of LPAs and side letters</li> </ul>

<b>Business Objective</b>	<b>Inherent Risks (without considering controls)</b>	<b>Management Controls Established</b>	<b>Management Controls Tested</b>
	(8) Fund's use of excessive leverage	<ul style="list-style-type: none"> <li>▪ Investment staff's ongoing monitoring</li> <li>▪ Semi-annual portfolio review</li> <li>▪ Advisory Board participation</li> <li>▪ Periodic meetings with GPs</li> <li>▪ Investment staff's review of GP quarterly reports</li> </ul>	Covered by other selected control tests
	(9) Fraud or mismanagement of funds	<ul style="list-style-type: none"> <li>▪ Investment staff's ongoing monitoring</li> <li>▪ Review of annual financial statements</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ongoing monitoring</li> <li>▪ Review of audited financial statements</li> </ul>
	(10) Inaccurate financial or performance reporting of the fund	<ul style="list-style-type: none"> <li>▪ Annual financial audit of the fund</li> <li>▪ Performance reporting by a third party</li> </ul>	Covered by other selected control tests
	(11) Key man risk (i.e., loss of key personnel)	<ul style="list-style-type: none"> <li>▪ LPA requiring GP to notify key man issue</li> <li>▪ Investment staff's ongoing monitoring</li> </ul>	Covered by other selected control tests
	(12) Headline risk (e.g., TRS' reputation negatively affected by scandals involving managers or funds)	<ul style="list-style-type: none"> <li>▪ TRS policy requiring GP disclosure of political contributions and use of placement agents</li> <li>▪ Investment staff's ongoing monitoring</li> <li>▪ Semi-annual portfolio review</li> </ul>	Covered by other selected control tests
Ensure that Private Markets investments are recorded at fair value in accordance with industry valuation standards	(13) No audits on funds performed or no timely receipt of audited financial reports from GP	<ul style="list-style-type: none"> <li>▪ LPA requiring both audit of funds and submission of audited financial reports</li> <li>▪ Investment Accounting's monitoring of GP audited financial statements</li> </ul>	<ul style="list-style-type: none"> <li>▪ Receipt of annual audited financial reports from GPs</li> </ul>
	(14) Inaccurate net asset value (NAV) reported by GP due to financial fraud or misstatement	<ul style="list-style-type: none"> <li>▪ Annual financial audit of the funds</li> <li>▪ Funds utilizing a third-party administrator subject to control reviews</li> </ul>	Covered by other selected control tests
	(15) Fair value reported by TRS not consistent with GP's NAV or TRS interest in funds not matching audited financial statements	<ul style="list-style-type: none"> <li>▪ Annual and quarterly financial reports received from GP (including partner's capital statement)</li> <li>▪ Investment Accounting's reconciliation of values between State Street and GP</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reconciliation to the partner capital statements</li> <li>▪ Review of annual financial statements</li> </ul>
	(16) TRS' or GP's valuation policies and procedures not consistent with industry standards	<ul style="list-style-type: none"> <li>▪ Annual financial audit of the funds</li> <li>▪ External consultants involved in developing valuation policy</li> </ul>	<ul style="list-style-type: none"> <li>▪ Review of the TRS Securities Valuation Guidelines</li> </ul>
	(17) Incomplete or outdated sections in the TRS Securities Valuation Guidelines	<ul style="list-style-type: none"> <li>▪ Oversight by the TRS Valuation Committee</li> <li>▪ Investment Accounting staff's monitoring of industry practices</li> </ul>	Covered by other selected control tests

<b>Business Objective</b>	<b>Inherent Risks (without considering controls)</b>	<b>Management Controls Established</b>	<b>Management Controls Tested</b>
	(18) GP's valuation policies and practices not covered as part of TRS staff's due diligence	<ul style="list-style-type: none"> <li>▪ Comprehensive due diligence checklists</li> </ul>	<ul style="list-style-type: none"> <li>▪ Performance of Investment staff's initial due diligence</li> </ul>
	(19) GP not using reputable auditor for its annual financial audits	<ul style="list-style-type: none"> <li>▪ Investment Accounting's summary and review of the audited financial statements of each underlying fund, including preparation of a summary of auditors hired by GPs and research on lesser known audit firms</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment Accounting's monitoring of GP's annual reports</li> </ul>
	(20) GP's NAV determined based on Non-GAAP (Generally Accepted Accounting Principles)	<ul style="list-style-type: none"> <li>▪ Investment Accounting staff's summary and review of accounting standards followed by GPs, and listing non-US GAAP investments</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment Accounting's monitoring of GP's annual reports</li> </ul>
	(21) NAV as of June 30 not as rigorous as audited value as well as potential significant value changes between June 30 and August 31	<ul style="list-style-type: none"> <li>▪ Investment staff's ongoing monitoring</li> <li>▪ Practical Expedience Method allowed</li> <li>▪ Value reflecting cash inflows and outflows during the period from June 30 to August 31</li> <li>▪ Valuation Committee's reasonableness checks for large variances in investment values</li> </ul>	<ul style="list-style-type: none"> <li>▪ The process to identify unusual variances</li> <li>▪ Reconciliation of partner's capital (PCAP) statement to annual report</li> <li>▪ Consideration of index changes between 6/30 and 8/31</li> </ul>
	(22) TRS not taking corrective action on problems in GP's valuation methods or results (e.g., due to lack of information sharing between front and back offices)	<ul style="list-style-type: none"> <li>▪ Both front and back office staff included as Valuation Committee members</li> </ul>	<ul style="list-style-type: none"> <li>▪ Benchmark information related to a valuation committee and collaboration between front office and back office</li> </ul>
	(23) Documentation not supporting TRS staff's due diligence results on GP's valuation policies, procedures, or practices	<ul style="list-style-type: none"> <li>▪ Documentation requirements</li> <li>▪ Information systems used for record keeping</li> </ul>	<ul style="list-style-type: none"> <li>▪ Initial Due Diligence</li> <li>▪ Ongoing Monitoring</li> </ul>
Establish long-term strategic partner network (SPN) relationship with Private Markets	(24) Unqualified or less qualified firms or managers selected as strategic partners	<ul style="list-style-type: none"> <li>▪ Premier List</li> <li>▪ Manager qualifications are evaluated as part of due diligence</li> <li>▪ Use of consultant inputs as part of evaluation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Policies and procedures, including evaluation criteria</li> <li>▪ Investment consultant's input into the evaluation process</li> </ul>

<b>Business Objective</b>	<b>Inherent Risks (without considering controls)</b>	<b>Management Controls Established</b>	<b>Management Controls Tested</b>
investment firms	(25) Strategic partners selected not on the Premier List	<ul style="list-style-type: none"> <li>▪ Investment Management Division's operating policy requirement</li> <li>▪ Investment staff's due diligence</li> <li>▪ Premier List</li> </ul>	<ul style="list-style-type: none"> <li>▪ Investment staff's due diligence</li> </ul>
	(26) Improper or undue influence used during the evaluation or selection process	<ul style="list-style-type: none"> <li>▪ Requirements to disclose financial relationships or conflicts of interest</li> </ul>	<ul style="list-style-type: none"> <li>▪ Disclosure obtained from prospective firms</li> </ul>
	(27) Final selection not supported by evaluation results	<ul style="list-style-type: none"> <li>▪ Documentation of evaluation results</li> </ul>	<ul style="list-style-type: none"> <li>▪ Supporting documentation for evaluation, including major steps taken</li> </ul>
	(28) Lack of transparency about the SPN evaluation and selection process (including the extent of due diligence performed by investment staff)	<ul style="list-style-type: none"> <li>▪ Prior experience establishing SPNs with public market firms</li> <li>▪ Management and Board approval for SPN contract</li> </ul>	<ul style="list-style-type: none"> <li>▪ IMD management's and TRS executive's approval of SPN contract, including key provisions</li> </ul>
	(29) Legal risk (e.g., contract with an SPN not including key elements or part of the contract not being enforceable)	<ul style="list-style-type: none"> <li>▪ Internal and external legal counsel's assistance for contract negotiations and development</li> </ul>	<ul style="list-style-type: none"> <li>▪ Confirmation with Legal Services staff</li> </ul>

# RESULTS AND RECOMMENDATIONS

## OVERALL RESULTS

Based on the audit test results, we determined that management controls are operating effectively to achieve the business objectives. No significant issues were identified. Our tests indicated many positive results on the effectiveness of controls management established. However, we identified opportunities to enhance or modify controls regarding compliance with the Trustee Ethics Policy, valuations of private markets investments, and the investment approval process.

## POSITIVE RESULTS

### **A. Controls for Selection and Monitoring of Private Markets Investments**

- Initial Due Diligence was performed including the Investment Recommendation and a review of the legal documents.
- A consultant's prudence letter was provided by an external consultant for each investment.
- Each investment was approved by the Internal Investment Committee (IIC).
- Each investment was included in the Semi-annual Portfolio Review, as applicable.
- TRS Investment Managers or other representatives attend annual meetings or participate in advisory board meetings.
- Each Fund Manager was included on the Premier List.
- Internal legal counsel was involved in the approval of the legal documents of each investment.
- Ongoing Monitoring was performed for each investment including the review of Valuation Statements, Capital Calls & Distribution Statements, Funding Requests, Capital Account Statements, Email Correspondence with GPs, Portfolio Review Documentation, Board Meetings Minutes, Investor Letters, Meeting Agendas/Presentations, and Meeting Notes.
- A Manager Certification Questionnaire was completed for each new manager.
- An Investment Certification Questionnaire was completed for each new investment.
- Documentation of face-to-face Meetings & On-site visits including back office & operational due diligence was maintained.
- The semi-annual portfolio review for both Private Equity and Real includes a section dedicated to the maintenance of the Premier List. Proposed removals, additions, and other changes were documented along with the rationale. Proposed changes were properly reflected in the revised Premier List.
- The Tactical Plan for both Private Equity and Real Assets is maintained and details the current Net Asset Value (NAV), current exposure, target exposure, and long term target capital. This report also summarizes the anticipated cash flows (contributions and distributions) for each fiscal year covered. This document is created with significant input from Rich Hall and Eric Lang, Managing Directors, and is included in and reviewed during the yearly Board meeting presentation.

## **B. Controls for Valuation of Private Markets Investments**

- Partner capital (PCAP) statements agreed to the accounting records.
- Audited financials were received timely (based on the report date).
- Reporter issuer agreed to the report issuer noted in the internal report (“Matrix” document).
- Each regional, smaller, lesser known accounting firm that Investment Accounting was Public Company Accounting Oversight Board (PCAOB) registered. We noted the following such audit firms and verified that they were PCAOB registered.
  - Mayer, Hoffman, McCann P.C.
  - EisnerAmper, LLP
  - Hein & Associates
  - Crow Horwath, LLP
- All the financials received are presented on a fair value basis or include fair value information.
- The basis of accounting for which the financials were issued was properly reflected in the Financial Statement Matrix spreadsheet.
- Investment accounting identifies and the Valuation Committee reviews all investments with valuation changes exceeding 20% on a quarterly basis.
- Each investment with a valuation change greater than 20% was identified in the Valuation Committee presentation for 8/31/2011 dated 9/28/2011. There were comments included discussing the cause of the changes in valuation. These changes related primarily to unrealized gains/losses, as applicable, that were attributed to specific securities held by the underlying funds.

## **C. Controls for Selection of SPNs**

- SPN selection goals and specific evaluation criteria have been established and they were relevant and appropriate.
- Consultants’ inputs were obtained during the evaluations and negotiations processes.
- Involvement of both internal Legal Services staff and external legal counsel during the contract negotiations and development process
- Use of standardized evaluation sheet to rank initial seven firms

## **SIGNIFICANT RESULTS<sup>1</sup>**

No significant issues and recommendations were identified.

## **OTHER REPORTABLE RESULTS**

While there were no significant issues noted during our testing, we did note opportunities to improve or modify controls, as described below:

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<sup>1</sup> A significant result is defined as a control weakness that is likely to create a high risk of not meeting business objectives if not corrected.

## **1. Identify Information for Trustees to Preclude Non-Compliance with Private Markets Prohibited Investments under the Board of Trustees Ethics Policy**

The Board of Trustees Ethics Policy prohibits Trustees, their spouses, and dependents from making direct or indirect personal investments in private investment funds in which TRS has invested. The policy further states that if a Trustee becomes aware that such a co-investment exists, the Trustee shall disclose the investment and date of purchase to the Executive Director. Further, if a Trustee becomes aware that TRS is considering an investment in a private investment fund in which the Trustee, or the Trustee's spouse, or dependent already has invested, the Trustee shall notify the Executive Director promptly. These requirements are found in the first paragraph of Section 4 of the Board of Trustees Ethics Policy. The policy does not specify what TRS should do to help Trustees comply with these requirements.

Funds managed by the firms included in the TRS private markets Premier List could be perceived as the funds in which Trustees may not invest. With regard to compliance with the above-referenced requirements of the Trustees Ethics Policy, there are several reasons why the Premier List should not be relied on by Trustees, including: (i) the Premier List only lists manager names, not funds, (ii) the Premier List is not an inclusive list of all funds in which TRS has active investments, (iii) The Premier list may include names of firms that are prospective firms with which TRS may invest at an undetermined future time and, as a result, strictly following this list could unnecessarily prohibit a Trustee's investment in a manager's fund for a certain period of time, and (iv) the Premier List is not distributed to all Trustees on a regular basis. For these reasons, the Premier List is not structured to assist Trustees to comply with the above-referenced requirements of the Trustees Ethics Policy.

We noted that IMD provides quarterly transparency reports that include lists of all private investment funds (including those from all of the component portfolios in External Private Markets and External Public Markets) in which TRS currently invests and information about upcoming investments in private investment funds that TRS is considering. These transparency reports could be used for purposes of complying with this provision of the Board of Trustees Ethics Policy.

### **Recommendation**

We recommend that Legal Services work with IMD staff to identify the information Trustees may rely on to preclude their non-compliance with the requirements of the first paragraph of Section 4 of the Board of Trustees Ethics Policy regarding their personal investments in private markets funds in which TRS has invested or is considering an investment.

### **Management Responses**

Management agrees with the recommendation and Legal Services will work with IMD staff to identify the information that Trustees may rely on to preclude their non-compliance with the requirements of the first paragraph of Section 4 of the Board of Trustees Ethics Policy regarding personal investments in private markets funds in which TRS has invested or is considering an investment. Legal Services and IMD believe that such information is presently sent to the Trustees in the transparency reports and will determine if any additional information or advice is necessary. This will be completed by December 31, 2012.

## **2. Reconcile the Partner Capital Statement with Audited Financial Statements**

For each private markets fund TRS invested in, Investment Accounting not only receives quarterly partner capital statement but also annual audited financial statements from general partners. Two key items in the partner capital statements are TRS' percentage ownership in the underlying fund and TRS' net asset value (NAV) in the underlying fund. We noted that Investment Accounting was not using the percentage ownership and the total NAV of the underlying fund included in the audited financial statements to reconcile back to the TRS NAV in the partner capital statement. This could be done by multiplying the percentage ownership by the total net asset value of the fund. Any material differences in the TRS' expected NAV based on the calculation and the NAV per the partner capital statement should be identified and addressed with the appropriate General Partner. This reconciliation has previously been being performed by Investment Operations prior to the transition of responsibilities to Investment Accounting and therefore, should have been continued by the Investment Accounting team after the transition.

### **Recommendation**

We recommend that the Investment Accounting team reconcile the NAV from the partner capital statement with the annual audited financial statements for all TRS private markets investments once a year.

### **Management Responses**

Management agrees with the recommendation to reconcile the NAV from the partner capital statement with the annual audited financial statements for all TRS private markets investments. TRS Investment Accounting will perform the additional reconciliation beginning in Fiscal Year 2013 (September 2012).

## **3. Consider Discontinuing Operation of the Valuation Committee**

TRS created a valuation committee based on the recommendation of an external service provider who assisted Internal Audit in the audit of Alternative Assets and Derivatives in 2008. At that time, there was heightened interest in valuation of securities in the financial markets, mostly affected by the credit crisis (and thus need to devalue credit-related financial instruments) as well as new accounting standards (Financial Accounting Standards No. 157) promulgated by the Financial Accounting Standards Board. Therefore, it was critical for TRS to closely monitor the valuation environment and relevant industry standards to ensure that the TRS valuation methods are appropriate according to these standards, especially for illiquid assets. As a result, TRS adopted a valuation policy and created a valuation committee to oversee the TRS valuation policies and procedures. In addition, at the time of these changes, the investment accounting function was not fully transitioned from the IMD to independently oversee the valuation of securities.

Ever since its creation, the Valuation Committee was instrumental in overseeing TRS valuation policies and processes. However, its importance has been lessened, considering the level of oversight performed by other groups. For example, fair values of private markets investments determined by general partners are compiled by the TRS custodian (State Street Bank) and these

values are monitored by the Investment Operations group and reconciled by the Investment Accounting team. Our survey of public pension funds also indicated that nine out of ten funds who responded did not have a valuation committee established within their organizations.

## **Recommendation**

We recommend that management consider discontinuing the operation of the TRS Valuation Committee by discussing the future of the committee in the next Valuation Committee meeting.

## **Management Responses**

Management agrees with the recommendation to consider discontinuing the operation of the TRS Valuation Committee. The committee was established when both investment and valuation oversight duties were performed within the Investment Management Division to ensure input from the TRS Financial Division. TRS Investment Accounting, within the TRS Financial Division, is now responsible for all valuation oversight. We agree that additional oversight and segregation of duties have been put in place to reduce the need for physical Valuation Committee meetings. As recommended, management will put this issue as an agenda item in the next Valuation Committee meeting for the fiscal year end to obtain committee members' opinion to decide on the future of the Valuation Committee.

## **4. Obtain IIC Approval for Investment Proposals Requiring Board Action**

We noted that the goals of establishing strategic partner relationships with global private markets investment firms were clear and that the SPN evaluation criteria established were relevant and appropriate. In addition, there was clear documentation of the evaluation and ranking of the initial seven prospective firms before advancing four of them to the next steps. According to IMD staff, there were a lot of due diligence efforts on these four firms, including on-site visits, telephone conversations, and negotiations of various contract terms. IMD staff also provided explanations for subsequent elimination of two firms and these explanations were reasonable. However, their due diligence efforts as well as their explanations were not sufficiently documented to demonstrate how and why the two firms were the most qualified when IMD staff was recommending them to the Board for approval in November 2011.

Although it appears that the firms selected have met most of the selection criteria, clear documentation would enhance transparency regarding the evaluation process to demonstrate that the most qualified firms were selected independently, objectively, and without any undue influence. Documentation standards, similar to those in place for other private markets investments, also would help to create a repeatable process in the future, especially in case of a key IMD staff member's departure.

Consistent with the requirement of the Investment Policy Statement, the SPN evaluation and selection did not have to go through the Internal Investment Committee's (IIC) review or approval process since the expected funding amount far exceeded the IMD staff's delegated authority. Although the IIC members were initially presented with the concept and goals of the private markets SPN and later updated about the selection process, this deal went directly to the Board for approval. The documentation could have been improved if this deal had gone through the IIC due to the rigor and thoroughness of its review and approval process. We noted that the

new IIC Charter that became effective June 1, 2012, implies that the investment that exceeds the IMD staff's authority under the IPS will be approved by the IIC.

### **Recommendation**

We recommend that the investment proposals requiring Board action be approved by the IIC, as required in the recently adopted IIC Charter.

### **Management Responses**

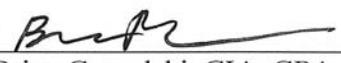
We agree with the recommendation and will follow the approval procedures of the IIC Charter as Internal Audit recommends. The implementation of this recommendation will become effective immediately.

\* \* \* \* \*

We appreciate the Investment Management Division, Investment Accounting, and Legal Services management and staff for their cooperation, courtesy, and professionalism extended to us during this audit.

  
\_\_\_\_\_  
Amy Barrett, CIA, CPA  
Chief Audit Executive

  
\_\_\_\_\_  
Hugh Ohn, CFA, CIA, CPA, FRM  
Director of Investment Audit & Compliance

  
\_\_\_\_\_  
Brian Gomolski, CIA, CPA  
Senior Investment Auditor

## APPENDIX A

### AUDIT OBJECTIVE, SCOPE, METHODOLOGY, AND CONCLUSION

We conducted this performance audit in accordance with generally accepted government auditing standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States and the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors, Inc.

These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our audit findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

#### AUDIT OBJECTIVE

The audit objective was to determine whether internal controls are in place and are working effectively to achieve the business objectives and mitigate significant risks to meeting these objectives. Business objectives related to private markets investments are as follows:

- Invest in private equity and real asset funds (including co-investments) to generate a long-term rate of return in excess of policy benchmark and provide portfolio diversification
- Ensure that private markets investments are recorded at fair value in accordance with industry valuation standards
- Establish long-term strategic partner network (SPN) relationship with private markets investment firms

#### SCOPE

The scope of the audit included the business objectives, risks, controls, and processes related to investing and due diligence activities performed by the External Private Markets (EPM) group of the IMD. Investing activities covered specific asset classes such as private equity and real assets as well as co-investing with general partners. Our tests covered sample investments made from 2009 through 2012. The scope also included the activities related to selection of private markets SPNs, which occurred from summer 2010 through November 2011.

