

Audit Committee Meeting

December 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

**December 14, 2012 – 9:00 a.m.
TRS East Building, 5th Floor, Boardroom**

- 1. Approve Minutes of September 14, 2012 Audit Committee Meeting**
– Mr. Christopher Moss, Chair

- 2. Receive State Auditor’s Office and Accounting Changes Reports**
 - A. State Auditor’s Office Report on the Audit of Fiscal Year 2012 Comprehensive Annual Financial Report (CAFR) – Ms. Angelica Ramirez and Mr. Greg Adams, State Auditor’s Office
 - B. Changes to Governmental Accounting Standards Impacting Pension Accounting and Financial Reporting – Mr. Don Green, and Mr. Joseph P. Newton, Gabriel Roeder Smith & Company

- 3. Receive Internal Audit Reports**
 - A. Telephone Counseling Center Performance Measure Audit Project Status – Ms. Jan Engler, Ms. Marianne Woods Wiley and Mr. Tom Guerin; Mr. Ron Franke, CliftonLarsonAllen LLP
 - B. Internal Network Vulnerability Agreed-Upon Procedures – Ms. Lih-Jen Lan and Mr. Chris Cutler; Mr. Ron Franke, CliftonLarsonAllen LLP
 - C. Quarterly Testing of Investment Compliance – Mr. Hugh Ohn and Mr. Brian Gomolski

- 4. Status of Prior Audit and Consulting Recommendations** – Ms. Amy Barrett

- 5. Receive Internal Audit Annual Report and Administrative Reports**
 - A. Fiscal Year 2012 Internal Audit Annual Report – Ms. Karen Morris
 - B. Quarterly Internal Audit Status Reports – Ms. Amy Barrett

TAB 1



**TEACHER RETIREMENT SYSTEM OF TEXAS
AUDIT COMMITTEE MEETING
September 14, 2012**

The Audit Committee of the Teacher Retirement System of Texas met on Friday, September 14, 2012 in the 5th 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
Charlotte Clifton, Board Vice 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
Karen Morris, Senior Manager, Internal Audit
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
Brian Gomolski, Senior Investment Auditor, Internal Audit
Toma Miller, Risk, Control, & Compliance Specialist, Internal Audit
Amy Morgan, Chief Information Officer
T.A. Miller, Deputy Information Officer
Christi Holman, Manager of Information Systems Support, Information Technology
Billy Lowe, Manager of Information Systems Support, Information Technology
Jerry Albright, Deputy Chief Investment Officer
Sylvia Bell, Director, Administrative Center, Investments
Eric Lang, Managing Director, Real Return, External Private Markets
David Veal, Chief of Staff to the Chief Investments Officer, Investment Division
Conni Brennan, General Counsel
Charmaine Skillman, Assistant General Counsel
Dennis Gold, Assistant General Counsel
Beckie Smith, Assistant General Counsel
Timothy Wei, Assistant General Counsel

TRS Staff (cont'd)

Mary Chang, Assistant General Counsel
Lynn Lau, Assistant Secretary to the Board and Program Specialist, Legal Department
Jamie Michels, Manager, General Accounting
Cindy Haley, Team Leader, Financial Reporting, General Accounting
Art Mata, Consultant, Benefit Accounting
Janet Bray, Director, Human Resources
Marianne Woods Wiley, Chief Benefit Officer
Mike Rehling, Manager, Benefit Processing
Adam Fambrough, Assistant Manager, Benefit Processing
Barbie Pearson, Assistant Manager, Benefit Counseling
Jay LeBlanc, Director, Risk Management & Strategic Planning
Michelle Pagán, ERM Specialist, Risk Management & Strategic Planning
Minerva Evans, Risk Management Specialist, Risk Management & Strategic Planning

Other Attendees

Leroy DeHaven, Texas Retired Teachers Association
Bill Barnes, Texas Retired Teachers Association
Janice Barnes, Texas Retired Teachers Association
Wayne Berryman, Texas Retired Teachers Association
Richard Briggs, Texas Retired Teachers Association
Jerry Pybus, Texas Retired Teachers Association
Carole Buchanan, Texas Retired Teachers Association
Tonna Duke, Texas Retired Teachers Association
Roger Huber, Texas Retired Teachers Association
Steven Huff, Reinhart Boerner Van Deuren s.c.
Greg Adams, State Auditor's Office
Angelica Ramirez, State Auditor's Office
Stephen Henry, Student, University of Texas at Austin
Victor Ferreira, Hewlett Packard
Robert Cowley, Deloitte & Touche, L.L.P.
Kathie Schwerdtfeger, Deloitte & Touche, L.L.P.