The audit scope included controls related to valuation of private markets securities for financial reporting purposes.

The audit scope did not include TRS investments in hedge funds which are managed by the External Public Markets (EPU) group. The scope also did not include the processes and controls related to the Emerging Manager Program under which due diligence has been outsourced to external advisors.

## **METHODOLOGY**

Our methodology included obtaining information on management's business objectives and risks, and focused on key processes and controls that management has established to address significant risks. To meet the audit objectives, we specifically performed the following procedures:

### **Selection and Monitoring of Private Markets Investments**

- Verification of initial due diligence performed (thru the "Tamale" database system) for the sample private equity and real assets commitments (including co-investments) selected
- Verification of ongoing monitoring of managers and funds
- Occurrence of updates on the Premier List
- Existence of development of Annual Capital Plan (Forecast of Capital Calls & Distributions)

### **Valuation Controls**

- Reconciliation of accounting records to the Quarterly Partner Capital (PCAP) Statements for the sample funds selected
- Review of auditors and basis of accounting ("Matrix" Review)
- Valuation Committee discussion of valuation changes in excess of 20% review

### **Selection of Strategic Partners**

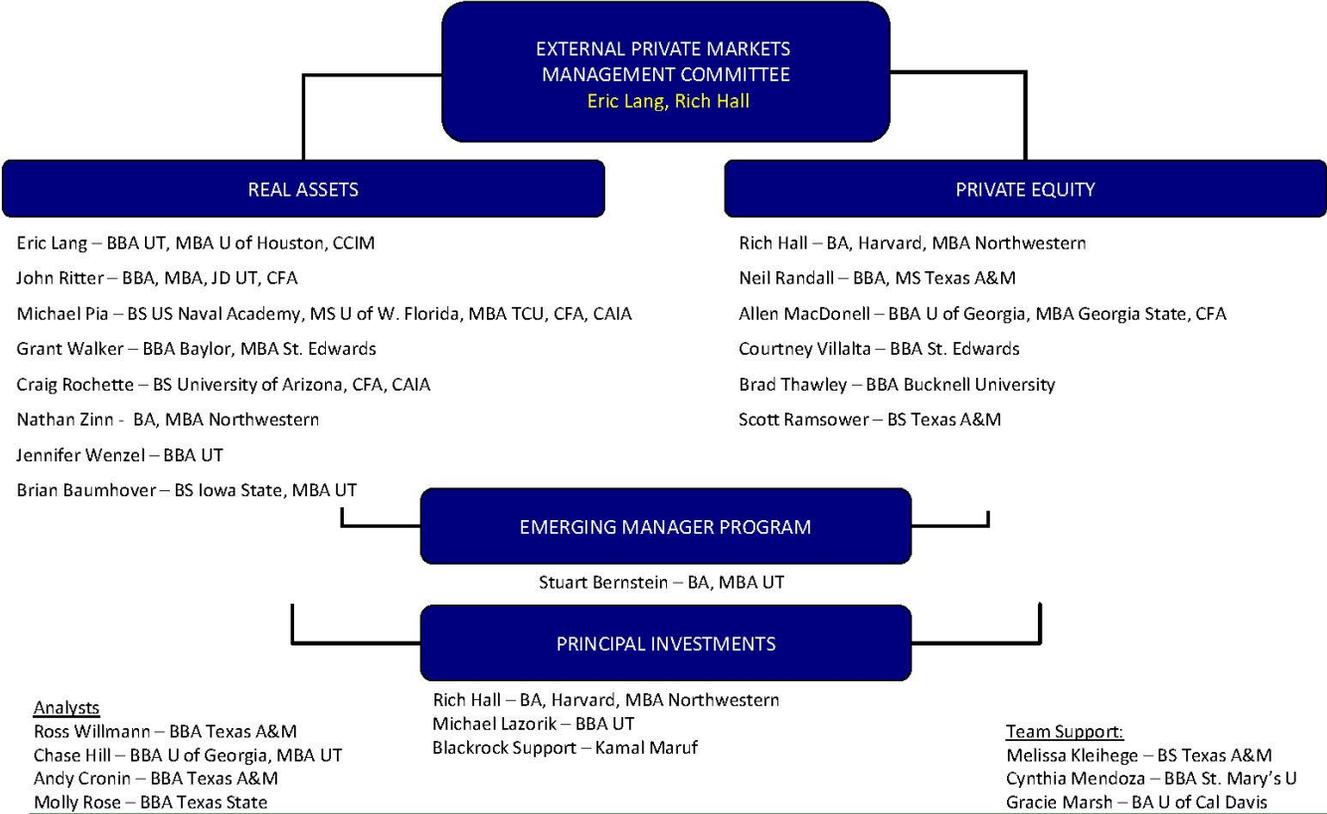
- Review of evaluation criteria for appropriateness and reasonableness
- Verification of disclosure on financial relationship or any conflicts of interest
- Validation of documentary support for the final firms selected

## **CONCLUSION**

Based on our audit results, we determined that management controls are operating effectively to achieve business objectives. We did not identify any significant issues. We noted many positive results and identified opportunities to enhance or modify controls regarding compliance with the Trustee Ethics Policy, valuations of private markets investments, and the investment approval process.

# APPENDIX B

## Private Markets Organization Chart

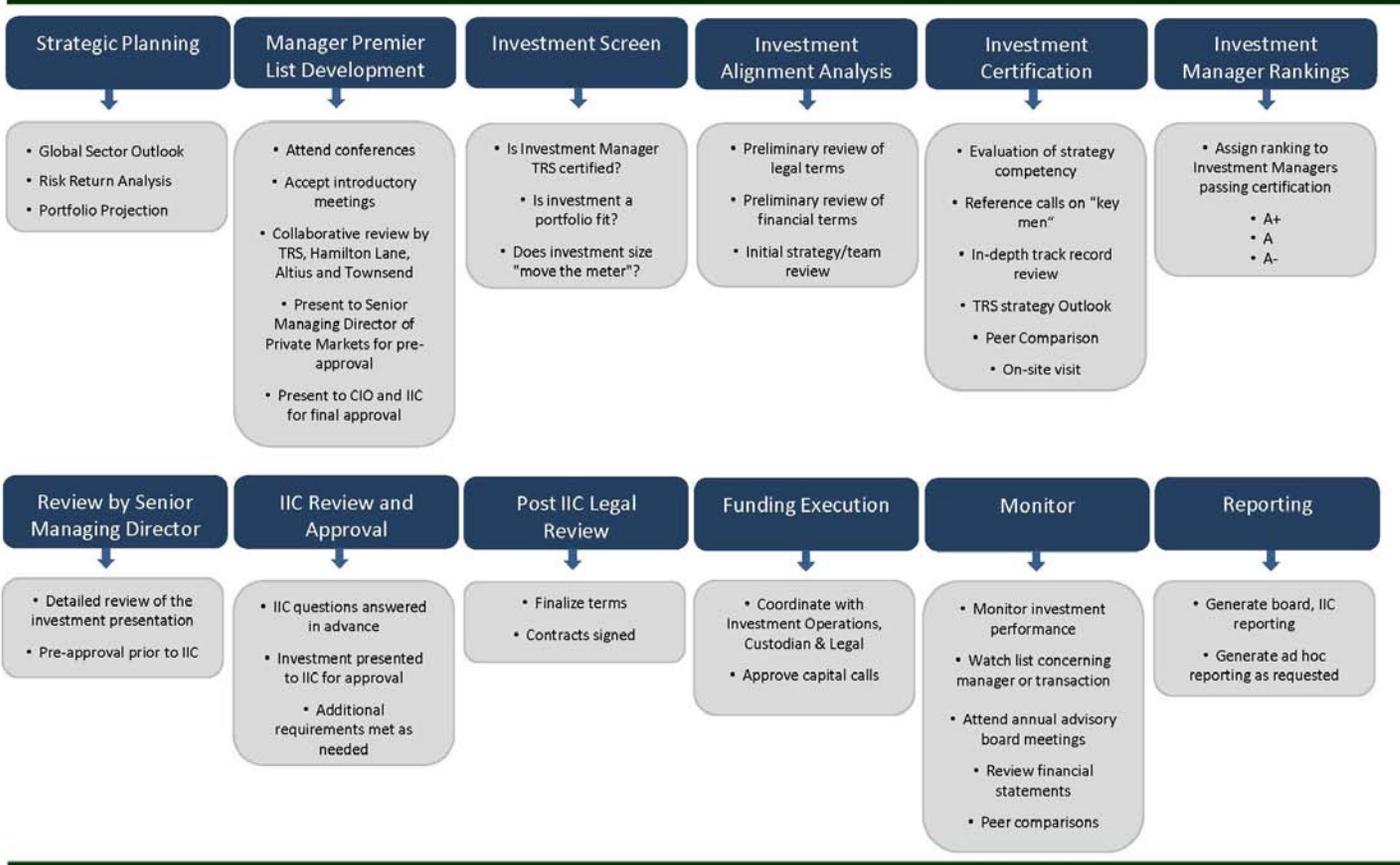


As of June 2012

# APPENDIX C

## Investment Process

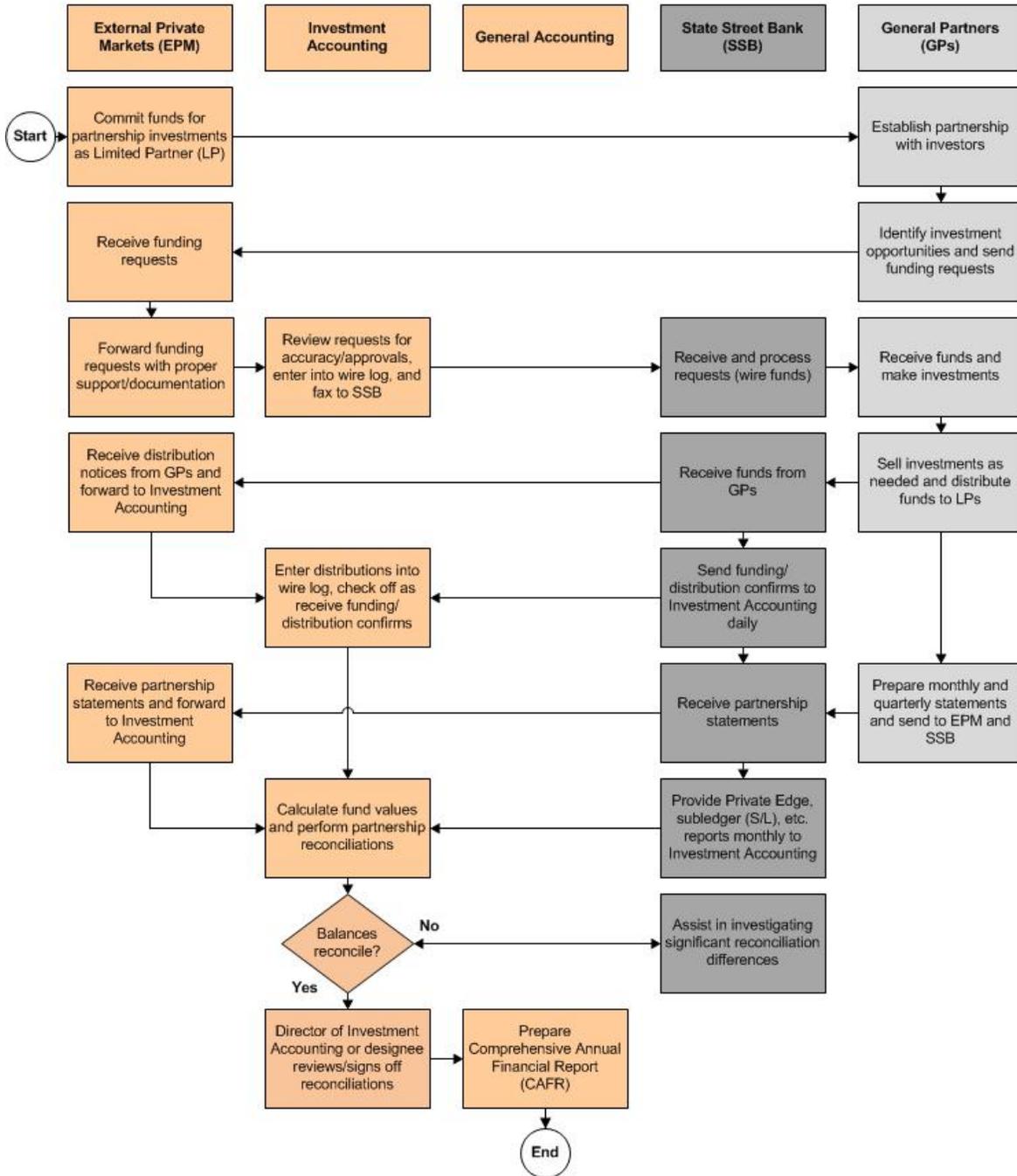
### External Private Markets (Real Estate and Private Equity)



APRIL 2012 UPDATE

# APPENDIX D

## Financial Reporting Process for Private Market Investments



**TAB 3B**

# QUARTERLY TESTING – INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), PROXY VOTING POLICY, WIRE TRANSFERS

CALENDAR QUARTER ENDED JUNE 30, 2012, EXCEPT AS NOTED

<b>Business Objectives</b>	1. <u>Board Reports</u> All required information is reported to the TRS Board of Trustees	2. <u>Investment Selection and Approval</u> Investments made are within delegated limits & established selection criteria	3. <u>Other (IPS, SLP, wire transfers, other reporting)</u> Risk limits are followed for other investment programs and activities	4. <u>Monitoring by Investment Compliance Specialist</u> Investment activities comply with IPS (for the three months ended July 31, 2012)
<b>Business Risks</b>	Board is not informed of key investment decisions & critical data	Approvals and funding exceed delegated limits	Risks exceed board established tolerances	Noncompliance is undetected or not timely resolved
<b>Management Assertions</b>	All required reports are made to the board	Approval and funding are within limits and made for qualified managers	Programs are within risk limits	Investment activities comply with investment policies (proxy, securities lending, IPS)
<b>Agreed-Upon Procedures</b>	<ul style="list-style-type: none"> <li>Compare board reports to IPS requirements</li> <li>Obtain underlying supporting documentation for the following reports: Counterparty Exposure, Value at Risk, and Tracking Error</li> </ul>	<ul style="list-style-type: none"> <li>Vouch selected Internal Investment Committee (IIC) approved investments to supporting documentation</li> <li>Verify new investments made within authorized limits</li> </ul>	<ul style="list-style-type: none"> <li>Validate monitoring of securities lending program</li> <li>Validate reporting requirements of new managers/funds</li> <li>Obtain senior management disclosures about known compliance violations</li> <li>Test supporting documentation for selected wire transfers</li> <li>Validate TRS filed annual report of Sudan investment activity</li> </ul>	Perform various compliance checks and monitor State Street's daily compliance reports
<b>Test Results</b>	No compliance exceptions identified except three Tear Sheets did not disclose prospective fee information as required by policy	No compliance exceptions identified	No compliance exceptions identified except that no annual report was filed of Sudan investment activity	No compliance exceptions identified
<b>Management Responses</b>	Emerging Manager fees are not typically negotiated prior to IIC approval; therefore, they were not disclosed. Going forward, estimated fees will be included on the Tear Sheets.	None	Responsibility for preparing the report was not clearly assigned. The December 2011 report has been filed. Management is taking steps to ensure future timely preparation of annual report.	None

Legend: Red - Significant to TRS    Orange - Significant to Business Objectives    Yellow - Other Reportable Exception    Green - Positive Test Result/ No Exception



August 24, 2012

Britt Harris, Chief Investment Officer

We have completed the **Quarterly Testing of compliance with the requirements of the Investment Policy Statement (IPS), Securities Lending Policy (SLP), Proxy Voting Policy, and procedures for wire transfers** as included in the *Fiscal Year 2012 Audit Plan*.

We performed the procedures that were agreed to by management of the Investment Management Division (IMD). These procedures include tests that supplement the current compliance monitoring procedures performed by State Street and Senior Investment Compliance Specialist.

This agreed-upon procedures engagement was performed in accordance with generally accepted government auditing standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States.

The sufficiency of the agreed-upon procedures performed is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The results of testing indicated the following exceptions:

- Three Tear Sheets (due diligence summary) for proposed new emerging manager investments did not include the prospective fees, as required under Article 1.7d of the IPS
- The annual report of Sudan investment activity was not filed with the presiding officer of each house of the legislature, the attorney general, and the US presidential special envoy to Sudan, as required under Government Code 806.102 and IPS Article 2.3c

Our testing procedures and results are included in **Appendix A**. The monitoring results of the Investment Compliance Specialist are included in this report in **Appendix B**.

### **Internal Control Structure**

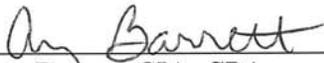
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas tested.

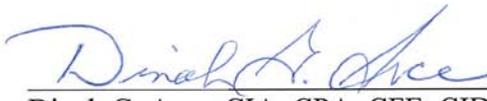
Had we performed additional procedures, or had we made an examination of the system of internal control, other matters might have come to our attention that would have been reported to you. This report relates only to the procedures specified above and does not extend to the internal control structure.

This report is intended solely for information and use by TRS management, the Board of Trustees, and oversight agencies, and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is not limited.

\* \* \* \* \*

We express our appreciation to management and key personnel of the Investment Management Division for their cooperation and professionalism shown to us during this quarterly testing.