Audit Committee Chair Christopher Moss called the meeting to order at 8:05 a.m. with a quorum of committee members present.

1. APPROVE MINUTES OF JUNE 8, 2012 AUDIT COMMITTEE MEETING

On a motion by Mr. Eric McDonald the proposed minutes of the June 8, 2012 Audit Committee meeting were approved as presented.

2. RECEIVE STATE AUDITOR'S OFFICE REPORT ON PLANNED AUDIT OF TRS' COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR FISCAL YEAR 2012

Mr. Greg Adams, State Auditor's Office (SAO) Project Manager, stated that the purpose of the audit of the Fiscal Year 2012 Comprehensive Annual Financial Report (CAFR) is to determine the following: whether financial statements are materially correct and in accordance with the United States Generally Accepted Accounting Principles; to test financial transactions and note

disclosure information; to test compliance with laws and regulations for which noncompliance would have a direct material effect on financial statement amounts; and to detect or record any fraud or illegal acts material to the financial statements. He stated that the SAO's audit opinion should be completed by November 13, 2012. He indicated that during November, the SAO will also produce a report on internal controls and compliance with other matters as required by Generally Accepted Governmental Auditing Standards and a required report to the Legislative Audit Committee. He outlined the independence of the SAO in conducting the audit and stated that, as in years past, Ms. Jan Engler will serve as the Internal Audit liaison.

3. RECEIVE INTERNAL AUDIT REPORTS

A. Audit of External Private Markets (EPM) Investments

Ms. Kathie Schwerdtfeger and Mr. Robert Cowley, Deloitte & Touche, L.L.P., explained the procedures that were followed in assessing the investments made by the External Private Markets group at TRS. Mr. Cowley stated that they looked at three areas: the initial investment phase; the ongoing monitoring that is performed with respective underlying investment managers; and the evaluation process.

Mr. Hugh Ohn stated that the results of the audit indicated that management controls are working effectively to achieve the business objectives of the EPM group. No significant issues were identified. Opportunities for improving controls with regards to three business objectives were identified and management agreed with the recommended actions.

B. 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 two exceptions were found this quarter and that management has taken action to mitigate these risks going forward.

C. Testing of Information Systems Support Change Management Process (Agreed-Upon Procedures)

Ms. Lih-Jen Lan explained the two tests were conducted in the change management process within Information Systems Support (ISS). One test found no exceptions. The second test identified some exceptions where change requests were not fully documented as required by the change management life cycle procedures provided by ISS management.

Ms. Christi Holman and Mr. Billy Lowe discussed changes that have been made within ISS and the change management process to ensure necessary documentation is completed and proper processes are followed going forward.

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

Ms. Amy Barrett stated that no exceptions were found in the access controls that were tested.

E. Quarterly Testing of Benefit Payments (Agreed-Upon Procedures)

Ms. Barrett reviewed the results of the Quarterly Testing of Benefit Payments and stated that it was a clean report. One minor exception concerning an expiry date was noted and has been corrected. It did not result in any financial impact.

4. RECEIVE STATUS OF PRIOR AUDIT AND CONSULTING RECOMMENDATIONS

Ms. Barrett gave a brief overview of the outstanding audit recommendations. She stated that all but one outstanding significant recommendation has been implemented. The exception is one that was reported last quarter and is set to be resolved with a policy update in January 2013. Ms. Barrett also updated the committee on the status of the backup generator stating that it should be delivered and installed by September 22, and an update will be given at the December Audit Committee Meeting.

Ms. Barrett noted that a new color category has been added to the report. Items highlighted in blue will indicate any recommendation that management has stated is complete but that Internal Audit has not yet had an opportunity to validate as having been satisfactorily implemented.

5. CONSIDER RECOMMENDATION TO THE BOARD OF TRUSTEES REGARDING PROPOSED REVISIONS TO THE INTERNAL AUDIT CHARTER

Ms. Barrett reviewed four proposed changes to the Internal Audit Charter. The first change defines the role of Internal Audit in supporting public sector governance. The second defines attestation engagements, or agreed-upon procedures engagements. The third change clarifies the responsibilities of Internal Audit in the following areas: audit of employer data and contributions, participation in a consulting or advisory capacity in information systems projects, and coordination of the TRS Enterprise Application Modernization (TEAM) Independent Program Assessment vendor. The final change is the incorporation of professional auditing standards' codes of ethics for internal auditors into the charter.

Upon a motion by Mr. McDonald, the Audit Committee voted to recommend that the Board of Trustees approve the proposed revisions to the Internal Audit Charter.

6. CONSIDER RECOMMENDATION TO THE BOARD OF TRUSTEES REGARDING THE PROPOSED AUDIT PLAN FOR FISCAL YEAR 2013

A. Options for Employer Audit for Fiscal Year 2013

Ms. Karen Morris presented options for conducting employer audits. She stated that this report is part of a larger study that began in fiscal year 2012 as listed in the Internal Audit Strategic Plan. She presented a report containing six options and stated that the recommended option is to perform a communications outreach to employers and other stakeholders and then to perform targeted reviews of employers based on specific risk areas. She stated that this work would

allow for Internal Audit to size up the error rate and provide more information to the Audit Committee in deciding the future direction of employer audits.

Ms. Barrett stated that 1000 hours have been allocated in the Fiscal Year 2013 Audit Plan to perform employer audits.

B. Proposed Audit Plan for Fiscal Year 2013

Ms. Barrett presented the proposed audit plan for fiscal year 2013 and gave a brief overview of the planned projects in each key business areas within TRS. She advised the Audit Committee that all assurance projects will be brought before them along with any consulting or advisory projects should those projects identify serious material weaknesses.

Chairman Moss called for a motion for the Audit Committee to recommend that the Board of Trustees approve the proposed audit plan for fiscal year 2013. On a motion by Mr. McDonald, the committee unanimously approved the recommendation to the Board.

7. RECEIVE INTERNAL AUDIT ADMINISTRATIVE REPORTS

A. Results of Quality Assurance and Improvement Program Self-Assessment

Ms. Barrett presented the results of the Internal Audit Quality Assurance and Improvement Program Self-Assessment. She stated that the self-assessment allows Internal Audit to assess its compliance with professional auditing standards. The self-assessment resulted in four recommendations for improvement that are being implemented.

B. Quarterly Internal Audit Status Reports

Ms. Barrett reviewed several standard administrative reports including the status of the audit plan. Ms. Barrett stated that Internal Audit completed roughly 94% of the audit plan for fiscal year 2012.

Ms. Barrett also noted that Internal Audit will be going through a required external quality assurance review in January 2013. The review occurs every three years and is performed by peers within the Internal Auditing profession.

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

This item was discussed in executive session pursuant to the Texas Open Meetings Act under section 551.074 of the Texas Government Code. At 9:45 a.m., the Audit Committee open session was recessed for the committee to convene in executive session.

The Audit Committee meeting reconvened in open session at 10:42 a.m. On a motion from Ms. Nanette Sissney and with unanimous approval, it was recommended that the Board of Trustees approve the proposed performance appraisal of the Chief Audit Executive.

The meeting adjourned at 10:43 a.m.

Approved by:

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

TAB 2

TAB 2A

Independent Auditor's Report

Teacher Retirement System Board of Trustees

Mr. R. David Kelly, Chairman
Ms. Charlotte Clifton, Vice Chair
Mr. Todd Barth
Ms. T. Karen Charleston
Mr. Joe Colonna
Mr. Eric C. McDonald
Mr. Christopher Moss
Ms. Anita Smith Palmer
Ms. Nanette Sissney

We have audited the accompanying financial statements of the major enterprise fund and the aggregate remaining fund information, consisting of the fiduciary funds and the nonmajor enterprise fund of the Teacher Retirement System (Retirement System), a component unit of the State of Texas, as of and for the year ended August 31, 2012, which collectively comprise the Retirement System's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Retirement System's management. Our responsibility is to express opinions on these financial statements based on our audit. The prior year comparative information has been derived from the Retirement System's fiscal year 2011 financial statements and, in our report dated November 10, 2011, we expressed an unqualified opinion on the major enterprise fund and the aggregate remaining fund information.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the respective financial position of the major enterprise fund and the aggregate remaining fund information of the Retirement System, as of August 31, 2012, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