  
\_\_\_\_\_  
Amy Barrett, CIA, CPA  
Chief Audit Executive

  
\_\_\_\_\_  
Dinah G. Arce, CIA, CPA, CFE, CIDA  
Senior Auditor

  
\_\_\_\_\_  
Hugh Ohn, CFA, CPA, CIA, FRM  
Director of Investment Audit and Compliance

## APPENDIX A AGREED UPON PROCEDURES AND RESULTS

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
1	1	IPS Article 1.7 - Verify that all requirements were reported to Board of Trustees	<ul style="list-style-type: none"> <li>Obtain copies of all reports required to be reported to Board of Trustees for testing period and compare to required information per the Investment Policy Statement (IPS)</li> </ul>	<ul style="list-style-type: none"> <li>Reports contained the required reporting information except for three new investments in which the Tear Sheets did not include information about prospective fees</li> </ul>	Because of the nature of Emerging Manager investing, fees are not typically negotiated prior to Internal Investment Committee (IIC) approval; therefore, they were not disclosed. Going forward, we will disclose an estimated fee amount on the Tear Sheet.
2	2	Article 3.3 – Verify existence of IMD’s prudent underwriting objectives for advisor’s due diligence	<ul style="list-style-type: none"> <li>Verify existence of Investment Management Division’s (IMD) prudent underwriting objectives for advisor's due diligence</li> <li>Select sample of Private Market investments approved during testing period, verify existence of advisor's report stating investment opportunity meets prudent underwriting standards and merits inclusion within respective portfolios</li> </ul>	<ul style="list-style-type: none"> <li>IMD's prudent underwriting objectives for advisor's due diligence existed</li> <li>Sample of investments selected for testing included advisor's report stating that investment opportunity meets prudent underwriting standards</li> </ul>	No response required
3	4	Article 8.8 – Test various limitations applicable to derivatives	<ul style="list-style-type: none"> <li>Sample over-the-counter (OTC) derivative transactions (including those managed through Agency Agreements) and obtain evidence that: <ul style="list-style-type: none"> <li>a) Each counterparty has credit rating required of IPS</li> <li>b) If collateral arrangements were used, determine that: <ul style="list-style-type: none"> <li>Net market value of all OTC derivative positions, less collateral posted, for any individual counterparty did not exceed \$500 million</li> </ul> </li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>No credit risk management violations for the quarter</li> </ul>	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<ul style="list-style-type: none"> <li>○ Net market value of all OTC derivative positions, without consideration of collateral, did not exceed 5% of the total market value of the Fund</li> <li>• If market value limits were breached, verify IMD informed Chief Investment Officer (CIO), Executive Director (ED), and Chairman of the appropriate Board committee as soon as practicable and corrective action taken within a 90-day period or corrective action plan was presented to Board at its next regularly scheduled meeting.</li> </ul>	<ul style="list-style-type: none"> <li>• No credit risk management violations for the quarter</li> </ul>	
4	4	Article 9.3d – Test security lending-monitoring of third party	Confirm securities lending agent is an organization rated A- or better by a Nationally Recognized Statistical Rating Organization (NRSRO)	Securities lending agent is an organization rated A- or better by a NRSRO	No response required
5	4	Article 9.9 – Verify whether leverage resulted in risk parameters being exceeded	<ul style="list-style-type: none"> <li>• Verify leverage was used only as authorized</li> <li>• Inquire if any risk parameters were exceeded and if so, was the limit caused by leverage</li> </ul>	<ul style="list-style-type: none"> <li>• Leverage was used only as authorized</li> <li>• No risk parameters were exceeded</li> </ul>	No response required
6	1	IPS Appendix A – Test for compliance with tracking error limits	<ul style="list-style-type: none"> <li>• Obtain tracking error reports, compare to tracking error policy limits</li> </ul>	<ul style="list-style-type: none"> <li>• Tracking error was within policy limits</li> </ul>	No response required
7	2	IPS Appendix B – Test approval authority and manager allocation limits	<ul style="list-style-type: none"> <li>• Select sample of approved investments and obtain Tear Sheet for each, observe the approved amounts are within authorized limits               <ol style="list-style-type: none"> <li>a) Initial allocation – .50%</li> <li>b) Additional or follow-on – 1%</li> <li>c) Total Manager Limits – 3%</li> <li>d) Total limit each manager organization – 6%</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• For the sample selected for testing, no manager or partner organization exceeded the authorized limits</li> </ul>	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<ul style="list-style-type: none"> <li>• Inquire if any “Special Investment Opportunities” were made for the quarter, and if so:               <ul style="list-style-type: none"> <li>a) Obtain documentation that the Special Investment Opportunity was either a distressed situation or market dislocation.</li> <li>b) Obtain documentation that the CIO notified the ED of each Special Investment Opportunity</li> <li>c) Obtain documentation that the CIO and the ED requested comments from the chairman of the appropriate board committee and TRS consultants and advisers.</li> <li>d) Verify that the Special Investment Opportunity did not exceed \$1 billion.</li> <li>e) Verify that no further investment in a special Investment Opportunity was made until the board reauthorized the CIO’s authority to designate a Special Investment Opportunity.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• There have been no investments in Special Investment Opportunities.</li> </ul>	
8	2	Appendix C – Verify new emerging managers were approved by IIC and limits are within policy requirements	<ul style="list-style-type: none"> <li>• Validate new emerging managers were approved by IIC</li> <li>• If applicable, obtain documentation that each new emerging manager is registered with the appropriate authorities</li> <li>• Validate that each new investment is a minimum size of \$5 million</li> <li>• Validate that total External Manager investment by TRS with each emerging manager did not exceed 40% of such emerging manager’s</li> </ul>	<ul style="list-style-type: none"> <li>• New emerging managers were approved by IIC</li> <li>• If applicable, obtained documentation that each new emerging manager is registered with the appropriate authorities</li> <li>• Each new investment had a minimum size of \$5 million</li> <li>• Total External Manager investment by TRS with each emerging manager did not exceed 40% of such emerging manager’s assets under management</li> </ul>	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			assets under management <ul style="list-style-type: none"> <li>• Validate total investment raised by emerging manager into PE or RA investment did not exceed 40% of size of such fund</li> </ul>	<ul style="list-style-type: none"> <li>• Total investment raised by an emerging manager did not exceed 40% of the size of such fund</li> </ul>	
9	3	IPS Addendum Appendix A Questionnaire (Political Contributions; Improper Influence; Placement Agents and Finders) - Verify managers' responses to the Questionnaire are being obtained and reported to the Board	<ul style="list-style-type: none"> <li>• For each investment selected for testing, verify that IMD obtained responses to the questionnaire</li> <li>• Determine that IMD compiled responses to the questionnaires and reported all results to Board semi-annually</li> </ul>	<ul style="list-style-type: none"> <li>• Each investment tested had a completed questionnaire</li> <li>• IMD compiled responses to the questionnaires for all new investments selected for testing and reported summary information in Transparency Report</li> </ul>	No response required
10	5	Disclose compliance issues identified by Senior Investment Compliance Specialist	Obtain the investment compliance report from the Senior Investment Compliance Specialist	No compliance issues identified by the Senior Investment Compliance Specialist	Refer to <b>Appendix B</b>
11	4	Obtain disclosures from Investment Senior Managing Directors, Legal Investment staff, and Chief Investment Officer (CIO) regarding their knowledge of compliance violations	Send request for disclosure to IMD Senior Managing Directors, Legal Investment staff, and CIO requesting disclosure of any known compliance violations during testing period	Obtained all disclosures from IMD Senior Managing Directors, Legal Investment staff, and CIO. No additional compliance violations were disclosed.	No response required
12	3	Verify Sudan/Iran Article 2.3c - Restricted Lists are Updated and reports filed	<ul style="list-style-type: none"> <li>• Ensure responsible staff have updated Sudan/Iran restricted lists</li> <li>• Determine whether TRS complied with the following requirements:               <ol style="list-style-type: none"> <li>a) Notification to Comptroller's Office regarding holdings of Sudan-Restricted Companies within 14 days after receiving the List</li> <li>b) 50% Divestment within 270 days</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• Staff has updated Sudan/Iran restricted lists</li> <li>• Compliance status was:               <ol style="list-style-type: none"> <li>a) Notification to the Comptroller's Office regarding holdings of Sudan-Restricted Companies within 14 days after receiving the List – completed</li> <li>b) 50% Divestment within 270 days</li> </ol> </li> </ul>	Responsibility for coordinating preparation of the annual Sudan report was not clearly assigned. The report that was due December 2011 was delivered by letter dated August 14, 2012. Management has now taken steps to ensure that (1) a specific employee has been assigned to coordinate preparation of the report with Investment Compliance for management's signature, (2) the reporting task has been scheduled by the employee with an electronic reminder,

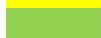
STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			c) 100% Divestment within 450 days d) File annual report of Sudan investment activity by December 31 of each year with the presiding officer of each house of the legislature, the attorney general, and the US presidential special envoy to Sudan, as required under Government Code 806.102	c) 100% Divestment within 450 days d) Annual report not filed by December 31, 2011	and (3) a reminder email, set for delayed delivery in December, has been prepared and will be delivered to the employee and other staff members, who will be alerted to respond if the assigned employee is not available to prepare the report for delivery by the reporting deadline.
13	3	Test authorizations of wire transfers	Obtain wire transfer reports for testing period, select sample of wire transfers, verify that supporting documentation exists for each	All wire transfers tested were properly authorized and correct amounts were wired	No response required
14	3	SLP Section 3 – Verify authorized collateralization	<ul style="list-style-type: none"> <li>Determine if cash collateral invested in authorized instruments</li> <li>Verify market value of collateral received under any repurchase agreement exceeds the market value of the cash distributed by a margin of not less than 2%</li> </ul>	<ul style="list-style-type: none"> <li>Cash collateral was invested in authorized instruments</li> <li>Market value of collateral received under any repurchase agreement exceeded the market value of the cash distributed by a margin of not less than 2%</li> </ul>	No response required
15	3	SLP Section 4 – Verify fair market value limits	<ul style="list-style-type: none"> <li>Obtain IMD reports (shock tests) showing fair market value of portfolio did not decline by more than .0035 per 1 basis point in interest rates</li> <li>Obtain supporting documentation</li> </ul>	<ul style="list-style-type: none"> <li>Fair market value of the portfolio did not decline by more than .0035 per 1 basis point in interest rates</li> <li>Supporting documentation exists</li> </ul>	No response required
16	3	SLP Section 5 - Reports	Validate that staff reviewed the progress of the securities lending program, including an overall evaluation of the performance of the lender with the Risk Committee	IMD reviewed the progress of the securities lending program and evaluated the performance of the lender with the Risk Management Committee	No response required

**Note: Testing procedures for the Investment Policy Statement (IPS), Securities Lending Policy (SLP), and wire transfers are for the quarter ending June 30, 2012, except as noted.**

## APPENDIX B

### COMPLIANCE WITH INVESTMENT AND RELATED POLICIES As of and for the three months ended July 31, 2012

Policy	Compliance Exceptions	Reportable Exceptions	Management Responses
Investment Policy Statement (IPS)	No	None	N/A
Securities Lending Policy (SLP)	No	None	N/A
Proxy Voting Policy	No	None	N/A

-  Unsatisfactory progress is being made or there have been significant delays in resolving issue.
-  Timely or satisfactory progress is being made toward resolving issue.
-  No exception or satisfactorily resolved issue.

**TAB 3C**

**TAB 3D**

**TAB 3E**

# QUARTERLY TESTING OF BENEFIT PAYMENTS

JANUARY 2012 – JUNE 2012

TRS Internal Audit Department

<b>Business Objectives</b>	To deliver retirement and related benefits authorized by law for members and their beneficiaries.		
<b>Business Risks</b>	<p><b>Fraud / Errors</b></p> <p>Benefit payments could be incorrect or fraudulent in these areas:</p> <ul style="list-style-type: none"> <li>• Payments to recent retirees</li> <li>• Benefit payments with an expiration date</li> </ul>	<p><b>Eligibility</b></p> <p>TRS members could retire with full benefits without meeting Rule of 80 or minimum requirements</p>	<p><b>Manual Voucher Payments</b></p> <p>Manual voucher payments could be processed incorrectly or without proper authorization</p>
<b>Management Assertions</b>	All benefit payments are valid	All retirees who received annuity benefit payments are eligible	All manually processed voucher payments are valid
<b>Agreed-upon Procedures</b>	<p>Matched benefit payments to supporting documents in two areas:</p> <ol style="list-style-type: none"> <li>1. Recent retiree benefit recalculations</li> <li>2. Benefit payment expiration dates</li> </ol>	<ol style="list-style-type: none"> <li>3. Recalculated Rule of 80 or minimum requirements for all new normal-age service retirements during the testing period</li> </ol>	<ol style="list-style-type: none"> <li>4. Matched 60 randomly selected manually processed voucher payments to supporting documentation</li> </ol>
<b>Test Results</b>	Future payment expiry date not set in Annuity Payroll System for one disability retiree. No financial impact.	No Exceptions	No Exceptions
<b>Management Responses</b>	Management agrees with the test results and is taking corrective action.	N/A	N/A

Legend of Results: **Red** - Significant to TRS  
**Yellow** - Other Reportable Exception

**Orange** - Significant to Business Objectives  
**Green** - Positive Test Result/No Exception



August 23, 2012

Mr. Don Green, Chief Financial Officer  
Ms. Marianne Woods Wiley, Chief Benefit Officer  
Ms. Betsey Jones, Director, Health Care Policy and Administration

We have completed the third and fourth **Quarterly Testing of Benefit Payments** as included in the *Fiscal Year 2012 Audit Plan*.

We performed the procedures listed below that were agreed to by management of Benefit Services, Health Care Policy and Administration, and the Finance Divisions. These procedures included four data-mining tests designed to identify anomalies in benefit payments during the current quarter and possible deviations from management's benefit processing controls.

For these two quarters, the tests performed included testing gross payment amounts made to recent retirees, manual benefit payments, normal age retirement criteria, and expiry date testing for five or ten year guaranteed period payments, disability retirement payment calculations for retirees with less than 10 years of service, and expiry dates greater than 50 years. There was one expiry date exception noted as a result of the test procedures performed. The detailed procedures and results of our testing are explained in **Appendix A**.

This agreed-upon procedures engagement was performed in accordance with generally accepted government auditing standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States.

The sufficiency of the agreed-upon procedures performed is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

### **Internal Control Structure**

We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas tested.

Had we performed additional procedures, or had we made an examination of the system of internal control, other matters might have come to our attention that would have been reported to you. This report relates only to the procedures specified above and does not extend to the internal control structure.

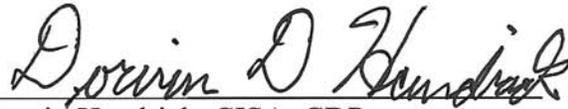
This report is intended solely for information and use by TRS management, the Board of Trustees, and oversight agencies, and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is not limited.

\* \* \* \* \*

We express our appreciation to management and key personnel of Information Technology, Benefit Services, Health Care Policy and Administration, and the Finance Divisions for their cooperation and professionalism shown to us during the quarterly testing.



Amy Barrett, CIA, CPA  
Chief Audit Executive



Dorvin Handrick, CISA, CDP  
Senior IT Auditor



Toma Miller  
Risk, Control, & Compliance Specialist



Jan Engler, CIA, CISA, CFE,  
Internal Audit Manager

## APPENDIX A

### AGREED UPON PROCEDURES AND RESULTS

1. Test Purpose: Test that gross annuity payments from January to June 2012 to recent retirees (December 2011 or later retirements) are calculated accurately.

Test Description: Query the *January to June 2012 Benefit Payments Data File* for all gross annuity payments that were related to recent member retirements and randomly select five sample items from each month for a total of 30 sample items. Recalculate the gross payment amount as follows: The annuitant's standard annuity payment is first recalculated based on the member's number of years of service and the average salary amount at the time of retirement and agreed to the supporting documentation in the TRS *Imaging System*. If applicable, recalculate the gross annuity payment amount using the annuity payment option adjustment factor(s) selected by the member per the supporting documentation in the TRS *Imaging System*.

Test Result: All 30 gross annuity payments to recent retirees from January to June 2012 were recalculated and traced to supporting documentation. No exceptions were noted.

2. Test Purpose: Test that the expiration date to stop the annuity payment timely is properly recorded in the system.

Test Description: Test the expiration date accuracy for a sample of annuity payments from January to June 2012 for the three groups described below. Agree the recorded expiration date to the auditor's calculation based on the imaged documents maintained in the TRS *Imaging System*. Each test is described as follows:

- a. Expiration date of guaranteed-period annuity options retirement
  - i. For guaranteed-period (5-year and 10-year) annuity options that TRS is paying the beneficiary because the retiree was deceased before the guaranteed period ended, obtain all records with an expiration date that is greater than the retirement date plus the guaranteed period. Agree these records to supporting documentation indicating the expiration date.
  - ii. Obtain all records where the payment status is active but there is no expiration date. Trace these records to the supporting documentation.
- b. Expiration date of disability retirement with less than 10 years service

The disabled retiree with less than 10 years service should receive a standard benefit amount of \$150 per month for the shortest period of the retiree's disability period, retiree's life, or total number of creditable service months.

- i. Obtain all records with a retiree death date but payment status is still active. Trace to the supporting documentation.
  - ii. Obtain all records that the gross payment amount is not the standard amount of \$150 and report differences.
  - iii. Obtain all records where the expiration date has expired but the payment status is still active. Trace to the supporting documentation.
  - iv. Obtain all records where the member was not the payee. Trace to the supporting documentation.
  - v. Obtain all records where the expiration date is greater than the retirement date plus years of member service. Select five random samples from each monthly data file to test by adding the number of creditable service months, based on the imaged documents in the TRS *Imaging System*, to the retirement date and comparing that number with the expiration date in the retirement system. Agree sample items to supporting documentation.
- c. Expiration date is longer than 50 years from the date of current payment record.

Obtain items from all payment records with an expiration date that is more than 50 years from each data file from January to June 2012 that have not been previously tested. Recalculate and agree the recorded expiration date to the supporting documentation.

Test Results:

- a. Expiration date of guaranteed-period annuity options retirement
- i. No exceptions were noted where the expiration date was greater than the retirement date plus the guaranteed period.
  - ii. All 46 unique sample items of records, with an active payment status but no expiration date, were traced to the supporting documentation. No exceptions were noted.
- b. Expiration date of disability retirement with less than 10 years service

An exception where the expiry date was not set in the *Annuity Payroll System* for one disability retiree with less than 10 years of service was noted. Since the expiry date that should have been set was over six years in the future, there was no financial impact at this time.

Management Response:

Benefit Accounting Disbursements and Benefit Processing agree that this is an exception. The immediate action to be taken would have been to add the correct

expiry date. However, prior to this action being taken TRS received notification of this annuitant's passing and the annuity payments have been stopped. We are working with IT to implement a fix to identify this type of exception should it occur in the future.

c. Expiration date is beyond 50 years from current payment records

The recalculated expiration date for the two records identified agreed to the recorded expiration date in the supporting documentation. No exceptions were noted.

3. Test Purpose: Test for normal-age service retirement benefits from January to June 2012 that do not meet the Rule of 80 with at least five years of service or the minimum retirement age of 65 with at least five years of service.

Test Description: Query the *January to June 2012 Benefit Payments Data File* for all payments that were related to normal-age service retirement benefits since December 2011. All proportionate retirements, early age retirements, and disability retirements are excluded. The annuitant's retirement age is calculated based on the year and month of the member's retirement date and birth date in the annuity system records. All records were recalculated by the auditor according to the stated criteria using the automated audit software.

Test Result: All normal-age service retirement benefits met the requirements of Rule of 80 with at least five years of service or with the minimum retirement age of 65 and at least five years of service. No exceptions were noted.

4. Test Purpose: Test that manual voucher payments are properly authorized and supported.

Test Description: Select a random sample of 10 manual voucher payments per month from the *January to June 2012 Benefit Payments Data File*. Trace and agree these manual voucher payments to the supporting documents maintained in the TRS *Imaging System*.

Test Results: We randomly selected 60 manual voucher payments to test. These test samples included 18 premium refunds, ten annuity pop-ups, nine qualified domestic relations order (QDRO) related payments, three payments were re-issued due to returned payments, six retiree requests to re-issue payment, five payment amount adjustments, five payments were re-issued due to retiree death, and four other payments that required manual processes. All payments were traced and agreed to the supporting documents. No exceptions were noted.

**TAB 4**

**TRS Internal Audit  
Summary of Audit Recommendations Status  
September 2012**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>11-305 Investment Travel Paid by Third Parties</b>					
	Develop Investment Management Division (IMD) travel policy	Implemented	Other Reportable	8/2011	8/2012
<b>11-306 Investments Performance Calculations and Reporting</b>					
	Include the performance calculation methodology used by State Street in TRS written operating policies and State Street Service Agreement	In Progress	Other Reportable	8/2011	1/2013
	Work with State Street to ensure that consistent investment returns for cash are reported to the Board	Implemented	Other Reportable	8/2011	8/2012
<b>11-307 Actively-Managed Internal Equity Portfolios, including Commission Sharing Arrangements (CSA)</b>					
	Store emails containing reasons for trade decisions in a document management system	Implemented	Other Reportable	5/2012	7/2012
<b>12-302 Investment Risk Management</b>					
	Perform model validations and expand scope of SSAE 16	Implemented	Other Reportable	6/2012	8/2012
	Consistently include status updates of EPU's re-underwriting process for managers that trigger risk signals	Implemented	Other Reportable	6/2012	8/2012
	Incorporate liquidity risk into the semi-annual Investment Risk Report to the Board	Implemented	Other Reportable	9/2012	8/2012

**Significant to Business Objectives**

	<ul style="list-style-type: none"> <li>• Past <i>original</i> estimated completion date</li> <li>• No management action plan <u>or</u> No progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>• Past <i>original</i> estimated completion date</li> <li>• Progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>• <i>Original</i> estimated completion date has not changed</li> <li>• Progress on management action plan</li> </ul>
	Satisfactory implementation of management action plan <u>or</u> Acceptance of risk by management
	Implementation of management action plan pending Internal Audit validation

**Other Reportable**

	<ul style="list-style-type: none"> <li>• Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>• No management action plan <u>or</u> No progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>• Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>• Progress on management action plan</li> </ul>
	<ul style="list-style-type: none"> <li>• Within <i>original</i> <u>or</u> first <i>revised</i> estimated completion date</li> <li>• Progress on management action plan</li> </ul>
	Satisfactory implementation of management action plan <u>or</u> Acceptance of risk by management

**TRS Internal Audit**  
**Summary of Audit Recommendations Status**  
September 2012

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>12-302 Investment Risk Management (continued)</b>					
	Document the assumption and methodology choices when using TruView to calculate VaR	Implemented	Other Reportable	12/2012	8/2012
<b>12-401 Building Security</b>					
	Card access procedures should be formalized, documented, implemented and include roles and responsibilities	In Progress	Other Reportable	7/2012	10/2012
	Procedure manual should include all tasks and a process to periodically review and update the procedure manual	In Progress	Other Reportable	10/2012	
<b>12-402 Investment Accounting</b>					
	Define and perform monitoring activities for the securities lending program	Implemented	Other Reportable	6/2012	7/2012
<b>12-403 Audit of Compensation, Payroll and Position Control</b>					
	Develop and issue guidance to managers regarding when payment of compensatory time for exempt employees may be requested	In Progress	Other Reportable	8/2012	1/2013
	Develop and implement a written procedures manual for payroll	In Progress	Other Reportable	4/2013	

**TRS Internal Audit**  
**Summary of Management Actions for Staff Recommendation for Backup Generator**  
**September 2012**

**Update on the Purchase of a Backup Generator**

**At the February 2012 TRS Board of Trustees Meeting,** Ken Welch, Deputy Director, reported a power-outage incident occurred in January 2012 that impacted TRS offices. He reported that the total staff costs for recovery from the incident were about \$6,000. Mr. Welch stated that staff recommended putting a backup generator in place to provide ongoing power and minimize the impact of a power outage. He updated the board that the Facilities Commission has already approved the award of a backup generator.