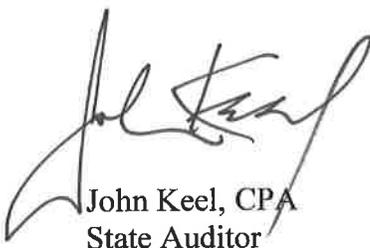
In accordance with *Government Auditing Standards*, we have also issued our report dated November 15, 2012, on our consideration of the Retirement System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is

to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 16 through 23 and Schedules of Funding Progress and Schedules of Contributions for the Pension Trust Fund and TRS-Care on pages 64 and 65 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Retirement System's financial statements. The information in Exhibit A and Schedules 1 through 4, as listed in the table of contents, is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information in Exhibit A and Schedules 1 through 4, as listed in the table of contents is fairly stated in all material respects in relation to the financial statements as a whole.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Retirement System's basic financial statements. The Introductory, Investment, Actuarial, Benefits, and Statistical sections are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.



John Keel, CPA
State Auditor

November 15, 2012

Required Communication with Those Charged with Governance
Based on the Audit of the Teacher Retirement System's Fiscal Year 2012 Financial Statements

We have audited the financial statements of the **Teacher Retirement System** for the year ended August 31, 2012, and have issued our report thereon dated November 15, 2012. Professional standards require that we provide you with the following information related to the audit.

No.	Item	Comments
1	The Auditor's Responsibilities Under Generally Accepted Auditing Standards	As stated in our engagement letter dated July 27, 2012, our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are presented fairly, in all material respects, in conformity with generally accepted accounting principles. Our audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
2	Planned Scope and Timing of the Audit	We performed the audit according to the planned scope and timing previously communicated to you in our engagement letter dated July 27, 2012.
3	Corrected and Uncorrected Misstatements	Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those the auditor believes are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements.
4	Other Information in Documents Containing Audited Financial Statements	Our financial statement audit opinion applies to the basic financial statements, which include the accompanying notes. We also applied certain limited auditing procedures to the Other Supplementary Schedules and concluded that such information was fairly stated in all material respects in relation to the basic financial statements taken as a whole. We did not opine on Management's Discussion and Analysis (MD&A), Schedules of Funding Progress and Schedules of Contributions for the Pension Trust Fund and TRS-Care. However, we performed limited procedures related to items noted above, which consisted of inquiring of management regarding the methods of measurement and presentation.
5	Management Representations	We have requested certain representations from management that are included in the management representation letter dated November 15, 2012. We also requested a representation letter dated November 15, 2012, from the Teacher Retirement System's general counsel regarding the existence of certain contingent liabilities that might require disclosure in the financial statements (QC added reference See C.1.13).

Required Communication with Those Charged with Governance
Based on the Audit of the Teacher Retirement System's Fiscal Year 2012 Financial Statements

No.	Item	Comments
6	Qualitative Aspects of the Entity's Significant Accounting Practices	Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Teacher Retirement System are described in Note 1 to the financial statements. During fiscal year 2012, management implemented accounting changes necessary to comply with Government Accounting Standards Board (GASB) Statement No. 62. No other new accounting policies were adopted and the application of existing policies was not otherwise changed during the year ended August 31, 2012. We noted no transactions entered into by the Teacher Retirement System during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a period that differs from when the transaction occurred.
7	Significant Difficulties Encountered During the Audit	We did not encounter any restrictions in performing our procedures or gaining access to individuals or records. Management and staff provided us with all of the information and support we requested in a timely manner.
8	Other Audit Findings or Issues	We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year. Those discussions occurred in the normal course of the audit.
9	Disagreements with Management	<p>For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report.</p> <p>We did not encounter any disagreements with management during the course of the audit.</p>
10	Management's Consultations with Other Accountants	In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Teacher Retirement System's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.
11	Significant Issues Discussed, or Subject to Correspondence, with Management	Prior to and throughout our audit engagement, we had routine discussions, or engaged in correspondence, with management regarding the Teacher Retirement System and the application of accounting principles and auditing standards. In our judgment, such discussions and correspondence did not occur in connection with our retention as auditors.

Required Communication with Those Charged with Governance
Based on the Audit of the Teacher Retirement System's Fiscal Year 2012 Financial Statements

No.	Item	Comments
12	Independence	The State Auditor's Office is independent to conduct the audit of the Teacher Retirement System's fiscal year 2012 financial statements. It is the State Auditor's Office's philosophy to conduct all projects in an environment of full independence; that is, free of any personal, external, or organizational impairment.
13	Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, or Abuse	We did not find evidence that fraud, illegal acts, violations of contracts or grant agreements, or abuse had, or might have, occurred.