**August 2012 Status Update:** The generator is scheduled to be delivered on September 13, 2012. It is estimated that the generator will be installed, tested, and operational by October 31, 2012.

**TAB 5**

## MEMORANDUM

TO: Audit Committee Members, TRS Board of Trustees  
Mr. Brian Guthrie, Executive Director

FROM: Amy Barrett, Chief Audit Executive

SUBJECT: Proposed Revisions to the Internal Audit Charter

DATE: September 14, 2012

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The purpose, authority, and responsibility of the internal audit activity are formally defined in the Internal Audit Charter. The Internal Audit Charter is consistent with the definition of internal auditing provided by the Institute of Internal Auditors, auditor codes of ethics, and professional auditing standards. These professional auditing standards require that the Internal Audit Charter be reviewed periodically and presented to senior management and the board of trustees for approval. The TRS Board of Trustees approved revisions to the Internal Audit Charter in September 2010.

Highlights of the proposed revisions include the following:

- Defining Internal Audit's role in supporting public sector governance
- Defining Attestation Engagements: Agreed-Upon Procedures
- Clarifying responsibilities of internal audit in the following important areas:
  - Audit of employer data and contributions
  - Participation in a consulting or advisory capacity in information systems projects
  - Coordination of the TRS Enterprise Application Modernization (TEAM) Independent Program Assessment vendor
- Incorporating professional auditing standards codes of ethics for internal auditors

# TEACHER RETIREMENT SYSTEM OF TEXAS

## INTERNAL AUDIT CHARTER

### ROLE OF INTERNAL AUDIT

Auditing is a cornerstone of good public sector governance. By providing unbiased, objective assessments of whether public resources are managed responsibly and effectively to achieve intended results, auditors help public sector organizations achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders. The public sector auditor's role supports the governance responsibilities of oversight, insight, and foresight. Oversight addresses whether public sector entities are doing what they are supposed to do and serves to detect and deter public corruption. Insight assists decision-makers by providing an independent assessment of public sector programs, policies, operations, and results. Foresight identifies trends and emerging challenges. Auditors use tools such as financial audits, performance audits, investigations, and advisory services to fulfill each of these roles.<sup>1</sup>

### MISSION

The mission of the Internal Audit department is to provide independent, objective assurance and consulting services designed to add value and improve the organization's operations. Internal Audit helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

### OBJECTIVES AND SCOPE OF WORK

#### Assurance Objectives

The objectives of assurance services are to provide formal, independent assurance to management and the Audit Committee that the organization's assets are safeguarded, that operating efficiency is enhanced, and that compliance is maintained with prescribed laws, and management and TRS Board of Trustees (Board of Trustees) policies. The assurance services objectives also include independent assessment of the organization's risk awareness and management, reliability and integrity of the organization's data, and achievement of the organization's goals and objectives.

#### Attestation Engagements: Agreed-Upon Procedures

Agreed-upon procedures consist of auditors performing specific procedures on the subject matter and issuing a report of findings based on the agreed-upon procedures. In an agreed-upon procedures engagement, the auditor does not express an opinion or conclusion, but only reports on agreed-upon procedures in the form of procedures and findings related to the specific procedures applied.<sup>2</sup>

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<sup>1</sup> The Institute of Internal Auditors *Supplemental Guidance: The Role of Auditing in Public Sector Governance*, 2<sup>nd</sup> Edition, January 2012

<sup>2</sup> *Government Auditing Standards* of the United States Government Accountability Office, 2011 Revision

### **Consulting and Advisory Services Objectives**

The objectives of consulting and advisory services are to provide management with assessments and advice for improving processes that will advance the goals and objectives of the organization. No assurance is provided.

The objectives of consulting services are to provide formal assessments and advice on the front-end of projects so that risks may be managed and internal controls may be designed at the beginning of a project. The objectives and the scope of consulting projects are agreed to by management.

The objectives of advisory services are to provide informal advice to management. Examples of advisory services include participating in various committees in a non-voting capacity; providing routine advice on policies, internal controls, and audit recommendations; providing training and risk management tools; facilitating meetings; and collecting benchmarking information.

### **Scope**

Internal Audit provides opinions on governance, risk management, and controls as the result of an individual assurance project or as an overall opinion of the adequacy of governance, risk management, and control within the organization. The scope of work of the Internal Audit department is to determine whether the organization's framework of risk management, control, and governance processes, as designed and represented by management, is functioning in a manner to ensure:

- Programs are operating within the highest fiduciary standards and are directed toward the requirements defined in the federal and state constitutions, laws, regulations, and TRS policies and procedures.
- Risks within and outside the organization are appropriately identified and managed.
- Risk and control information is effectively communicated throughout the organization.
- Ethics-related programs and activities are effective.
- Significant financial, managerial, and operating information is accurate, reliable, and timely.
- Significant legislative or regulatory issues impacting the organization are recognized and addressed appropriately.
- Interaction with appropriate internal committees occurs as needed.
- Employee actions are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Employer (reporting entity) data and contributions reported to TRS are accurate, complete, and in compliance with applicable laws and rules.
- Resources are acquired economically, used efficiently, and adequately protected.
- Programs, plans, and objectives are monitored and achieved in line with the TRS mission.

- Quality and continuous improvement are fostered in the organization's control process.
- Internal controls are in place and are functioning effectively to accomplish business and strategic objectives.
- Information technology controls including information systems security controls are in place and are functioning effectively.
- Contractors are meeting the obligations of their contracts while in conformance with applicable laws, regulations, policies, procedures, and best practices.
- Specific operations, processes and programs are reviewed at the request of management or the Audit Committee.

During the performance of professional services, recommendations for improvement in risk management, control, and governance processes may be identified. This information will be communicated to management and the Audit Committee.

## **AUTHORITY**

### **Legal Basis for the Internal Audit Function**

The Internal Audit department operates within the Teacher Retirement System of Texas under:

- Article 16, Section 67 of the Texas Constitution
- Title 8, Subtitle C, *Texas Government Code*
- Chapter 2102 (Texas Internal Auditing Act), *Texas Government Code*

### **Delegation of Authority Relevant to the Performance of Engagements**

To fulfill the mission and objectives of the internal audit function, the chief audit executive and staff of the Internal Audit department are hereby authorized by the Board of Trustees to:

- Have unrestricted access to all TRS divisions, departments, personnel, activities, confidential and non-confidential data and records, information systems, physical property, and contractors relevant to the performance of engagements, subject to applicable state and federal laws.
- Have access to contractor records and files in line with contract terms and specifically the "right to audit" section.
- Have unrestricted access to the chair of the Audit Committee, Audit Committee members, and the executive director.
- Allocate resources, set frequencies, select subjects, determine scope of work, and apply the techniques required to accomplish assurance and consulting objectives.
- Obtain the necessary assistance of personnel in units of the organization where audits are performed, as well as other specialized services from within or outside the organization.
- Obtain timely reports from management on actions proposed and taken pertaining to audit recommendations.

The chief audit executive and staff of the Internal Audit department are not authorized to:

- Perform any operational duties for the organization. Compliance duties are not considered operational duties.
- Initiate or approve accounting transactions external to the Internal Audit department.
- Direct the activities of any organization employee not employed by the Internal Auditing department, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the internal auditors.

Section 3.1.1 of the Bylaws of the Board of Trustees states the purpose and responsibilities of the Audit Committee.

## **INDEPENDENCE AND OBJECTIVITY**

### **Organizational Placement**

The chief audit executive reports functionally to the Board of Trustees through the Audit Committee and administratively to the executive director of the Teacher Retirement System. This reporting structure provides for Internal Audit independence and objectivity as required by Texas State law and professional standards.

## **RESPONSIBILITIES AND ACCOUNTABILITY**

The chief audit executive and staff of the Internal Audit department shall be accountable to the Board of Trustees, the Audit Committee, and the executive director to:

- Develop a flexible annual audit plan using an appropriate risk-based methodology, considering any risks or control concerns identified by management and the Board of Trustees, and submit that plan to the Audit Committee for review and approval as well as provide periodic updates.
- Develop short-term and long-term strategic goals for Internal Audit.
- Implement the approved audit plan including appropriate plan amendments, and special projects requested by management and the Audit Committee.
- Provide quarterly reports comparing actual results to the annual audit plan.
- Assess the adequacy and effectiveness of the organization's processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work, including the effectiveness of the Enterprise Risk Management (ERM) program.
- Report significant issues related to the processes for controlling the activities of the organization including potential improvements to those processes.
- Provide quarterly reports to the Audit Committee and management summarizing the results of audit activities including the implementation status of prior audit recommendations.

- Provide copies of audit reports to management, the Audit Committee, the Board of Trustees and oversight agencies specified in state law.
- Evaluate and assess significant new or changing functions, services, processes, operations, information systems and internal controls concurrent with their development, implementation, and/or expansion.
- Partner with management for all operations to understand the internal control environment, risks, and risk mitigation activities.
- Provide support to the internal investment compliance program.
- Participate in a consulting or advisory capacity in the planning, design, development, implementation, and modification phases of major information systems to determine whether:
  - adequate controls are incorporated during the development phases of business processes and systems before implementation
  - adequate project and risk management processes are in place and functioning effectively to mitigate risks that may hinder achieving project goals and objectives
  - thorough systems testing is performed at appropriate development phases
  - information security is addressed at appropriate development phases and at implementation
  - processes are in place and functioning effectively to develop and maintain complete and accurate systems documentation
  - the intended purpose and objectives of the system implementation or modifications have been met
- Facilitate and monitor the timely hiring and coordination of the TRS Enterprise Application Modernization (TEAM) program Independent Program Assessment vendor and ensure direct access to executive management and the Board of Trustees.
- Select, train, develop and retain professional audit staff members who collectively have the knowledge, skills, abilities, experience, expertise, and professional certifications to meet the requirements of this charter.
- Maintain an effective quality assurance and improvement program to include supervision, training, internal reviews, and external reviews.
- Keep management and the Audit Committee informed of emerging trends and successful practices in risk management, control, and governance through training and other forms of communication.
- Provide the Audit Committee a list of Internal Audit annual performance goals and results and the *Annual Internal Audit Report* required by state law.
- Provide the Audit Committee periodic reports on the sufficiency of Internal Audit resources.
- Assist in the deterrence of fraud by examining and evaluating the adequacy and the effectiveness of the system of internal controls and administering the internal fraud and ethics hot line.

- Report immediately any known incident of significant fraud to executive management, the Audit Committee, the Board of Trustees, and the State Auditor’s Office.
- Conduct or participate as appropriate in the investigation of suspected illegal or fraudulent activities within the organization and report results to executive management and the Audit Committee.
- Act as the primary point of contact related to audits, investigations, or inquiries of the State Auditor’s Office and other external audit groups.
- Consider the scope of work of external auditor groups as appropriate for the purpose of providing optimal audit coverage to the organization at a reasonable overall cost.
- Coordinate with other control and monitoring functions (risk management, legal, accounting, ethics, investments compliance, and physical and information systems security).

## STANDARDS OF AUDIT PRACTICE

The chief audit executive and staff members of the Internal Audit department will comply with the following professional standards:

- *Texas Government Code*, Chapter 2102 (Texas Internal Auditing Act)
- *International Standards for the Professional Practice of Internal Auditing* and the *Code of Ethics* of The Institute of Internal Auditors, Inc., see **Appendix A**
- *Government Auditing Standards* of the United States Government Accountability Office and their Code of Ethics, see **Appendix A**
- *Information Systems Standards, Guidelines and Procedures for Auditing and Control Professionals* of the Information Systems Audit and Control Association, as applicable

\*\*\*\*\*

## SIGNATURE SECTION

The Internal Audit Charter revision was adopted by the Board of Trustees of the Teacher Retirement System of Texas on September 14, 2012.

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Christopher Moss  
Chair, Audit Committee  
Board of Trustees

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R. David Kelly  
Chair  
Board of Trustees

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Amy L. Barrett, CIA, CPA  
Chief Audit Executive

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Brian Guthrie  
Executive Director

## APPENDIX A

### ***Code of Ethics of The Institute of Internal Auditors, Inc.***

Internal auditors are expected to apply and uphold the following principles:

1. **Integrity** - The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.
2. **Objectivity** - Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.
3. **Confidentiality** - Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
4. **Competency** - Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

### **Rules of Conduct**

#### **1. Integrity**

Internal auditors:

- 1.1. Shall perform their work with honesty, diligence, and responsibility.
- 1.2. Shall observe the law and make disclosures expected by the law and the profession.
- 1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- 1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

#### **2. Objectivity**

Internal auditors:

- 2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
- 2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.
- 2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

### **3. Confidentiality**

Internal auditors:

- 3.1. Shall be prudent in the use and protection of information acquired in the course of their duties.
- 3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

### **4. Competency**

Internal auditors:

- 4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- 4.2. Shall perform internal audit services in accordance with the *International Standards for the Professional Practice of Internal Auditing*.
- 4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

## **Government Auditing Standards of the United States Government Accountability Office Code of Ethics**

The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are:

- a. the public interest;
- b. integrity;
- c. objectivity;
- d. proper use of government information, resources, and positions; and
- e. professional behavior.

### **The Public Interest**

The public interest is defined as the collective well-being of the community of people and entities the auditors serve. Observing integrity, objectivity, and independence in discharging their professional responsibilities assists auditors in meeting the principle of serving the public interest and honoring the public trust. The principle of the public interest is fundamental to the responsibilities of auditors and critical in the government environment.

A distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embodies the concept of accountability for public resources, which is fundamental to serving the public interest.

## **Integrity**

Public confidence in government is maintained and strengthened by auditors performing their professional responsibilities with integrity. Integrity includes auditors conducting their work with an attitude that is objective, fact-based, nonpartisan, and non-ideological with regard to audited entities and users of the auditors' reports. Within the constraints of applicable confidentiality laws, rules, or policies, communications with the audited entity, those charged with governance, and the individuals contracting for or requesting the audit are expected to be honest, candid, and constructive.

Making decisions consistent with the public interest of the program or activity under audit is an important part of the principle of integrity. In discharging their professional responsibilities, auditors may encounter conflicting pressures from management of the audited entity, various levels of government, and other likely users. Auditors may also encounter pressures to inappropriately achieve personal or organizational gain. In resolving those conflicts and pressures, acting with integrity means that auditors place priority on their responsibilities to the public interest.

## **Objectivity**

The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional responsibilities. Objectivity includes independence of mind and appearance when providing audits, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest. Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditors' responsibility to the public. The concepts of objectivity and independence are closely related. Independence impairments impact objectivity.

## **Proper Use of Government Information, Resources, and Positions**

Government information, resources, and positions are to be used for official purposes and not inappropriately for the auditor's personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audited entity or the audit organization. This concept includes the proper handling of sensitive or classified information or resources.

In the government environment, the public's right to the transparency of government information has to be balanced with the proper use of that information. In addition, many government programs are subject to laws and regulations dealing with the disclosure of information. To accomplish this balance, exercising discretion in the use of information acquired in the course of auditors' duties is an important part in achieving this goal. Improperly disclosing any such information to third parties is not an acceptable practice.

Accountability to the public for the proper use and prudent management of government resources is an essential part of auditors' responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public's expectations for auditors.

Misusing the position of an auditor for financial gain or other benefits violates an auditor's fundamental responsibilities. An auditor's credibility can be damaged by actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an auditor's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the auditor serves as an officer, director, trustee, or employee; or an organization with which the auditor is negotiating concerning future employment.

### **Professional Behavior**

High expectations for the auditing profession include compliance with all relevant legal, regulatory, and professional obligations and avoidance of any conduct that might bring discredit to auditors' work, including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditors' work was professionally deficient. Professional behavior includes auditors putting forth an honest effort in performance of their duties and professional services in accordance with the relevant technical and professional standards.

# TEACHER RETIREMENT SYSTEM OF TEXAS

## INTERNAL AUDIT CHARTER

### ROLE OF INTERNAL AUDIT

Auditing is a cornerstone of good public sector governance. By providing unbiased, objective assessments of whether public resources are managed responsibly and effectively to achieve intended results, auditors help public sector organizations achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders. The public sector auditor's role supports the governance responsibilities of oversight, insight, and foresight. Oversight addresses whether public sector entities are doing what they are supposed to do and serves to detect and deter public corruption. Insight assists decision-makers by providing an independent assessment of public sector programs, policies, operations, and results. Foresight identifies trends and emerging challenges. Auditors use tools such as financial audits, performance audits, investigations, and advisory services to fulfill each of these roles.<sup>1</sup>

### MISSION

The mission of the Internal Audit department is to provide independent, objective assurance and consulting services designed to add value and improve the organization's operations. Internal Audit helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

### OBJECTIVES AND SCOPE OF WORK

#### Assurance Objectives

The objectives of assurance services are to provide formal, independent assurance to management and the Audit Committee that the organization's assets are safeguarded, that operating efficiency is enhanced, and that compliance is maintained with prescribed laws, and management and **TRS Board of Trustees (Board of Trustees)** policies. The assurance services objectives also include independent assessment of the organization's risk awareness and management, reliability and integrity of the organization's data, and achievement of the organization's goals and objectives.

#### Attestation Engagements: Agreed-Upon Procedures

Agreed-up procedures consist of auditors performing specific procedures on the subject matter and issuing a report of findings based on the agreed-upon procedures. In an agreed-upon procedures engagement, the auditor does not express an opinion or conclusion, but only reports on agreed-upon procedures in the form of procedures and findings related to the specific procedures applied.<sup>2</sup>

<sup>1</sup> The Institute of Internal Auditors *Supplemental Guidance: The Role of Auditing in Public Sector Governance*, 2<sup>nd</sup> Edition, January 2012

<sup>2</sup> [Government Auditing Standards of the United States Government Accountability Office, 2011 Revision](#)

### **Consulting and Advisory Services Objectives**

The objectives of consulting and advisory services are to provide management with assessments and advice for improving processes that will advance the goals and objectives of the organization. No assurance is provided.

~~In particular, the~~The objectives of consulting services are to provide formal assessments and advice on the front-end of projects so that risks may be managed and internal controls may be designed at the beginning of a project. ~~Typically, the~~ The objectives and the scope of ~~the consulting~~ projects are agreed to by management.

The objectives of advisory services are to provide informal advice to management. Examples of advisory services include participating in various committees in an ~~an~~ ex-officio non-voting capacity; providing routine advice on policies, internal controls, and audit recommendations; providing training and risk management tools; facilitating meetings; and collecting benchmarking information.

### **Scope**

Internal Audit provides opinions on governance, risk management, and controls as the result of an individual assurance project or as an overall opinion of the adequacy of governance, risk management, and control within the organization. The scope of work of the Internal Audit department is to determine whether the organization's framework of risk management, control, and governance processes, as designed and represented by management, is functioning in a manner to ensure:

- Programs are operating within the highest fiduciary standards and are directed toward the requirements defined in the federal and state constitutions, laws, regulations, and TRS policies and procedures.
- Risks within and outside the organization are appropriately identified and managed.
- Risk and control information is effectively communicated throughout the organization.
- Ethics-related programs and activities are effective.
- Significant financial, managerial, and operating information is accurate, reliable, and timely.
- Significant legislative or regulatory issues impacting the organization are recognized and addressed appropriately.
- Interaction with appropriate internal committees occurs as needed.
- Employee actions are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Employer (reporting entity) data and contributions reported to TRS are accurate, complete, and in compliance with applicable laws and rules.
- Resources are acquired economically, used efficiently, and adequately protected.
- Programs, plans, and objectives are monitored and achieved in line with the TRS mission.

- Quality and continuous improvement are fostered in the organization's control process.
- Internal controls are in place and are functioning effectively to accomplish business and strategic objectives.
- Information technology controls including information systems security controls are in place and are functioning effectively.
- Contractors are meeting the obligations of their contracts while in conformance with applicable laws, regulations, policies, procedures, and best practices.
- Specific operations, processes and programs are reviewed at the request of management or the Audit Committee.

During the performance of ~~audit work,~~ professional services, recommendations for improvement in risk management, control, and governance processes may be identified. This information will be communicated to management and the Audit Committee.

## **AUTHORITY**

### **Legal Basis for the Internal Audit Function**

The ~~internal audit function~~ Internal Audit department operates ~~as a component unit~~ within the Teacher Retirement System of Texas under:

- Article 16, Section 67 of the Texas Constitution
- Title 8, Subtitle C, *Texas Government Code*
- Chapter 2102 (Texas Internal Auditing Act), *Texas Government Code*

### **Delegation of Authority Relevant to the Performance of Engagements**

To fulfill the mission and objectives of the internal audit function, the chief audit executive and staff of the Internal Audit department are hereby authorized by the Board of Trustees to:

- Have unrestricted access to all TRS divisions, departments, personnel, activities, confidential and non-confidential data and records, information systems, physical property, and contractors relevant to the performance of engagements, subject to applicable state and federal laws.
- Have access to contractor records and files in line with contract terms and specifically the "right to audit" section.
- Have unrestricted access to the chair of the Audit Committee, Audit Committee members, and the executive director.
- Allocate resources, set frequencies, select subjects, determine scope of work, and apply the techniques required to accomplish assurance and consulting objectives.
- Obtain the necessary assistance of personnel in units of the organization where audits are performed, as well as other specialized services from within or outside the organization.
- Obtain timely reports from management on actions proposed and taken pertaining to audit recommendations.

The chief audit executive and staff of the Internal Audit department are not authorized to:

- Perform any operational duties for the organization. Compliance duties are not considered operational duties.
- Initiate or approve accounting transactions external to the Internal Audit department.
- Direct the activities of any organization employee not employed by the Internal Auditing department, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the internal auditors.

Section 3.1.1 of the Bylaws of the Board of Trustees states the purpose and responsibilities of the Audit Committee.

## **INDEPENDENCE AND OBJECTIVITY**

### **Organizational Placement**

The chief audit executive reports functionally to the Board of Trustees through the Audit Committee and administratively to the executive director of the Teacher Retirement System. This reporting structure provides for Internal Audit independence and objectivity as required by Texas State law and professional standards.

## **RESPONSIBILITIES AND ACCOUNTABILITY**

The chief audit executive and staff of the Internal Audit department shall be accountable to the Board of Trustees, the Audit Committee, and the executive director to:

- Develop a flexible annual audit plan using an appropriate risk-based methodology, considering any risks or control concerns identified by management and the Board of Trustees, and submit that plan to the Audit Committee for review and approval as well as provide periodic updates.
- Develop short-term and long-term strategic goals for Internal Audit.
- Implement the approved audit plan including appropriate plan amendments, and special projects requested by management and the Audit Committee.
- Provide quarterly reports comparing actual results to the annual audit plan.
- Assess the adequacy and effectiveness of the organization's processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work, including the effectiveness of the Enterprise Risk Management (ERM) program.
- Report significant issues related to the processes for controlling the activities of the organization including potential improvements to those processes.
- Provide quarterly reports to the Audit Committee and management summarizing the results of audit activities including the implementation status of prior audit recommendations.

- Provide copies of audit reports to management, the Audit Committee, the Board of Trustees and oversight agencies specified in state law.
- Evaluate and assess significant new or changing functions, services, processes, operations, information systems, and internal controls concurrent with their development, implementation, and/or expansion.
- Partner with management for all operations to understand the internal control environment, risks, and risk mitigation activities.
- ~~Coordinate our services and activities with control and monitoring groups such as operations, risk management, compliance, and legal, as appropriate.~~
- Provide support to the internal investment compliance programs.
- Participate in a consulting or advisory capacity in the planning, design, development, implementation, and modification phases of major information ~~related~~ systems to determine whether:
  - adequate controls are incorporated ~~in the systems during the development phases of business processes and systems before implementation~~
  - adequate project and risk management ~~techniques processes are in place and functioning effectively to mitigate risks that may hinder achieving project goals and objectives are used~~
  - thorough systems testing is performed at appropriate stages development phases
  - information security is addressed at appropriate development phases and at implementation
  - processes are in place and functioning effectively to develop and maintain completed and accurate systems documentation ~~is complete and accurate~~
  - the intended purpose and objectives of the system implementation or modifications have been met
- Facilitate and monitor the timely hiring and coordination of the TRS Enterprise Application Modernization (TEAM) program Independent Program Assessment vendor and ensure direct access to executive management and the Board of Trustees.
- Select, train, develop and retain professional audit staff members who collectively have the knowledge, skills, abilities, experience, expertise, and professional certifications to meet the requirements of this charter.
- Maintain an effective quality assurance and improvement program to include supervision, training, internal reviews, and external reviews.
- Keep management and the Audit Committee informed of emerging trends and successful practices in risk management, control, and governance through training and other forms of communication.
- Provide the Audit Committee a list of Internal Audit annual performance goals and results and the *Annual Internal Audit Report* required by state law.
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- Assist in the deterrence of fraud by examining and evaluating the adequacy and the effectiveness of the system of internal controls and administering the internal fraud and ethics hot line.

- Report immediately any known incident of significant fraud to executive management, the Audit Committee, the Board of Trustees, and the State Auditor's Office.
- Conduct or participate as appropriate in the investigation of suspected illegal or fraudulent activities within the organization and report results to executive management and the Audit Committee.
- Act as the primary point of contact related to audits, investigations, or inquiries of the State Auditor's Office and other external audit groups.
- Consider the scope of work of external auditor groups as appropriate for the purpose of providing optimal audit coverage to the organization at a reasonable overall cost.
- Coordinate with other control and monitoring functions (risk management, legal, accounting, ethics, investments compliance, and physical and information systems security).

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The chief audit executive and staff members of the Internal Audit department will comply with the following professional standards:

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- *Information Systems Standards, Guidelines and Procedures for Auditing and Control Professionals* of the Information Systems Audit and Control Association, as applicable.

## SIGNATURE SECTION

The Internal Audit Charter revision was adopted by the Board of Trustees of the Teacher Retirement System of Texas on September 14~~7~~, 201~~20~~.

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Christopher Moss ~~Philip Mullins~~  
Chair, Audit Committee  
Board of Trustees

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R. David Kelly  
Chair  
Board of Trustees

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Amy L. Barrett, CIA, CPA  
Chief Audit Executive

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Brian Guthrie ~~Ronnie Jung~~  
Executive Director

## APPENDIX A

### Code of Ethics of The Institute of Internal Auditors, Inc.

Internal auditors are expected to apply and uphold the following principles:

1. **Integrity** - The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.
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4. **Competency** - Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

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### **4. Competency**

Internal auditors:

- 4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
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A distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embodies the concept of accountability for public resources, which is fundamental to serving the public interest.

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**TAB 6**

**TAB 6A**

## MEMORANDUM

**TO:** Audit Committee Members, TRS Board of Trustees  
Mr. Brian Guthrie, Executive Director

**FROM:** Amy Barrett, Chief Audit Executive  
Karen Morris, Senior Audit Manager

**SUBJECT:** Pension Fund Risks and Options for Employer Audits

**DATE:** September 14, 2012

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We have completed our study of public pension funds regarding employer audits as included in the *Fiscal Year 2012 Audit Plan* and the *TRS Internal Audit 2012-2016 Strategic Plan*.

The study had two objectives:

- (1) To identify current activities of public pension funds in the area of employer audits and
- (2) To identify options for future employer audits

The survey of public pension funds related to employer audits was reported at the June 2012 Audit Committee. These survey results were considered in the development of options for future TRS employer audits. Subsequently, we met with other state agencies who gather information about TRS employers, specifically school districts, and gained understanding of the employer data gathered through the employer reporting system (TRAQS).

The options development process included identifying the following (page 3):

- pension fund risks associated with not conducting employer audits
- incentives for employers not to comply
- financial impact associated with the risks
- error rate sensitivity for 1% error in member, employer, state, and federal/private grant contributions
- associated compliance requirements and penalties

In considering our options (page 4), we identified the need to gather more information to determine the extent of errors in employer reported eligibility, compensation, and retiree return to work data and promote communications with TRS stakeholders on this topic. We recommend the following options beginning in fiscal year 2013:

- Develop a communications and outreach plan for TRS stakeholders regarding potential audit areas
- Perform limited scope desk reviews on targeted risks areas in school districts and charter schools, report the status to the Audit Committee, and determine future direction
- Increase support to executive management in investigative reviews and special projects pertaining to eligibility, compensation, and retiree return to work

Successful implementation of these options will require commitment of resources within TRS as follows:

- Internal Audit: allocate 1000 project hours in fiscal year 2013 (primarily 4<sup>th</sup> quarter) to coordinate the overall project with significant focus on the communication strategy and the process to gather employers' data
- Executive management: provide overall strategic guidance
- Government Relations: educate legislators on this topic and the potential for statutory change to assess employer penalties
- Legal Services: provide expertise on plan interpretations, proposed communications, and resolution of issues
- Communications: deliver information to employers about potential audits and employer self-assessments
- Benefit Accounting: assist in communications with employers, identify employer training materials, assist Internal Audit with employer data gathering, and work with employers in resolving issues

Please see the attached report and appendices<sup>i</sup> for additional detail supporting pension fund risks and options for employer audits and reviews.

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<sup>i</sup> See Appendix A (page 5) for employer and member contribution rates effective September 1, 2012  
See Appendix B (page 6) for fiscal year 2011 contributions and monetary impact of errors  
See Appendix C (pages 7 - 9) for statute regarding penalty interest on employer late deposits

## PENSION FUND RISKS – EMPLOYER REPORTING

Risk	Employer Incentives	Financial Impact	Error Rate Sensitivity	Compliance Requirements and Penalties
1. TRS loses IRS Qualified Plan status (failure to operate by plan requirements)	None; no responsibility for qualified plan status	<ul style="list-style-type: none"> <li>• TRS could pay monetary penalties to IRS</li> <li>• TRS will have to “unwind” errors</li> </ul>	See <b>Appendix B</b> (page 6)  <b>MEMBER:</b> 1% Error= \$22,439,550 Underpaid pension trust contribution	Federal- IRS Code, State Laws, TRS Laws and Rules; Fiduciary duty to operate as a qualified plan
2. Ineligible members reported	Provide benefits to retain employees for small portion of contribution costs	<ul style="list-style-type: none"> <li>• Future benefits exceed expected contributions</li> <li>• State contributions paid on ineligible salaries</li> </ul>	1% Error= \$1,838,086 Underpaid TRS-Care contributions	<b>IRS:</b>  <u>IRS discovers through audit:</u> TRS could pay taxes on members’ salary, taxes on amounts rolled over plus any interest and penalties
3. Not all eligible members reported	Reduce contribution costs; increase net pay of employees	Reduced state, employer and member contributions; actuarial cost to member to buy unreported service	<b>EMPLOYER:</b> 1 % Error = \$4,199,685 Underpaid pension trust contributions	<u>TRS identifies operational problem and reports to IRS:</u> IRS Voluntary Correction Program: \$25,000 fee to IRS for submission of proposal to correct problems
4. Eligible member salaries underreported (prior to final average salary calculation)	Reduce contribution costs; increase net pay of employees	<ul style="list-style-type: none"> <li>• Reduced state, employer and member contributions</li> <li>• State contributions offset certain differences</li> </ul>	1% Error = \$1,587,240 Underpaid TRS-Care contributions	<b>TRS Law</b> (see <b>Appendix C</b> , pages 7-9)
5. Member salaries paid from federal funds/private grants unreported	Reduce contribution costs; increase available federal funds/private grants dollars	State pays contributions instead of federal funds/private grant sources	<b>STATE:</b> 1% Error = \$15,957,718 Underpaid pension trust contributions	<u>Employer Penalty Interest:</u> Employers must pay interest on the unpaid member and employer deposits when they fail to remit by the monthly due date.
6. Ineligible/inflated salaries reported (used in final average salary calculation)	Incur small portion of contribution costs; increase retirement benefit to retain employee	<ul style="list-style-type: none"> <li>• Excess future benefits exceed contributions</li> <li>• State contributions paid on ineligible salaries</li> </ul>	1% Error= \$2,571,059 Underpaid TRS-Care contributions	<u>Collection of Contributions from Federal or Private Sources; Offense, Penalty</u> TRS is required to notify certain parties of noncompliance; employer noncompliance is a Class C misdemeanor.
7. Retirees’ pension and TRS-Care surcharges unreported	Reduce pension surcharge and TRS-Care surcharge costs	Uncollected pension and TRS-Care surcharges	<b>FEDERAL FUNDS/PRIVATE GRANTS:</b> 1% Error= \$3,247,647 Underpaid pension trust contributions	TRS may not consider salaries paid from certain fund sources as eligible salaries; certain penalties could apply
8. Annuities not reduced when retirees return to work without break in service	Retain experienced employee; retiree receives ineligible annuity	Overpaid annuities; uncollected surcharges		
9. Years of service credit manipulated (overreported service credit)	Increase future benefit to employee without cost	Excess future benefits exceed expected contributions	1% Error= \$257,859 Underpaid TRS-Care contributions	<u>Penal Provisions</u> Criminal penalties can occur for intentional misreporting of salary deductions to defraud TRS

## OPTIONS FOR EMPLOYER AUDITS AND REVIEWS IN FISCAL YEAR 2013

OPTION	DESCRIPTION	Recommended (Yes/No)
1. No Employer Audits	No new process is implemented to verify accuracy of employer and members pension and TRS-Care contributions	No  This option does not address fiduciary duty, inherent risks with qualified plan status, and financial risks to TRS
2. Employer Self-Assessments	<ul style="list-style-type: none"> <li>• Employers assess their compliance with eligibility, compensation, and retiree return to work laws and rules. A tutorial web based self-assessment program is developed by Internal Audit.</li> <li>• Selected employers send the results to Internal Audit for review and follow-up – “perception of detection”</li> </ul>	No  Self-assessments would not provide assurance on the accuracy of employer reported data and contributions; Internal Audit may not be the best resource to conduct training
3. Full Scope Desk Audits of Selected Employers	<ul style="list-style-type: none"> <li>• Internal Audit conducts desk audits of employers based on annual risk assessment in the following areas:               <ul style="list-style-type: none"> <li>➢ Eligibility</li> <li>➢ Compensation</li> <li>➢ Retiree Return to Work</li> </ul> </li> <li>• Employers submit supporting personnel and payroll data electronically to Internal Audit.</li> <li>• Onsite audits are conducted if fraud is suspected</li> </ul>	No  Very resource intensive upfront to review all types of employers in all risk areas; project would span across fiscal years  Not focused on specific risks to provide timely information on extent of errors
4. Limited Scope Desk Audits of Multiple Employers in Targeted Risk Areas	<ul style="list-style-type: none"> <li>• Internal Audit phases in desk audits of multiple employers with scope limited to targeted risk areas.</li> <li>• Fiscal year 2013 audits would be limited to school districts and charter schools and scoped to include one or more of the following risk areas:               <ul style="list-style-type: none"> <li>➢ Eligibility</li> <li>➢ Compensation</li> <li>➢ Retiree Return to Work</li> </ul> </li> </ul>	<b>Yes</b>  Internal Audit can “size the error rate” with minimal travel costs. Number of issues to address is limited to a specific risk.
5. Investigative Audits	Internal Audit conducts desk and onsite audits of employers’ personnel and payroll data to support Legal Services and executive management in investigations and special projects on an “as-needed” basis.	<b>Yes</b>  Audit can respond to known complaints when onsite fieldwork is necessary
6. Field Audits	<ul style="list-style-type: none"> <li>➢ Internal Audit staff conducts onsite audits of employer’s personnel and payroll documentation supporting contributions to TRS.</li> <li>➢ Employers would be selected for onsite audits based on an annual risk assessment. Scope includes:               <ul style="list-style-type: none"> <li>➢ Eligibility</li> <li>➢ Compensation</li> <li>➢ Retiree Return to Work</li> </ul> </li> </ul>	No  Travel and hotel costs for audit staff would increase significantly  Need to “size error rate” prior to committing resources  Audits might reveal multiple issues with small financial impact

**APPENDIX A**

**Contribution Rates Effective September 1, 2012**

<b>Employer Contributions</b>	<b>Member Contributions</b>	<b>State Contributions</b>
<ul style="list-style-type: none"> <li>• Salary above Statutory minimum salary (6.4%) – public schools only</li> </ul> <p><i>Note: the amount collected by TRS through this report reduces the amount of state contribution due TRS from the state at fiscal year-end.</i></p> <ul style="list-style-type: none"> <li>• Federal Funds Private Grant (6.4%)</li> <li>• New Member 1<sup>st</sup> 90 days (6.4%)</li> <li>• Pension Surcharge (12.8%)</li> <li>• Non-educational/General Funds (6.4%) - senior universities, medical and dental schools</li> <li>• Educational/General-Local Funds (6.4%) – senior universities, junior/community colleges, medical and dental schools</li> </ul>	<p>Member Retirement contribution (6.4%)</p>	<p>A state contribution rate of 6.4% of the aggregate annual compensation (payroll) of all members of the system during the fiscal year (less amount contributed by the employers)</p>
<b>Employer Contributions</b>	<b>Member Contributions</b>	<b>State Contributions</b>
<ul style="list-style-type: none"> <li>• Retirees’ Health Insurance Program (.55%) – public schools only</li> <li>• Federal Grant TRS-Care (.5% )- public schools only</li> <li>• TRS-Care surcharge (varies \$37 - \$1100 based on TRS-Care plan selected, years of service, ad coverage options effective 9/1/2011)</li> </ul>	<p>Member TRS Care contribution (.65%)</p>	<p>The State TRS-Care contribution rate will be 0.5% of the aggregate annual compensation (payroll) of all members of the system during the fiscal year</p>

**APPENDIX B**

**Fiscal Year 2011 Contributions and Monetary Impact of Error**

<b>Pension Trust Fund</b>	<b>FY 2011 CAFR* DATA</b>	<b>% of Total Member, State, Reporting Entity Contributions (rounded)</b>	<b>Assume 1% Error Rate Monetary Impact</b>	<b>Total Monetary Impact</b>
Member Contributions	\$2,243,955,725	48.9%	\$22,439,550	\$22,439,550
State Contributions	1,595,771,774	34.8%	15,957,718	15,957,718
Federal/Private Funding Sources Contributions (pass through by reporting entities)	324,764,720	7.1%	3,247,647	3,247,647
Reporting Entities	411,889,817	9.0%	4,118,898	} 4,199,685
Reporting Entity Surcharge	8,078,699	.2%	80,787	
<b>TOTAL</b>	<b>\$4,584,460,735</b>	<b>100%</b>		<b>\$45,844,600</b>
<b>TRS-Care Trust Fund</b>	<b>FY 2011 CAFR DATA</b>	<b>% of Total Member, State, Reporting Entity Contribution (rounded)</b>	<b>Assume 1% Error Rate Monetary Impact</b>	<b>Total Monetary Impact</b>
Member contributions	\$183,808,580	29.41%	\$1,838,086	\$1,838,086
State contributions	257,105,886	41.12%	2,571,059	2,571,059
Federal/Private Funding Sources Contributions (pass through by reporting entities)	25,784,985	4.10%	257,859	257,859
Reporting Entities	155,471,641	24.85%	1,554,716	} 1,587,240
Reporting Entity Surcharge	3,252,369	.52%	32,524	
<b>TOTAL</b>	<b>\$625,423,461</b>	<b>100%</b>		<b>\$6,254,244</b>

\*TRS Comprehensive Annual Financial Report for Fiscal Year Ended August 31, 2011

## APPENDIX C

### Penalty Interest on Late Contributions and Fees

#### **Texas Government Code, Title 8, Subtitle C, Chapter 825, Subchapter E. Collection of Membership Fees and Contributions**

##### ***§ 825.408. Interest on Contributions and Fees; Deposits in Trust***

- (a) An employer that fails to remit, before the seventh day after the last day of a month, all member and employer deposits and documentation of the deposits required by this subchapter to be remitted by the employer for the month shall pay to the retirement system, in addition to the deposits, interest on the unpaid or undocumented amounts at an annual rate compounded monthly. The rate of interest is the rate established under Section 825.313(b) (1), plus two percent. Interest required under this section is creditable to the interest account. On request, the retirement system may grant a waiver of the deadline imposed by this subsection based on an employer's financial or technological resources.
- (b) An employer and its trustees or other governing body hold amounts due to the retirement system under this subtitle in trust for the retirement system and its members and may not divert the amounts to any other purpose.

### Criminal Offense, Penalty

#### **Texas Government Code, Title 8, Subtitle C, Chapter 825, Subchapter E. Collection of Membership Fees and Contributions**

##### ***§ 825.406. Collection of Contributions from Federal or Private Sources; Offense; Penalty<sup>i ii</sup>***

- (a) If an employer applies for money provided by the United States, an agency of the United States, or a privately sponsored source, and if any of the money will pay part or all of an employee's salary, the employer shall apply for any legally available money to pay state contributions required by Section 825.404 or 830.201.
- (b) When an employer receives money for state contributions from an application made in accordance with Subsection (a), the employer shall immediately send the money to the retirement system for deposit in the state contribution account.
- (c) Monthly, employers shall:
  - (1) report to the retirement system in a form prescribed by the system a certification of the total amount of salary paid from federal funds and private grants and the total amounts provided by the funds and grants for state contributions for the employees; and
  - (2) retain the following information:
    - (A) the name of each employee paid in whole or part from a grant;
    - (B) the source of the grant;
    - (C) the amount of the employee's salary paid from the grant;
    - (D) the amount of the money provided by the grant for state contributions for the employee; and
    - (E) any other information the retirement system determines is necessary to enforce this section.