This information is intended solely for the use of the Board of Trustees and management of the Teacher Retirement System and is not intended to be and should not be used by anyone other than these specified parties.

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Teacher Retirement System Board of Trustees

Mr. R. David Kelly, Chairman
Ms. Charlotte Clifton, Vice Chair
Mr. Todd Barth
Ms. T. Karen Charleston
Mr. Joe Colonna
Mr. Eric C. McDonald
Mr. Christopher Moss
Ms. Anita Smith Palmer
Ms. Nanette Sisney

We have audited the financial statements of the major enterprise fund and the aggregate remaining fund information, consisting of the fiduciary funds and the nonmajor enterprise fund of the Teacher Retirement System (Retirement System), a component unit of the State of Texas, as of and for the year ended August 31, 2012, which collectively comprise the Retirement System's basic financial statements and have issued our report thereon dated November 15, 2012. Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

We have chosen not to comply with a reporting standard that specifies the wording to be used in discussing restrictions on the use of this report. We believe the use of such wording is not in alignment with our role as a legislative audit function.

Internal Control Over Financial Reporting

Management of the Retirement System is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Retirement System's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Retirement System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Retirement System's internal control over financial reporting.

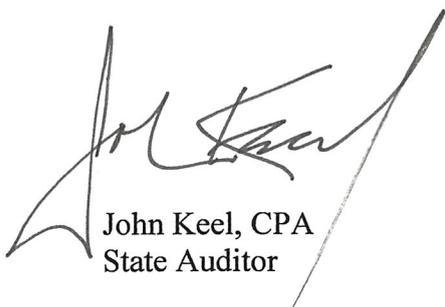
A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 16 through 23 and Schedules of Funding Progress and Schedules of Contributions for the Pension Trust Fund and TRS-Care on pages 64 and 65 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Retirement System's financial statements. The information in Exhibit A and Schedules 1 through 4, as listed in the table of contents, is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information in Exhibit A and Schedules 1 through 4, as listed in the table of contents is fairly stated in all material respects in relation to the financial statements as a whole.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Retirement System's basic financial statements. The Introductory, Investment, Actuarial, Benefits, and Statistical sections are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.



John Keel, CPA
State Auditor

November 15, 2012

Schedule of Findings and Responses

Section 1

The Retirement System Should Ensure That It Has Adequate Change Management Controls Over Its Automated Systems Containing Financial Data

Reference No. 2012-1

Type of finding: Significant Deficiency

The Teacher Retirement System (Retirement System) does not have an adequate change management process in place for three of its automated systems that process data contained in its financial statements. Those three automated systems are: the General Ledger Accounting System; the Annuity Payroll System; and the TRS [Teacher Retirement System of Texas] Reporting and Query System. Enhancements to the Retirement System's change management process would help ensure that program environments are appropriately separated and protected from unauthorized modifications.

The Retirement System uses the General Ledger Accounting System to record journal entries and produce most of the data in its financial statements. The Retirement System uses the Annuity Payroll System and the TRS Reporting and Query System to account for retirement contribution revenues and retirement benefit payments. The Retirement System reported that it received approximately \$2.2 billion in employee retirement contributions and paid approximately \$7.7 billion in retirement benefits in fiscal year 2012. Additional controls exist outside of the change management process that should detect and prevent material misstatements of those funds in the Retirement System's financial statements.

Texas Administrative Code Information Security Standards

Title 1, Texas Administrative Code, Section 202.25, requires agencies to implement information resources security safeguards. These include:

- Managing access to information systems to ensure that the users are authorized.
- Protecting the confidentiality of data and systems and ensure that only authorized users have access to the data.
- Using a change management process that helps ensure the information owner approves system changes prior to implementation.
- Establishing a process for controlling modifications to software to ensure information resources are protected against improper modification before, during, and after system implementation.

Title 1, Texas Administrative Code, Section 202.25, requires the Retirement System to use a change management process that controls program changes to help ensure that information resources are protected against improper modification before, during, and after system implementation (see text box for additional information). An adequate change management process would help the Retirement System ensure that funds are adequately safeguarded. Ideally, program changes should be reviewed before implementation, and the programmer who creates the program changes should not be the person who migrates those changes into production.

Although the programmers responsible for maintaining the Retirement System's three automated systems migrate program changes into production, the Retirement System has implemented controls that could allow the managers responsible for the three automated systems to monitor all program changes. Currently, programmers must use a change management tool when they migrate program changes for the three automated systems into production. That change management tool sends email notifications to information systems support management when program changes are migrated into production. Those emails contain both the new program code and the program code that is being replaced, which would allow the recipients to effectively monitor the program changes. Auditors reviewed a random sample of 30 documented changes (from a total of 211 documented changes made during fiscal year 2012) for the General Ledger Accounting System, Annuity Payroll System, and the TRS Reporting and Query System. For the 30 documented changes reviewed, there was no evidence that recipients reviewed those emails during fiscal year 2012.

As a result, there is still a risk that unauthorized or unintentional modifications to production data could be made and that the funds are not adequately safeguarded.

Recommendations

The Retirement System should ensure that its automated systems are protected against improper modification before, during, and after system implementation. Specifically:

- The Retirement System should consider implementing controls that protect its automated systems from improper modification, such as having a knowledgeable person other than the programmer review and migrate program changes to production.
- If the Retirement System chooses to continue its current monitoring process, it should ensure that knowledgeable individuals receive the emails from the change management tool, review the program changes documented in the emails, and document their reviews.

Management's Response

TRS has been working to improve the agency's change management control environment through the implementation of new automated tools and improved procedures. The need for improvement was identified through TRS's own Internal Audit reviews as well as through feedback from the State Auditor's office during the Fiscal Year 2011 audit. Management laid out additional measures to strengthen the process to the Board's Audit Committee in September 2012.

Management is in agreement with the recommendation and will implement Option 2 by the end of the second quarter, February 28, 2013. The TRS software development team will continue to refine processes to ensure that its automated systems, GLAS, TRAQs, and ANPA, are protected against improper modification. An additional step will be added to the PAC review process by February 28, 2013, which will include documenting the review of the automatically generated PAC emails by a knowledgeable individual. These reviews will include looking for improper modifications to the code.

TAB 2B



New GASB Standards

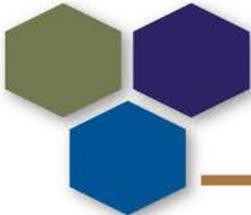
December 14, 2012

Joseph P. Newton, FSA
Joe.newton@gabrielroeder.com

GRS

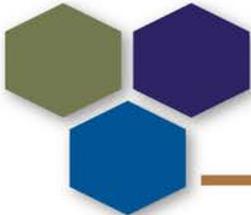
Gabriel Roeder Smith & Company
Consultants & Actuaries
www.gabrielroeder.com

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What has GASB done?

- ◆ The Statements change current pension accounting and financial reporting standards for state and local governments
 - ▶ Disconnect pension accounting from pension funding
 - ▶ Require employers to recognize the Net Pension Liability (NPL) on their balance sheets (*where NPL is code for the Unfunded Accrued Liability based on Market Value of Assets*)
 - ▶ Require employers to recognize a new measure of the Pension Expense (PE) on their income statements, which would be different from their actuarially determined contributions (ARC)
 - ▶ Replace most of the current note disclosures and required supplementary information with information based on the new measures



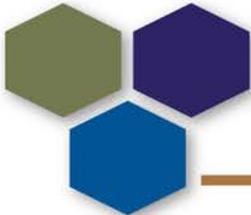
Timing

◆ GASB 67 Plan Reporting

- ▶ Effective for fiscal years beginning after June 15, 2013
- ▶ For TRS, August 31, 2014 financial statements

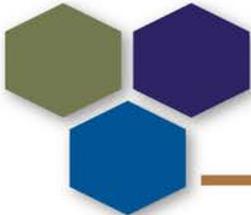
◆ GASB 68 Employer Reporting

- ▶ Effective for fiscal years beginning after June 15, 2014
- ▶ For the State, August 31, 2015 financial statements
 - Local employers could be various



Big Picture

- ◆ There will be a liability on the governments' books that is larger than ever seen
 - ▶ It will encompass all systems
 - ▶ This will be a “bumpy” liability; changing each year with a new blended discount rate and change in market value of assets
- ◆ There will be an expense on the governments' books-a larger expense than ever seen
 - ▶ The shorter amortization will accelerate recognition of pension cost
- ◆ The changes only impact the accounting rules, but