## APPENDIX C

(d) The retirement system may:

- (1) require from employers reports of applications for money;
- (2) require evidence that the applications include requests for funds available to pay state contributions to the retirement system for employees paid from the grant; and
- (3) examine the records of any employer to determine compliance with this section and rules promulgated under it.

(e) A person commits an offense if the person is an administrator of an employer and knowingly fails to comply with this section.

(f) An offense under Subsection (e) is a Class C misdemeanor.

(g) An employer who fails to comply with this section may not, after the failure, apply for or spend any money from a federal or private grant. The retirement system shall report alleged noncompliance to the attorney general, the Legislative Budget Board, the comptroller of public accounts, and the governor. The attorney general shall bring a writ of mandamus against the employer to compel compliance with this section.

### **Penal Provisions**

#### **Texas Government Code, Title 8, Subtitle C, Chapter 821, Subchapter B. Penal Provisions**

##### ***§ 821.101. Conversion of Funds; Fraud***

(a) A person commits an offense if the person knowingly or intentionally confiscates, misappropriates, or converts funds that represent deductions from a member's salary or that belong to the retirement system.

(b) A person commits an offense if the person knowingly or intentionally makes or permits the making of a false record for or statement to the retirement system in an attempt to defraud the retirement system.

(c) A member commits an offense if the member intentionally receives as a salary money that should have been deducted as provided by this subtitle from the member's salary.

(d) A person commits an offense if the person knowingly or intentionally violates a requirement of this subtitle other than ones described by Subsection (a), (b), or (c).

##### ***§ 821.102. Penalties***

(a) An offense under Section 821.101(a) or 821.101(b) is a felony punishable by imprisonment in the Texas Department of Criminal Justice for not less than one nor more than five years.

(b) An offense under Section 821.101(c) is a misdemeanor punishable by a fine of not less than \$100 nor more than \$500.

(c) An offense under Section 821.101(d) is a misdemeanor punishable by a fine of not less than \$100 nor more than \$1,000.

## APPENDIX C

### **§ 821.103. Cancellation of Teacher Certificate**

(a) After receiving notice from the board of trustees of an offense under Section 821.101 and after complying with Chapter 2001 and rules adopted by the State Board for Educator Certification, the State Board for Educator Certification may cancel the teacher certificate of a person if the State Board for Educator Certification determines that the person committed the offense.

(b) The executive director of the State Board for Educator Certification may enter into an agreed sanction.

(c) A criminal prosecution of an offender under Section 821.101 is not a prerequisite to action by the State Board for Educator Certification or its executive director.

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<sup>i</sup> Section 97 of Act 2009, 81st Leg., ch 1328 provides: For purposes of interpreting and implementing Section 825.406, Government Code, the Teacher Retirement System of Texas may not consider salaries of personnel paid in whole or in part from education stabilization funds distributed to school districts under the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5) as being paid from federal funds.

<sup>ii</sup> Act of 2011, 82nd Leg., 1st C.S., ch. 4 (S.B. 1), section 79.01 provides: For purposes of interpreting and implementing Section 825.406, Government Code, the Teacher Retirement System of Texas may not consider salaries of personnel paid wholly or partly from the Education Jobs Fund distributed to school districts under Title I of Pub. L. No. 111-226 as being paid from federal funds.

**TAB 6B**

# Fiscal Year 2013 Audit Plan

## *September 14, 2012*

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Amy Barrett, CIA, CPA  
Chief Audit Executive

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Christopher Moss  
Chair, Audit Committee, Board of  
Trustees

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Brian Guthrie  
Executive Director

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R. David Kelly  
Chair, Board of Trustees



# Executive Summary

## **Professional and Statutory Requirements**

This document provides the *Fiscal Year 2013 Audit Plan* (Audit Plan) for the Teacher Retirement System of Texas (TRS) as required by professional auditing standards and the *Texas Internal Auditing Act* (Act). The Act requires state agencies to conduct a program of internal auditing that includes an annual audit plan that is prepared using risk assessment techniques and identifies individual audit projects to be conducted during the year. The Audit Plan is required to be evaluated and updated annually for recommendation of approval by the TRS Audit Committee of the Board of Trustees (Audit Committee) to the TRS Board of Trustees (Board). Internal Audit is independent of management and provides objective assurance and consulting services designed to add value and improve TRS' operations.

## **Audit Plan Development and Scope**

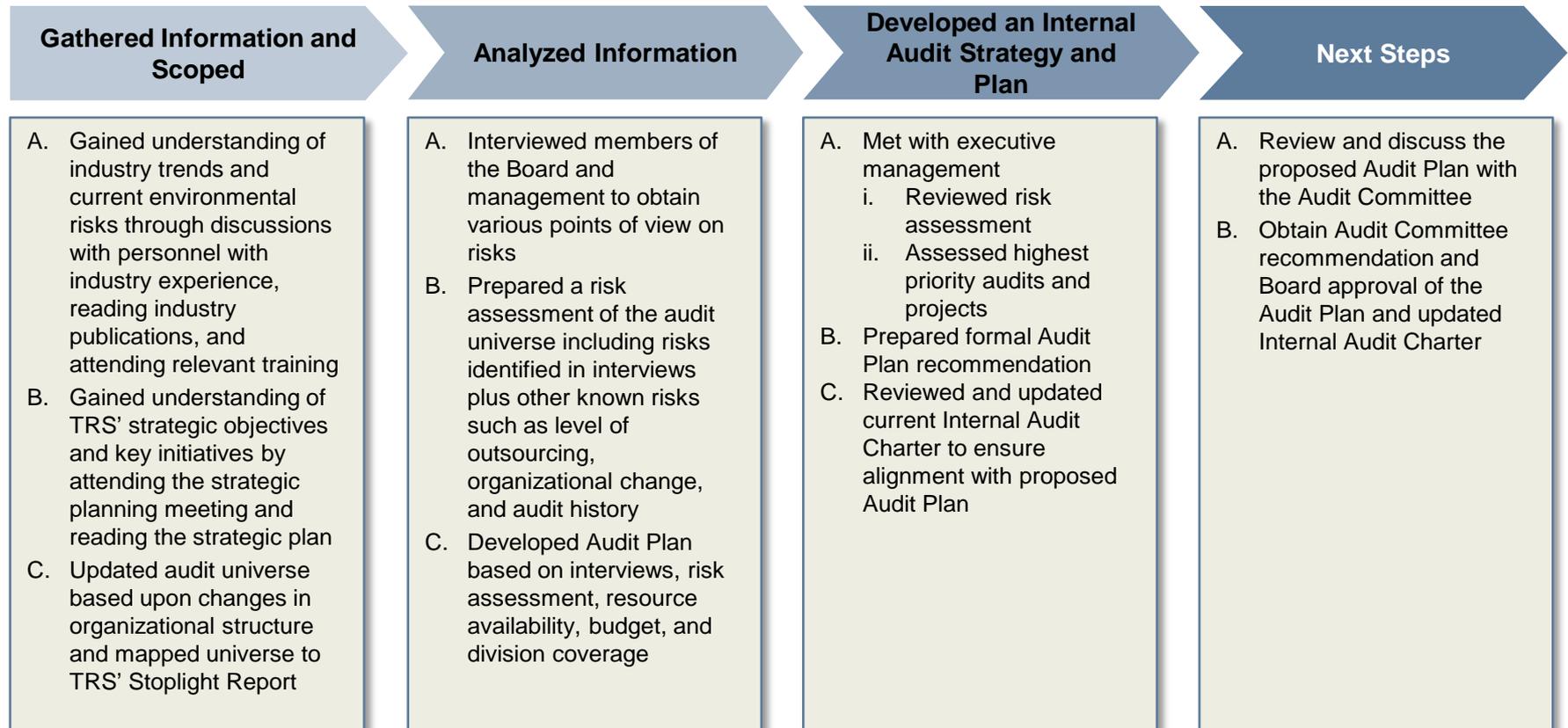
Our Audit Plan is designed to provide coverage of key risks, given the existing staff and approved budget. See the appendices for information regarding the internal audit budget, performance measures, and audit universe mapped to the TRS Enterprise Risk Inventory or "Stoplight Report" provided by Enterprise Risk Management.

## **Changes Subsequent to Approval**

Interim changes to the Audit Plan will occur from time to time due to changes in business risks, timing of TRS' initiatives, and staff availability. We will report Audit Plan changes to senior management and present changes to the Audit Committee at the following quarterly Audit Committee meeting. Amendments to the approved Audit Plan deemed to be significant (based on discussions with the executive director and audit committee chair) will be submitted to the Audit Committee for approval. The State Auditor's Office also requires notification of material changes to the Audit Plan.

# Risk Assessment & Audit Planning Approach

*An internal audit risk assessment was conducted in coordination with the board and management to identify perceived areas of risk and potential internal audit projects. This year's risk assessment was designed to create an audit plan which addresses risks to critical objectives while impacting staff time the least. The Audit Plan also includes hours for special projects and requests. The following approach was taken in creating the Audit Plan:*



# Trustees and Management Interviewed

*The tables below list the members of the Board and management who were interviewed to assess the highest areas of risk inherent to public pension plans like TRS. Questions discussed included the following:*

- 1) Highest areas of concern for TRS?*
- 2) Risks that could have significant consequences to TRS?*
- 3) Emerging issues that Internal Audit should monitor?*
- 4) Special requests?*

## TRS Board members interviewed:

- R. David Kelly, Board Chair
- Charlotte Clifton, Vice Chair
- Christopher Moss, Audit Committee Chair
- Nanette Sissney, Audit Committee Member
- Todd Barth, Audit Committee Member
- Eric C. McDonald, Audit Committee Member
- Anita Smith Palmer, Audit Committee Member
- Joe Colonna, Board Member
- T. Karen Charleston, Board Member

## TRS management interviewed:

- Ken Welch, Deputy Director
- Don Green, Chief Financial Officer
- Conni Brennan, General Counsel
- Jerry Albright, Deputy Chief Investment Officer
- Sylvia Bell, Director of Investment Operations
- Amy Morgan, Chief Information Officer
- Janet Bray, Director of Human Resources
- Marianne Woods Wiley, Chief Benefit Officer
- Betsey Jones, Director of Health Policy and Administration
- Howard Goldman, Director of Communications
- Ray Spivey, Director of Governmental Relations

# Risks Identified Without Consideration of Mitigating Factors

*The following table sets forth risks identified during the interview process. Each risk was considered when creating the Audit Plan.*

Risk Area	Description
1. <b>Ethics:</b> Ethics violations due to corruption or bad actors	a. Kickbacks and bribes
	b. Insider trading
	c. Ethics policy violations
	d. Lack of transparency
2. <b>Fraud:</b> Fraud, waste, and abuse	a. Misappropriation of assets, including information resources
	b. Manipulation of financial data
	c. Waste of resources
3. <b>Communication:</b> Ineffective communication and governance	a. Mishandled legislative requests
	b. Communication policy violations
	c. Social media mismanagement
	d. Inadequate personnel practices (policies, training, performance management, administration, workforce continuity)
4. <b>TEAM:</b> Mismanagement of TEAM program risks	Risks areas include project management (e.g., budget, schedule, resource utilization, third party oversight, etc.), organizational change management, and data management
5. <b>Strategic:</b> Unmet strategic objectives	a. Poor customer service and response time
	b. Unmet program goals for Historically Underutilized Businesses

## Risks Identified, continued

Risks	Description
6. <b>Financial:</b> Financial mismanagement	a. Accounting standard changes not implemented or not implemented timely
	b. Financial report misstatements
	c. Tax report inaccuracies (e.g., 1099's)
	d. Board report inaccuracies
7. <b>Compliance:</b> Noncompliance with laws and regulations	a. Loss of qualified plan status
	b. Board policies noncompliance
	c. Federal and state legislation noncompliance (e.g., Dodd-Frank, HIPAA)
8. <b>Operations:</b> Operational mismanagement	a. Unavailable information systems
	b. Confidential data breach
	c. Ineffective and inefficient processes and use of resources
	d. Improper record retention and storage
	e. Unidentified and unmanaged investment risks (e.g., counterparty, liquidity, environmental)
9. <b>Audit:</b> Lack of audit quality	a. High risks not addressed by Audit Plan
	b. Unreliable audits
	c. Unimplemented audit recommendations; lack of audit follow-up
	d. Required reports not submitted to oversight bodies
	e. Ineffective audit communications to Audit Committee

# Types of Projects to Cover Risk Areas

**Risks identified were considered by Internal Audit when identifying and prioritizing various projects. An important part of the Audit Plan is that the identified processes, systems and initiatives should receive differing types / levels of review based on their importance and perceived risk. Our standard types of internal audit activities are as follows:**

## Audit (Assurance)

- Audit Focus: Assess evidence available in order to conclude on an audit objective; assurance is provided
- Deliverable: Audit report for public distribution unless protected by statute
- Estimated level of effort per project: 400 - 500 hours

## Agreed-Upon Procedures

- Agreed-Upon Procedures Focus: Determine specific steps to test with management's agreement and report on results; used for data analytics and quarterly testing of specific data and transactions
- Deliverable: Agreed-upon procedures report for public distribution (use is limited to those with understanding of procedures performed)
- Estimated level of effort per project: 100 - 300 hours

## Formal Consulting

- Consulting Focus: Respond to requests for formal study or assessment with recommendations; no assurance provided
- Deliverable: Consulting report or memo for limited distribution; significant material weaknesses identified would be reported to executive management and the Audit Committee as required by professional auditing standards
- Estimated level of effort per project: 100 - 200 hours

## Informal Consulting (Advisory)

- Advisory Focus: Participate in activities in a non-voting capacity, e.g., provide training and input on policies and procedures
- Deliverable: Verbal discussion or a brief memo to management
- Estimated level of effort per year: 10 – 100 hours

# Audit Plan: Executive Division

*The tables on this and the following pages summarize the name of each project, risks to be addressed, type of project, reason for including in the Audit Plan, and description of work to be performed.*

Title	Risks	Type	Reason	Description
Ethics and Communications Policies Compliance Audit	Ethics, communication, compliance	Audit	Risk Assessment, Required	Assess compliance with trustee and employee ethics policies; present results of employee ethics survey; assess compliance with communications policy
Fraud Risk Identification and Prevention Audit	Fraud	Audit	Request, Required	Identify highest areas of fraud risks and related controls; validate that controls are sufficient and working to mitigate fraud risks (e.g., accounts payable, refunds, inactive accounts).
Internal Ethics and Fraud Hotline Administration	Fraud	Advisory	Audit Charter	Follow up on hotline calls (both internal and external)
Fraud, Waste, and Abuse Prevention (FWAP) Committee	Fraud	Advisory	Audit Charter	Attend Fraud, Waste, and Abuse Prevention (FWAP) committee meetings and participate in policy updates and communications initiatives
Meetings Attendance	Communication	Advisory	Audit Charter	Attend Executive Council, Leadership Team, Social Media Advisory Committee and Risk Oversight Committee meetings
Special Requests	All	All	Request	Complete projects as requested by management; complete surprise inspections to gain understanding of controls in an area and provide “perception of detection”

## Audit Plan: TEAM-Related Initiatives

Title	Risks	Type	Reason	Description
Independent Program Assessment Support	TEAM	Advisory	Risk Assessment	Coordinate and monitor activities of Independent Program Assessment vendor and ensure direct access to executive management and the Board
TEAM Committees Participation	TEAM	Advisory	Audit Charter	Participate in TEAM Executive Steering Committee and other committees as requested

# Audit Plan: Benefit Services Division

Title	Risks	Type	Reason	Description
Call Center Performance Measures	Strategic, operations	Audit	Request	Assess whether call center hold times are being captured and reported accurately; assess whether improvements to processes could be made to reduce hold times
Benefit Payment Testing (financial audit)	Financial	Audit	Request	Test accuracy of benefit payments to support State Auditor's Office for the financial audit
Benefit Payment Testing	Compliance	Agreed-Upon Procedures	Request	Test benefit payments for accuracy, support, and compliance with TRS Laws and Rules (every 6 months)
Benefit Processing Surprise Inspection	Compliance, operations	Advisory	Request	Perform surprise inspections of Benefit Services to assess compliance with documented procedures

# Audit Plan: Health Care Division

Title	Risks	Type	Reason	Description
Health Care Administration Audit	Operations	Audit	Risk Assessment	Assess whether controls are working effectively to achieve program goals and mitigate significant risks.
Health Care Vendor Update Meetings	Operations	Advisory	Risk Assessment	Attend quarterly meetings with health care vendors to understand results and issues
Vendor and Auditor Selection Observation	Ethics, compliance	Advisory	Risk Assessment	Observe large vendor and service provider auditor selection process in non-voting capacity

# Audit Plan: Information Technology Division

Title	Risks	Type	Reason	Description
Backup and Recovery Audit	Operations	Audit	Risk Assessment, Request	Assess reliability of processes for backup of critical data and information systems and the ability to restore these systems and data timely and accurately; includes hot site observation
Health Insurance Portability and Accountability Act (HIPAA) IT Security Rule Recommendations Implementation and Validation	Compliance	Audit	Risk Assessment, Audit Charter	Validate implementation of management's action plan and assess adequacy of actions taken to address risks noted in the information security audit report from August 2011
Internal Network Vulnerabilities Scan	Operations	Agreed-Upon Procedures	Audit Charter	Identify vulnerabilities within the TRS network that could compromise confidentiality, integrity and availability of TRS data, and negatively impact operations
Network Penetration Test; Security Risk Assessment Review	Operations	Advisory	Audit Charter	Obtain, read, and follow-up on any issues identified during the network penetration tests and security risk assessment conducted by the information security officer
Technology Committee Meetings Attendance	Operations	Advisory	Risk Assessment, Audit Charter	Attend meetings to stay apprised of initiatives relating to enterprise security and information technology operations

# Audit Plan: Finance Division

Title	Risks	Type	Reason	Description
Employer Reporting Audit	Compliance	Audit	Risk Assessment, Request	Assess whether employers are reporting data and contributions to TRS completely and accurately in areas such as eligibility, compensation, and return-to-work
Procurement and Contracting Audit	Ethics, strategic, compliance, operations	Audit	Risk Assessment, Request	Assess compliance with TRS procurement and contracting requirements, efficiency of operations, and whether Historically Underutilized Business (HUB) program goals are being met
1099 Reporting and Payment Processing	Financial, compliance	Consulting	Request	Flowchart disbursement activities and 1099 reporting process; inquire about past reporting problems, and suggest process enhancements.
Budget Transfer Inspection	Fraud, Financial	Advisory	Request	Perform surprise inspections of budget transfer process and assess whether transfers are properly approved and supported
Accounting Standards Changes Monitoring	Financial	Advisory	Audit Charter	Monitor impact of accounting standards changes on TRS financial statements
Financial Audit Coordination	Financial	Advisory	Audit Charter	Coordinate activities of State Auditor's Office audit of TRS financial statements to ensure deadlines are met; coordinate quarterly update meetings with executive management and State Auditor's Office

# Audit Plan: Investment Management Division

Title	Risks	Type	Reason	Description
Investments Selection and Monitoring (Emerging Managers)	Ethics, strategic	Audit	Risk Assessment	Assess effectiveness of ongoing monitoring and reporting of investment activities (e.g., public markets, private markets, and emerging managers); audit emerging managers in fiscal year 2013
Derivatives Audit	Financial, compliance, operations	Audit	Request	Determine whether actions taken by TRS comply with the Commodity Futures Trading Commission's new requirements for special entities like TRS for internal and external derivatives usage; determine whether program goals such as efficiency and portfolio risk management have been met
Investment Policy Compliance Testing (quarterly)	Ethics, compliance	Agreed-Upon Procedures	Audit Charter	Assess and monitor compliance with investment policy requirements including placement agent disclosures and Internal Investment Committee processes quarterly; test board report accuracy; provide input to policy changes
Contractual Allowance Identification	Fraud	Consulting	Request	Obtain contractual allowance clauses in asset management contracts, document understanding of how allowances are tracked and monitored, and report results to executive management

## Audit Plan: Investment Management Division, continued

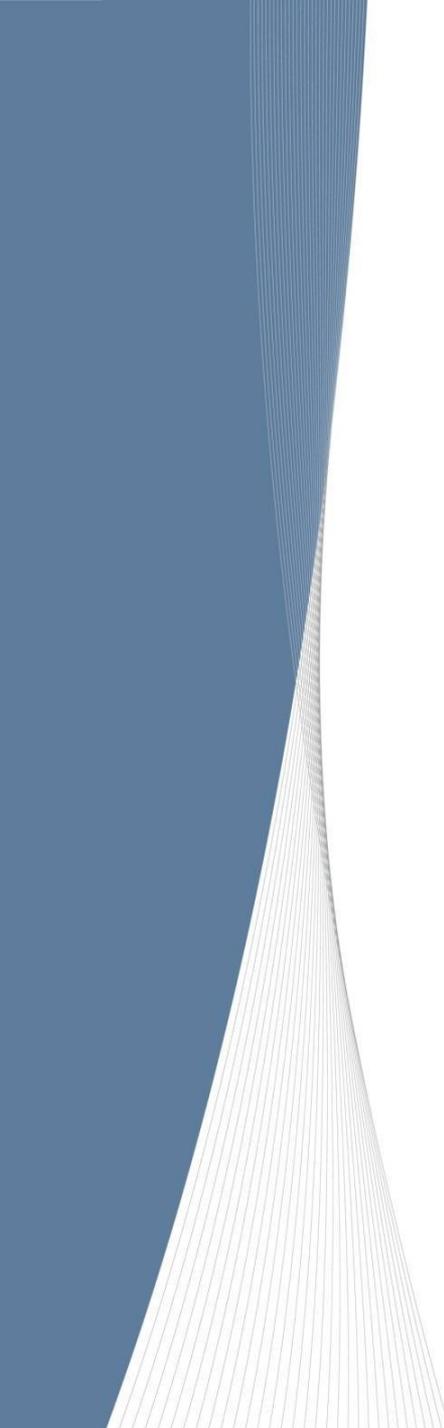
Title	Risks	Type	Reason	Description
Incentive Compensation Review	Fraud, financial	Advisory	Request	Review incentive compensation calculations to determine if it is awarded in accordance with plan provisions; reconcile performance to State Street numbers
Employee Trading Policy Compliance Monitoring	Ethics	Advisory	Audit Charter	Maintain watch list and monitor for inappropriate trading activities such as front-running and insider trading; monitor and report on compliance with the Employee Trading Policy
Emerging Risks Monitoring	Financial, compliance, operations	Advisory	Audit Charter, Request	Monitor risks reported in the media and assess implications to TRS portfolio and investment administration and operations
Investment Committees Attendance	Operations	Advisory	Audit Charter	Stay current on Investment Management Division (IMD) initiatives by attending Internal Investment Committee, Derivatives Operations, Technology and Operations Workgroup, Securities Lending, and IMD staff meetings
Travel Inspection	Fraud, compliance	Advisory	Request	Perform surprise inspections of travel processed by the Investment Management Division to review adherence to established procedures

# Audit Plan: Internal Audit Department

Title	Risks	Type	Reason	Description
External Quality Assurance Review	Compliance	Audit	Required	External review team will assess Internal Audit's compliance with professional auditing standards
Annual Internal Audit Report	Compliance	Audit	Required	Prepare annual report of audit activities in accordance with State Auditor's Office instructions
Audit Recommendations Follow-up	All	Audit	Required	Follow-up and report on status of outstanding audit recommendations; validate that significant recommendations have been implemented as reported
Audit Plan	Audit, compliance	Advisory	Required	Prepare annual audit plan based on a documented risk assessment in accordance with professional auditing standards and the Texas Internal Auditing Act
Audit Committee Meetings Preparation	Audit, communication	Advisory	Audit Charter	Prepare communications and attend Audit Committee and Board meetings
Internal Audit Strategic Plan	Audit, Strategic	Advisory	Audit Charter	Update, execute, and measure results of internal audit strategic plan initiatives

## Audit Plan: Areas Discussed But Excluded From Plan

Area	Risks	Reason for Exclusion
Executive (Human Resources)	Insufficient personnel policies, training, performance management, and personnel administration	Human Resources audit deferred to future to provide time for new management to implement initiatives
Executive	Critical records not retained and stored	TRS staff enrolled in the TRS leadership development program will study and make recommendations on improving electronic records retention
TEAM	TEAM program risks not identified or managed	The Independent Program Assessment vendor will identify program risks and report quarterly to the Board; the vendor is expected to be selected at the December Board meeting
Executive; TEAM	TEAM resource demand and other workload constraints not identified and managed as to impact on TRS' operations	Management is studying the impact of TEAM and other workload constraints and taking steps to address understaffed areas; the Independent Program Assessment will consider risks to TEAM due to lack of resources and report on that risk as part of its regular reporting to the Board

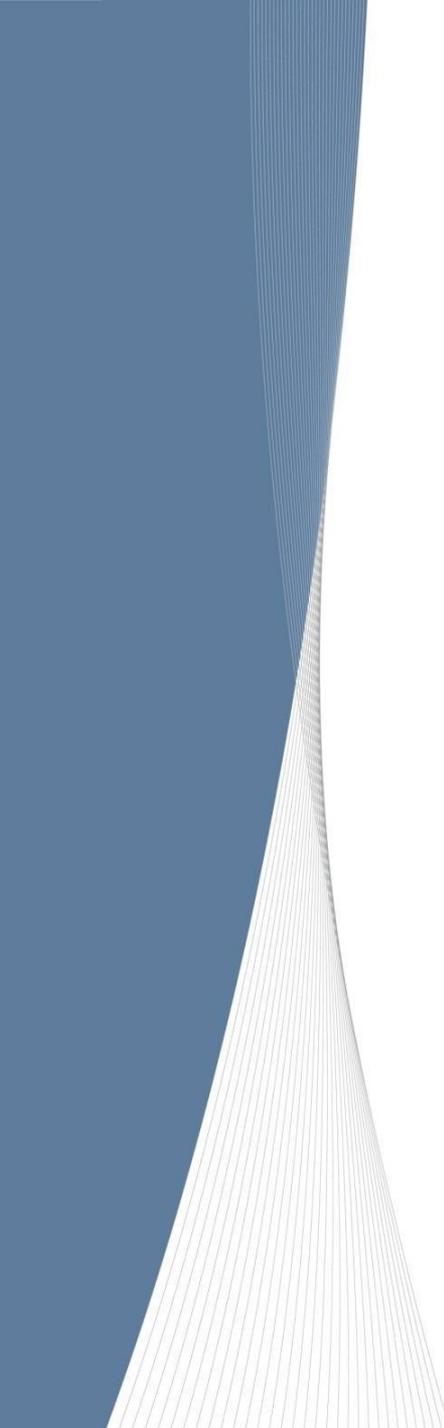


# **Appendix A**

## **Internal Audit Operating Budget**

## Internal Audit Operating Budget

LINE ITEM	Budget FY 2012	Budget FY 2013
000 – Salaries	\$921,440	\$921,440
000 – Benefits	205,356	215,680
200 – Professional Fees	622,500	628,500
505 – Travel-In-State	4,500	7,000
510 – Travel-Out-of-State	14,000	13,500
705 – Dues, Fees, and Staff Development	25,000	25,000
710 – Subscriptions and Reference Materials	4,500	4,500
Total Operating Budget (excluding indirect costs such as computers, office space, and utilities)	\$1,797,296	\$1,815,620
Full Time Equivalent (FTE) Positions	10.0	10.0

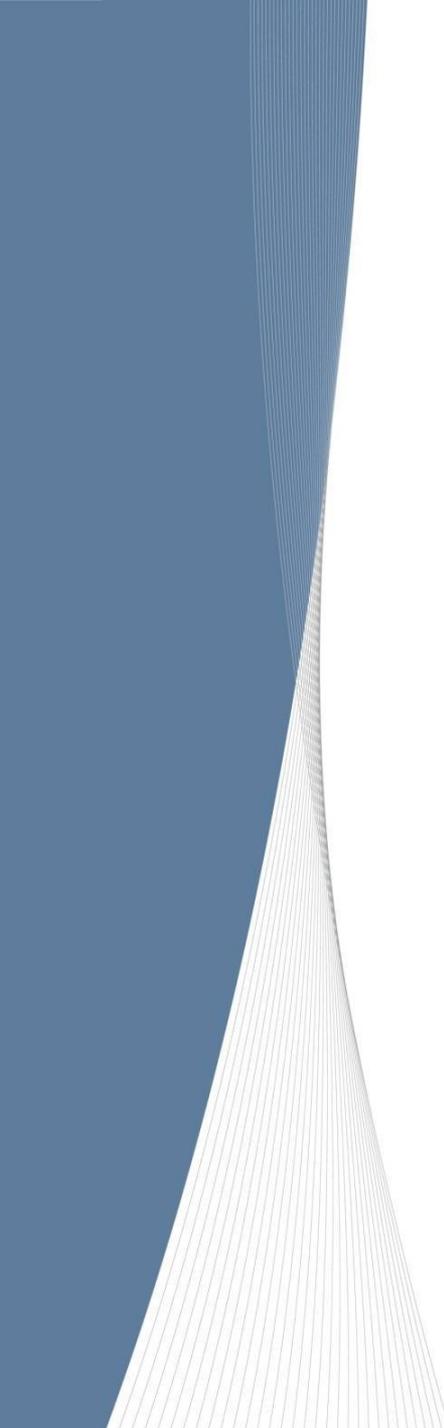


**Appendix B**  
**Internal Audit**  
**Performance Measures**

# Internal Audit Performance Measures

***Internal Audit performance measures related to the execution of the Audit Plan are as follows:***

1. Plan and execute employer audit activities with significant direction and input from TRS subject matter experts
2. Facilitate and monitor timely hiring and coordination of TEAM Independent Program Assessment vendor
3. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests)
4. Complete external quality assurance review with no significant compliance exceptions
5. Enhance trust through transparency and ongoing two-way communication with trustees and executive management through regular meetings, requests for audit plan input, and feedback on performance
6. Enhance value through allocating time for special requests throughout the year
7. Identify and utilize at least two internal or external resources to train and mentor audit staff in employer reporting and information technology
8. Systematically monitor emerging investment issues and impact to TRS via the investment compliance program
9. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services
10. Facilitate success of external financial audit by effectively providing audit support, coordinating meetings, reserving facilities, and gathering schedule requests to enable timely outcomes with no surprises



**Appendix C**  
**Auditable Process Universe Mapped**  
**to TRS Stoplight Report**

**Teacher Retirement System of Texas  
Audit Universe**

Enterprise		Operations	Finance	Investments
Pension Funding	Communications & External Relations	Pension Benefit Administration	General Accounting & Reporting	Investment Operations
See Pension Benefit Administration	<ul style="list-style-type: none"> <li>• <b>Social media</b></li> <li>• Board elections</li> <li>• Open records request compliance</li> </ul>	<ul style="list-style-type: none"> <li>• Actuarial assumptions (external) (FY10)</li> <li>• <b>Benefit payment testing (FY12)</b></li> <li>• Beneficiary claims controls (FY09)</li> <li>• Member data change controls (FY 09)</li> <li>• <b>Benefit processing controls (FY12)</b></li> <li>• Qualified Domestic Assistance Orders (FY12)</li> <li>• Disability</li> <li>• <b>Benefit accounting controls</b></li> <li>• Inactive and escheated accounts</li> <li>• Annual statements</li> <li>• Mail room operations</li> <li>• MyTRS website application controls</li> </ul>	<ul style="list-style-type: none"> <li>• <b>CAFR (external) (FY12)</b></li> <li>• <b>Wire transfers (FY12)</b></li> <li>• Investment valuation and accounting audit (FY12)</li> <li>• Payroll, accounts payable, travel (external) (FY09)</li> <li>• Compensation, payroll and position control (FY12)</li> <li>• Salary classification (external) (FY10)</li> <li>• Cash receipts (FY10)</li> <li>• Inventory</li> <li>• <b>Tax reporting (1099s)</b></li> <li>• Closing process</li> </ul>	<ul style="list-style-type: none"> <li>• Investment technology controls (FY 10)</li> <li>• <b>Soft dollars (FY08)</b></li> <li>• <b>Vendor paid expenses (FY09)</b></li> <li>• <b>Commission sharing arrangements (CSA) (FY11)</b></li> <li>• <b>Travel, including third party paid travel (FY11)</b></li> <li>• <b>Incentive compensation (FY12)</b></li> <li>• Settlement</li> <li>• Investment performance analytics (FY11)</li> <li>• Master custody services (FY12)</li> <li>• Cash flow projections</li> <li>• Corporate actions</li> <li>• <b>Proxy voting (FY12)</b></li> </ul>
Retiree Health Care	Governmental/Association Relations	Health Care Administration	Budget	Investment Reporting
See Health Care Administration	<ul style="list-style-type: none"> <li>• Legislation tracking system controls</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Third party vendor contract compliance (external) (FY12)</b></li> <li>• <b>Healthcare vendor selection and contract monitoring</b></li> <li>• <b>Healthcare administration controls</b></li> <li>• Healthcare payments and collections (FY10)</li> <li>• Appeals process</li> <li>• Premium refund testing (FY12)</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Budget allocations and transfers (FY10)</b></li> <li>• Budget process and reporting</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Investment policy compliance (FY12)</b></li> <li>• State Street's compliance calculations (FY12)</li> <li>• Investment performance measurement (FY11)</li> <li>• Investment risk management (FY12)</li> </ul>
Workforce Continuity	TEAM	403(b)	Employer Reporting	Market
<ul style="list-style-type: none"> <li>• Employee recruiting and hiring practices (FY10)</li> <li>• Employee training compliance (FY11)</li> <li>• Policy setting and monitoring</li> </ul>	<ul style="list-style-type: none"> <li>• Information technology governance (FY10)</li> <li>• <b>Independent program assessment (external)</b></li> <li>• TEAM risk assessment: risk identification status</li> <li>• TEAM risk assessment: resource utilization</li> </ul>	<ul style="list-style-type: none"> <li>• 403(b) certification process</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Employer audits</b></li> <li>• Employer reporting administration controls</li> <li>• TRAQS application controls</li> </ul>	<ul style="list-style-type: none"> <li>• Asset liability study (external) (FY09)</li> <li>• Tactical asset allocation</li> <li>• Investment benchmark selection (FY11)</li> <li>• Actively-managed internal equity portfolio (FY11)</li> <li>• Passively-managed portfolio</li> <li>• Hedge fund portfolio (FY11)</li> <li>• <b>Derivatives, including futures, forwards, and swaps (FY11)</b></li> </ul>

Enterprise		Operations	Finance	Investments
Governance	Legacy Information Systems	Customer Service	Procurement & Contract Management	Credit
<ul style="list-style-type: none"> <li>• Investment fiduciary study (external) (FY11)</li> <li>• Sunset review (external) (FY07)</li> <li>• Control environment, governance, and ethics (FY09)</li> <li>• Information and communications</li> <li>• Strategic planning</li> <li>• Enterprise risk management</li> <li>• Trustee orientation (FY10)</li> <li>• Board reporting (FY12)</li> <li>• Open Meetings Act compliance</li> <li>• Internal Audit Quality Assurance Review (external) (FY10)</li> </ul>	<ul style="list-style-type: none"> <li>• Change management controls (FY12)</li> <li>• Application-level controls of legacy systems</li> </ul>	<ul style="list-style-type: none"> <li>• Performance measures (External) (FY11)</li> <li>• Telephone counseling center / telecommunications</li> <li>• IT help desk</li> </ul>	<ul style="list-style-type: none"> <li>• Board advisors contract monitoring</li> <li>• Outside counsel procurement and monitoring (FY09)</li> <li>• Contract administration and purchasing (FY09)</li> <li>• Contract worker onboarding, monitoring and compliance (FY10)</li> <li>• HUB program compliance and reporting</li> <li>• Software license management</li> </ul>	<ul style="list-style-type: none"> <li>• External manager portfolio (FY11)</li> <li>• Private markets portfolio (FY12)</li> <li>• Emerging manager portfolio</li> <li>• Trading center (including broker selection and execution) (FY11)</li> </ul>
Business Continuity	Information Security	Tax Qualification Status		Liquidity/Leverage
<ul style="list-style-type: none"> <li>• Disaster recovery</li> <li>• System and data backup</li> <li>• Business continuity plan (FY09)</li> <li>• Risk management (health and safety, insurance) (FY12)</li> </ul>	<ul style="list-style-type: none"> <li>• Information security governance</li> <li>• Network penetration tests (external) (FY12)</li> <li>• Internal vulnerability scans</li> <li>• Patch management</li> <li>• Database administration controls</li> <li>• Information security policy compliance (FY12)</li> <li>• Logical access controls (FY12)</li> <li>• TAC 202 and HIPAA IT Security Rule compliance (FY11)</li> <li>• Cloud computing</li> </ul>	See Pension Benefit Administration		<ul style="list-style-type: none"> <li>• Securities lending (FY12)</li> <li>• Asset management fees (FY10)</li> <li>• Funding and distributions related to private markets commitments (FY12)</li> </ul>
Fraud Prevention & Detection	Confidential Information		<p><b>Red</b> Indicates areas in the audit universe covered by internal or external audit or agreed upon procedures projects planned for FY13</p> <p><b>Blue</b> Indicates areas that could be audited but coverage is provided through consulting or advisory projects planned for FY13</p> <p><b>(Year)</b> Indicates last year audited</p>	
<ul style="list-style-type: none"> <li>• Fraud risk identification and prevention controls (FY09)</li> </ul>	<ul style="list-style-type: none"> <li>• Building security and physical access controls (FY12)</li> <li>• HIPAA privacy and confidentiality compliance</li> <li>• Social Security number scans (FY10)</li> </ul>			
Records Management				
<ul style="list-style-type: none"> <li>• Records retention (FY11)</li> <li>• Imaging system application and management controls</li> </ul>				

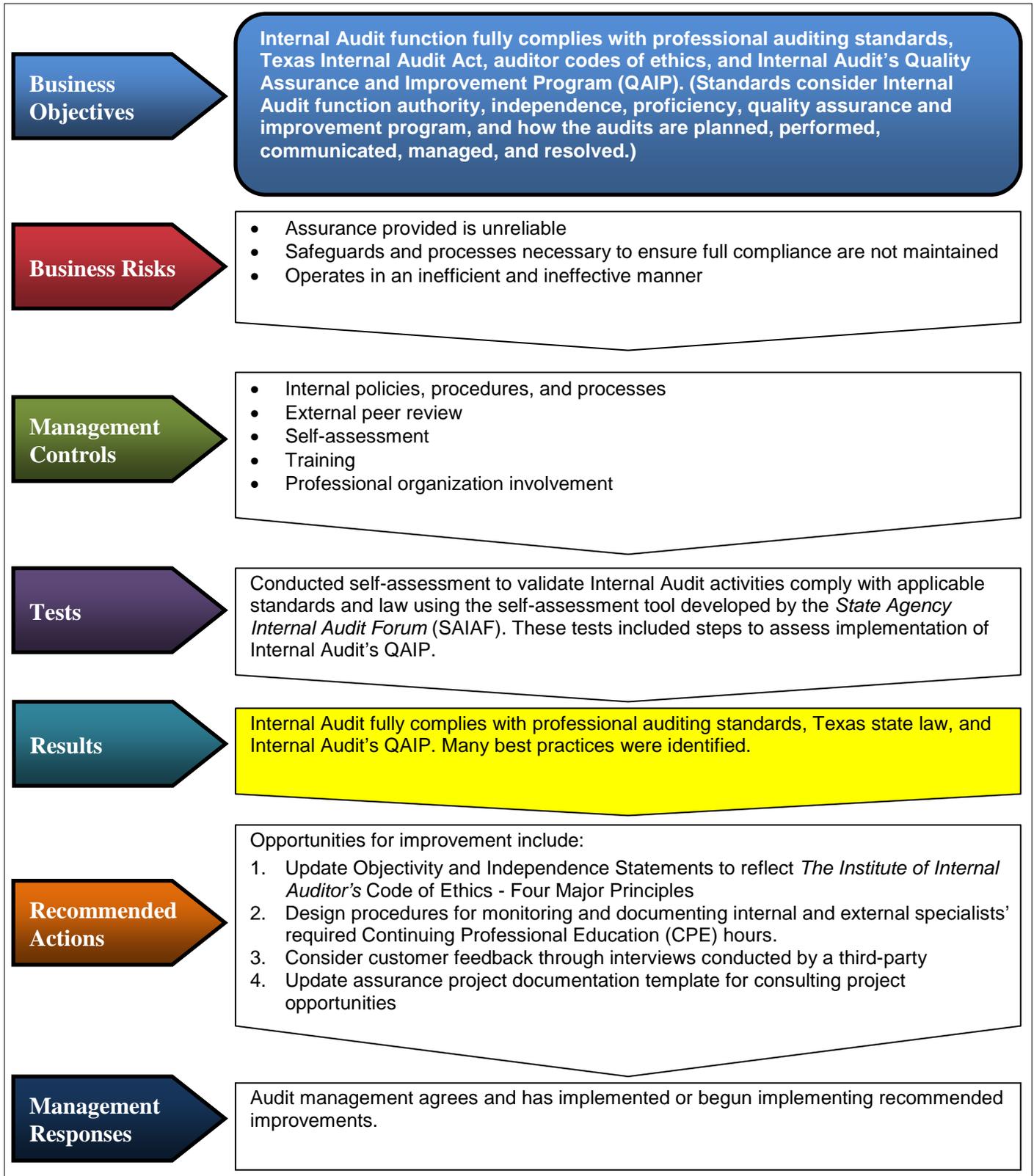
**TAB 7**

**TAB 7A**

# INTERNAL AUDIT QUALITY ASSURANCE SELF-ASSESSMENT

AUGUST 30, 2012

TRS Internal Audit Department



Legend of Results:

**Red** - Significant to TRS  
**Yellow** - Other Reportable Issue

**Orange** - Significant to Business Objectives  
**Green** - Positive Finding or No Issue

**TAB 7B**

**Teacher Retirement System of Texas**  
**September 2012 Audit Committee Agenda Items Mapped to TRS Enterprise Risk Inventory**

<b>Enterprise</b>		<b>Operations</b>	<b>Finance</b>	<b>Investments</b>
Pension Funding	Communications & External Relations	<b><i>Pension Benefit Administration</i></b> Agenda Item 3E	<b><i>General Accounting &amp; Reporting</i></b> Agenda Item 2	Investment Operations
Retiree Health Care	Governmental/ Association Relations	Health Care Administration	Budget	<b><i>Investment Reporting</i></b> Agenda Item 3B
Workforce Continuity	TEAM	403(b)	<b><i>Employer Reporting</i></b> Agenda Item 6A	<b><i>Market</i></b> Agenda Item 3A
<b><i>Governance</i></b> Agenda Items 4, 5, 6B, 7A, 7B, 8	<b><i>Legacy Information Systems</i></b> Agenda Item 3C	Customer Service	Procurement & Contract Management	Credit
Business Continuity	<b><i>Information Security</i></b> Agenda Item 3D	Tax Qualification Status		Liquidity/Leverage
Fraud Prevention & Detection	Confidential Information			
Records Management				

# Fiscal Year 2012 Internal Audit Advisory Services<sup>1</sup>

## June – August 2012

<b>BENEFIT SERVICES</b>
<p><b>TEAM PROJECT</b></p> <ul style="list-style-type: none"> <li>• Executive Steering Committee Participation</li> <li>• Business Rules Committee Participation</li> <li>• Commitments Gathering Participation</li> <li>• Monthly meetings with TEAM Project Manager</li> <li>• Core Management Team: Standing Prioritization Review Meeting</li> <li>• Independent Program Assessment – Request for Offer (RFO) Coordination</li> <li>• Reporting Entity Outreach Committee Participation</li> <li>• Enterprise Security Project</li> </ul>
<b>HEALTH BENEFITS</b>
<ul style="list-style-type: none"> <li>• Health Plan Administrator (HPA) and Pharmacy Benefit Manager (PBM) Vendor Quarterly Update Meeting Participation</li> </ul>
<b>INVESTMENTS</b>
<ul style="list-style-type: none"> <li>• Personal Trading Monitoring, Weekly Meetings with Legal Services, Quarterly Reporting to Executive Director</li> <li>• Derivatives Operations Group Meetings Participation</li> <li>• Monthly Securities Lending Update Meetings Participation</li> <li>• Internal Investment Committee (IIC) Attendance</li> <li>• Investment Management Division (IMD) Staff Meeting Attendance</li> <li>• Technology and Operations Working (TOW) Group Meeting Attendance</li> <li>• Monthly Council of Compliance Officers Conference Calls – provide relevant information to IMD</li> <li>• TRS Trading Policy Training for IMD Summer Interns</li> <li>• Review of Investment Policy Statement Revisions</li> <li>• Key Process Flowcharts – Corporate Actions, Passive Portfolio</li> </ul>
<b>FINANCIAL SERVICES</b>
<ul style="list-style-type: none"> <li>• Valuation Committee Participation</li> <li>• Coordination of State Auditor’s Office TRS Comprehensive Annual Financial Report (CAFR)</li> </ul>
<b>EXECUTIVE</b>
<ul style="list-style-type: none"> <li>• Survey of Provisions of Incentive Pay Plans of Select Public Pension and Endowment Funds</li> <li>• Hot Line Call Facilitation</li> <li>• New Employee Orientation Training</li> <li>• Social Media Advisory Committee</li> <li>• Fraud, Waste and Abuse Prevention Committee</li> <li>• TRS 75<sup>th</sup> Anniversary Committee</li> <li>• Surprise Inspections</li> <li>• Key Process Flowcharts – Legal Services (Securities Class Actions)</li> </ul>
<b>INFORMATION TECHNOLOGY</b>
<ul style="list-style-type: none"> <li>• Internal Vulnerability Scan Statement of Work</li> </ul>

<sup>1</sup> Advisory Services (non-audit services) - The scope of work performed does not constitute an audit under Generally Accepted Government Auditing Standards (GAGAS).

## Status of Fiscal Year 2012 Planned Assurance, Consulting, and Advisory Services as of August 2012

AREA	ASSURANCE	CONSULTING/ADVISORY
<b>Benefit Services and Benefit Accounting</b>	<ul style="list-style-type: none"> <li>✓ Benefit payments: testing on behalf of State Auditor's Office (SAO) in support of the Comprehensive Annual Financial Report (CAFR) audit</li> <li>Benefit quarterly testing:               <ul style="list-style-type: none"> <li>• Gross annuity payments, manual payments</li> <li>• Key controls</li> <li>• Legislative changes (n/a for FY 2012)</li> <li>• TRS Rules and Laws compliance</li> </ul> </li> <li>✓ 1<sup>st</sup> QTR</li> <li>✓ 2<sup>nd</sup> QTR</li> <li>3<sup>rd</sup> QTR</li> <li>✓ 4<sup>th</sup> QTR (includes results of 3<sup>rd</sup> QTR testing)</li> </ul>	<ul style="list-style-type: none"> <li>Key process flowcharts and controls identification:</li> <li>Benefit Accounting -               <ul style="list-style-type: none"> <li>✓ District Reports                   <ul style="list-style-type: none"> <li>• Disbursements (deferred to FY 2013)</li> <li>• Special Service Buyback (deferred to FY 2013)</li> </ul> </li> </ul> </li> <li>✓ Reporting entity study of other pension system practices</li> </ul>
<b>Health Benefits</b>		<ul style="list-style-type: none"> <li>✓ Health benefits vendor quarterly meetings attendance</li> <li>✓ Healthcare auditor contract award participation (non-voting)</li> </ul>
<b>Investments</b>	<ul style="list-style-type: none"> <li>✓ Private partnership selection and monitoring controls (especially co-investments)</li> <li>✓ Investment risk management</li> <li>✓ State Street compliance calculations</li> <li>✓ Bloomberg access controls (incorporated into technology security testing procedures)</li> <li>Investment policy compliance: Continuous testing (including board reports and wire transfers)               <ul style="list-style-type: none"> <li>✓ 1<sup>st</sup> QTR</li> <li>✓ 2<sup>nd</sup> QTR</li> <li>✓ 3<sup>rd</sup> QTR</li> <li>✓ 4<sup>th</sup> QTR</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>✓ Investment Compliance program:               <ul style="list-style-type: none"> <li>• Investment Policy Statement</li> <li>• Securities Lending</li> <li>• Proxy Voting</li> <li>• Employee Trading</li> </ul> </li> <li>✓ Trade pre-clearance</li> <li>✓ Committee participation/attendance:               <ul style="list-style-type: none"> <li>• Internal Investments Committee</li> <li>• Technology and Operations Workgroup</li> <li>• Derivatives</li> <li>• Securities Lending</li> </ul> </li> <li>✓ Investment Policy Statement review</li> <li>✓ Incentive pay calculation review</li> <li>✓ Key process flowchart:               <ul style="list-style-type: none"> <li>• Corporate actions</li> <li>• Passive portfolio</li> </ul> </li> </ul>
<b>Financial Services and Staff Services</b>	<ul style="list-style-type: none"> <li>✓ Investment accounting and valuation</li> <li>✓ Compensation, payroll, and position control (including Human Resources)</li> <li>✓ Building security</li> </ul>	<ul style="list-style-type: none"> <li>✓ SAO coordination for financial audit</li> <li>✓ Valuation committee participation</li> </ul>

**Legend:** ✓ Project or activity completed  
 ★ Project in progress  
 ❖ Ongoing during the quarter

**Status of Fiscal Year 2012 Planned Assurance, Consulting, and Advisory Services as of August 2012**

AREA	ASSURANCE	CONSULTING/ADVISORY
<b>Executive</b>	<p>Follow-up status report on outstanding audit recommendations</p> <ul style="list-style-type: none"> <li>✓ 1<sup>st</sup> QTR</li> <li>✓ 2<sup>nd</sup> QTR</li> <li>✓ 3<sup>rd</sup> QTR</li> <li>✓ 4<sup>th</sup> QTR</li> </ul>	<p>Internal controls opinion planning (deferred)</p> <ul style="list-style-type: none"> <li>✓ Internal Audit quality assurance self-assessment</li> <li>✓ Committee participation: <ul style="list-style-type: none"> <li>• Fraud, Waste, and Abuse Prevention Committee</li> <li>• Website Advisory Committee</li> <li>• Leadership Committee</li> <li>• Risk Oversight Committee</li> <li>• Executive Council</li> <li>• Issues Management Team</li> <li>• Social Media Advisory Committee</li> </ul> </li> <li>✓ Policy reviews and training participation: <ul style="list-style-type: none"> <li>• Ethics policy</li> <li>• Internal policies</li> </ul> </li> <li>✓ Fraud and ethics hotline</li> <li>✓ Key process flowcharts: <ul style="list-style-type: none"> <li>• Legal Services: Securities class action claims</li> <li>• Human Resources: Performance management, compliance and administration</li> </ul> </li> <li>✓ Surprise inspections – various</li> </ul>
<b>Information Technology</b>	<p>Quarterly testing of security controls</p> <ul style="list-style-type: none"> <li>✓ 1<sup>st</sup> QTR</li> <li>✓ 2<sup>nd</sup> QTR</li> <li>✓ 3<sup>rd</sup> QTR</li> <li>✓ 4<sup>th</sup> QTR</li> </ul> <p>✓ Change management controls</p>	<ul style="list-style-type: none"> <li>✓ Committee participation: <ul style="list-style-type: none"> <li>• TRS Enterprise Application Modernization (TEAM) Executive Steering Committee <ul style="list-style-type: none"> <li>○ Business Rules team</li> <li>○ Commitments Gathering</li> </ul> </li> <li>• Information Resources Operations Committee</li> <li>• MyTRS</li> <li>• Information Security Program Core Team</li> </ul> </li> <li>✓ Hot site observation</li> </ul>

**Source: Approved Fiscal Years 2012-2014 Audit Plan**

**Internal Audit Performance Measures - Fiscal Year 2012  
4th Quarter Ending August 31, 2012**

Target Performance	Status
1. Complete 90% of original assurance projects.	Achieved
2. Facilitate success of external financial audit.	Achieved
3. Increase risk coverage by increasing use of data-mining tools (quarterly testing of benefits, information security, and investment compliance).	Achieved
4. Ensure adequate expertise to perform audits by publishing a request for qualifications.	Achieved
5. Ensure outstanding audit recommendations are fully implemented by following up and reporting on their status quarterly.	Achieved
6. Improve identification and maintenance of risks and controls through implementation of an automated tool (TeamRisk).	Achieved
7. Achieve 75% or higher utilization (direct time/total available hours) of professional staff time on assurance, consulting, and advisory services.	Achieved
8. Provide training on internal controls to TRS' managers and staff.	Achieved
9. Implement fiscal year 2012 objectives and initiatives of the Internal Audit strategic plan.	Achieved*
10. Provide the Audit Committee with quarterly and annual status reports (performance measures, Quality Assurance and Improvement Program, and annual report).	Achieved

**Legend: Target Status**

	Target not achieved
	Behind in achieving target
	On task to achieve target
	Achieved target

\* Some administrative initiatives were deferred due to additional resources allocated to the TEAM Project.

**Teachers Retirement System of Texas**  
**Internal Ethics and Fraud Hotline**  
**Incident Report Activity Summary**  
1/1/2010 (inception) through 8/31/2012

<b>Time Period</b>	<b>Number of Calls</b>	<b>Status</b>
1/1/2010 – 8/31/2010	1	Resolved
9/1/2010 – 8/31/2011	2	Resolved
9/1/2011 – 11/30/2011	0	N/A
12/1/2011 – 3/30/2012	1	Resolved
3/30/2012 – 05/31/2012	0	N/A
06/01/2012 – 08/31/2012	0	N/A

Resolved – fully investigated by the Triage Team and all actions agreed to by the Triage Team have occurred.

Per the TRS Fraud and Ethics Hotline Procedures:

- The Audit Committee Chair will be kept apprised of the status of investigations and will be notified of any suspected fraud in accordance with TRS’s Fraud, Waste, and Abuse Prevention Policy.
- The Audit Committee will be provided with statistics quarterly regarding calls received, their disposition, and those resulting in identification of fraud and notification to the State Auditor’s Office hotline.
- The Audit Committee may instruct Internal Audit to perform an audit of matters relating to issues identified with the allegation in accordance with the Audit Committee Charter.
- Internal Audit will consider results of hotline calls and actions by the Triage Team in developing the annual audit plan or amendments to that plan.

**ACCOUNTING AND AUDITING UPDATES**  
**4th Quarter**  
**Fiscal Year 2012**

**1. GASB releases two new pension standards**

The Governmental Accounting Standards Board (GASB) has released two new standards that have significant impact on state and local government pension plans.

Statement No. 67, *Financial Reporting for Pension Plans*, revises existing guidance for the financial reports of most pension plans. It requires governments providing defined benefit pensions to recognize their long-term obligation for pension benefits as a liability, and to more comprehensively and comparably measure the annual costs of pension benefits. It also enhances accountability and transparency through revised and new note disclosures and required supplementary information (RSI). Statement No. 67 is effective for plan fiscal years beginning after June 15, 2013.

Statement No. 68, *Accounting and Financial Reporting for Pensions*, revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. It builds upon the existing framework for financial reports of defined benefit pension plans, which includes a statement of fiduciary net position (the amount held in a trust for paying retirement benefits) and a statement of changes in fiduciary net position. It also enhances note disclosures and RSI for both defined benefit and defined contribution pension plans. Statement No. 68 is effective for employer fiscal years beginning after June 15, 2014.

**2. SEC approves rules on key terms for regulating derivatives**

The Securities and Exchange Commission (SEC) has taken another step toward regulating the over-the-counter derivatives market by approving rules and interpretations for key definitions of certain derivative products. It further defined the terms “swap” and “security-based swap” and whether a particular instrument is a “swap” regulated by the Commodity Futures Trading Commission (CFTC) or a “security-based swap” regulated by the SEC. The SEC also addressed “mixed swaps”, which are regulated by both agencies, and “security-based swap agreements”, which are regulated by the CFTC but over which the SEC has antifraud and other authority.

**3. SEC approves rule requiring audit trail of trading activity**

The SEC has voted to require the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) to establish a market-wide consolidated audit trail that will significantly enhance regulators’ ability to monitor and analyze trading activity. The new rule requires the exchanges and FINRA to jointly submit a comprehensive plan detailing how they would develop, implement, and maintain a consolidated audit trail that must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. Currently, there is no single database of comprehensive and readily accessible data regarding orders and executions.



## *In brief*

# An overview of financial reporting developments

No. 2012-35  
August 17, 2012

## ***PCAOB adopts Auditing Standard related to audit committee communications***

### **What's new?**

On August 15, 2012, the Public Company Accounting Oversight Board (PCAOB) adopted [Auditing Standard No. 16, \*Communications with Audit Committees\*](#). The standard establishes requirements that enhance the relevance and quality of the communications between the auditor and the audit committee, and is intended to foster constructive dialogue between the two on significant audit and financial statement matters. The enhanced communications may benefit audit committees in their oversight responsibilities and auditors in conducting effective audits.

### **What are the key provisions?**

Auditing Standard No. 16 retains or enhances communication requirements that exist in the PCAOB's interim standards or the SEC's communication requirements and adds new communication requirements that are generally linked to performance requirements in other PCAOB standards. Among these enhancements are:

- Certain matters regarding the company's accounting policies, practices and estimates including, but not limited to, a description of processes and assumptions management used in critical estimates;
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions including the business rationale for such transactions; and
- The auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

While existing practice or the requirements of other regulatory bodies have evolved to include communications with the audit committee beyond those required by the previous standards, the new standard incorporates these communications and provides the audit committee with additional information about significant aspects of the audit.

Many of these communications are linked to the results of audit procedures or the conduct of the audit and include:

- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms, or other persons not employed by the auditor that are involved in the audit;
- The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
- Situations in which the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting;
- Difficult or contentious matters for which the auditor consulted outside the engagement team;
- The auditor's evaluation of going concern;
- Departures from the auditor's standard report; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

### **What's the effective date?**

The standard and related amendments, if approved by the SEC, will be effective for public company audits of fiscal periods beginning after December 15, 2012.

Audits of brokers and dealers will be subject to PCAOB audit committee communication requirements if the SEC approves the use of PCAOB auditing standards for audits of such entities.

### **What's next?**

The adopted standard and amendments will become finalized upon approval by the SEC.

### **Questions?**

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams that have questions should contact the National Professional Services Group (1-973-236-7800).

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**Authored by:**

Tom Gaidimas

Partner

Phone: 1-973-236-5036

Email: [thomas.gaidimis@us.pwc.com](mailto:thomas.gaidimis@us.pwc.com)

Marc Panucci

Partner

Phone: 1-973-236-4885

Email: [marc.a.panucci@us.pwc.com](mailto:marc.a.panucci@us.pwc.com)

Patrick O'Donnell

Senior Manager

Phone: 1-973-236-4870

Email: [patrick.m.odonnell@us.pwc.com](mailto:patrick.m.odonnell@us.pwc.com)

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## Internal Audit Staff Quarterly Accomplishments

- Amy Barrett and Karen Morris were speakers at the Institute of Internal Auditors International Conference held in Boston during July 2012. The topic was “Plan for the Future and Get the Right Resources: Successful Approaches to Internal Audit Strategic Planning.” Ms. Barrett moderated the panel that included Ms. Morris as well as two audit executives from the private and public sectors.
- Lih-Jen Lan passed the Certified Information Systems Security Professional (CISSP) exam in May.
- Stephen Henry completed his summer internship with the Internal Audit Department. He proved to be a significant asset to the team by making recommendations for internal audit to improve its operations in the Quality Assurance and Improvement Plan Self-Assessment and incorporating updates to the Internal Audit Charter. Stephen is returning to The University of Texas at Austin where he is a senior majoring in accounting.

## MEMORANDUM

**TO:** Audit Committee Members, TRS Board of Trustees  
Mr. Brian Guthrie, Executive Director

**FROM:** Amy Barrett, Chief Audit Executive

**SUBJECT:** External Quality Assurance Review of TRS Internal Audit

**DATE:** September 14, 2012

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Per the *Texas Government Code*, Internal Audit is required to undergo an external quality assurance review (QAR) every three years to determine whether the department is operating in compliance with professional auditing standards. The QAR team will spend one week at TRS in January, 2013 to conduct their independent review and will report the results of their review to Audit Committee. The QAR team consists of three volunteers with broad experience in Texas state government and public pension plans.

### **Karin Hill, CIA, CGAP, CRMA, MBA**

Ms. Hill is the Chief Audit Executive at the Texas Juvenile Justice Department. She has been an auditor for 20 years with former positions at Texas Youth Commission and Texas Commission for the Blind. She has chaired the Research Committee for the Austin Chapter of the Institute of Internal Auditors since 2009 and led the chapter to a first place award in 2011 for its project on "Improving Organizational Governance Through Implementing Internal Audit Standard 2110." She was a principle author of the State Agency Internal Audit Forum Peer Review process, and is on the curriculum committee for the 2012 Texas Fiscal Officer Academy. Ms. Hill holds a Master of Business Administration degree from Southwest Texas State University, a Bachelor of Science degree in Management/Accounting from Park College, and an Associate's degree in Financial Management from the Community College of the Air Force.

### **Nicki Russell, CIA, CPA**

Ms. Russell is an internal auditor for the Missouri State Employees Retirement System (MOSERS). She has been an auditor for 13 years with prior positions at the Missouri State Auditor's Office. She has served in several leadership positions within the Central Missouri Chapter of the Institute of Internal Auditors and was an examiner for the Missouri Quality Award. Ms. Russell earned a Bachelor of Science in Business Administration with a major in Accounting from the University of Central Missouri. She is currently working on her Master's degree in Public Affairs with an emphasis in public management from the University of Missouri.

### **Jennifer Hymel, MBA**

Ms. Hymel is the Director of Compliance Assurance at the Texas County and District Retirement System. As such, her duties include internal audit and administrative performance benchmarking. Prior to entering this role in 2006, she served as the Director of Member Services, Director of Planning and Development, and as a project manager. Ms. Hymel holds a Master of Business Administration degree and a Bachelors of Business Administration degree from the University of Texas at Austin.