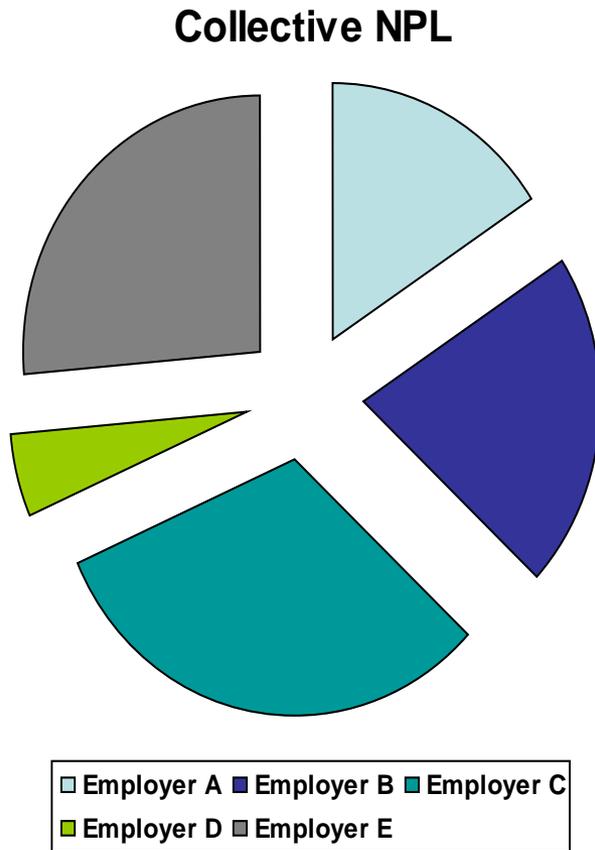
Before and After

	GASB 25/27	GASB 67/68
Liability	Up to six allowable actuarial cost methods	Only Individual Entry Age* allowed
Asset Offset	Various asset smoothing methods allowed	Fair market value
Expense	Various amortization periods and methods allowed	Rigid rules for Pension Expense components
LTeROR	Flexible on plan's return assumption	Still flexible on plan's return assumption

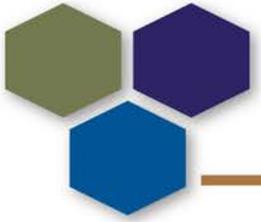
* Not ultimate EA method; normal cost is calculated using same benefit structure as PVB for each individual employee

Cost-Sharing Plans

Proportionate Shares

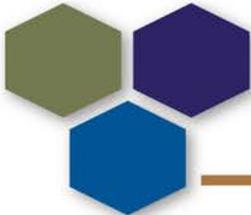


- Cost-Sharing Plan – “A multiple-employer defined benefit pension plan in which the pension obligations to the employees of more than one employer are pooled and pension plan assets can be used to pay the benefits of the employees of any employer that provides pensions through the pension plan.”
- Under GASB 27, employers in a cost-sharing plan report the contractually required contribution in their financial statements
- Under GASB 68, employers in cost-sharing plans will have to report their proportionate share of the collective Net Pension Liability



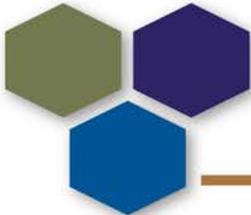
Non-employer Contributing Entities

- ◆ Legally required to contribute *directly to* the pension plan of another entity
- ◆ Classification
 - ▶ “Special funding situations” (SFSs)
 - ▶ Other circumstances
- ◆ SFS reporting requirements
 - ▶ NECE—similar to cost-sharing
 - ▶ Employers—liability reduced by measure of NECE involvement
 - ▶ Could eliminate it completely



Determining the Discount Rate

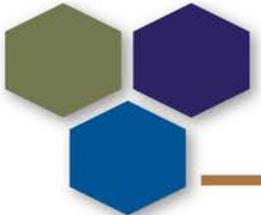
- ◆ Discount rate used in determining the Total Pension Liability (TPL) is a blend of two rates:
 - ▶ Long-term expected rate of return on pension plan investments
 - This rate is generally consistent with the funding valuation
 - 8.00% for TRS
 - ▶ Yield or index rate for a 20-year, tax-exempt general obligation municipal bond
 - Will vary
 - ~4.0%
- ◆ Weight given to the long-term rate is based on a closed group projection



Determining the Discount Rate

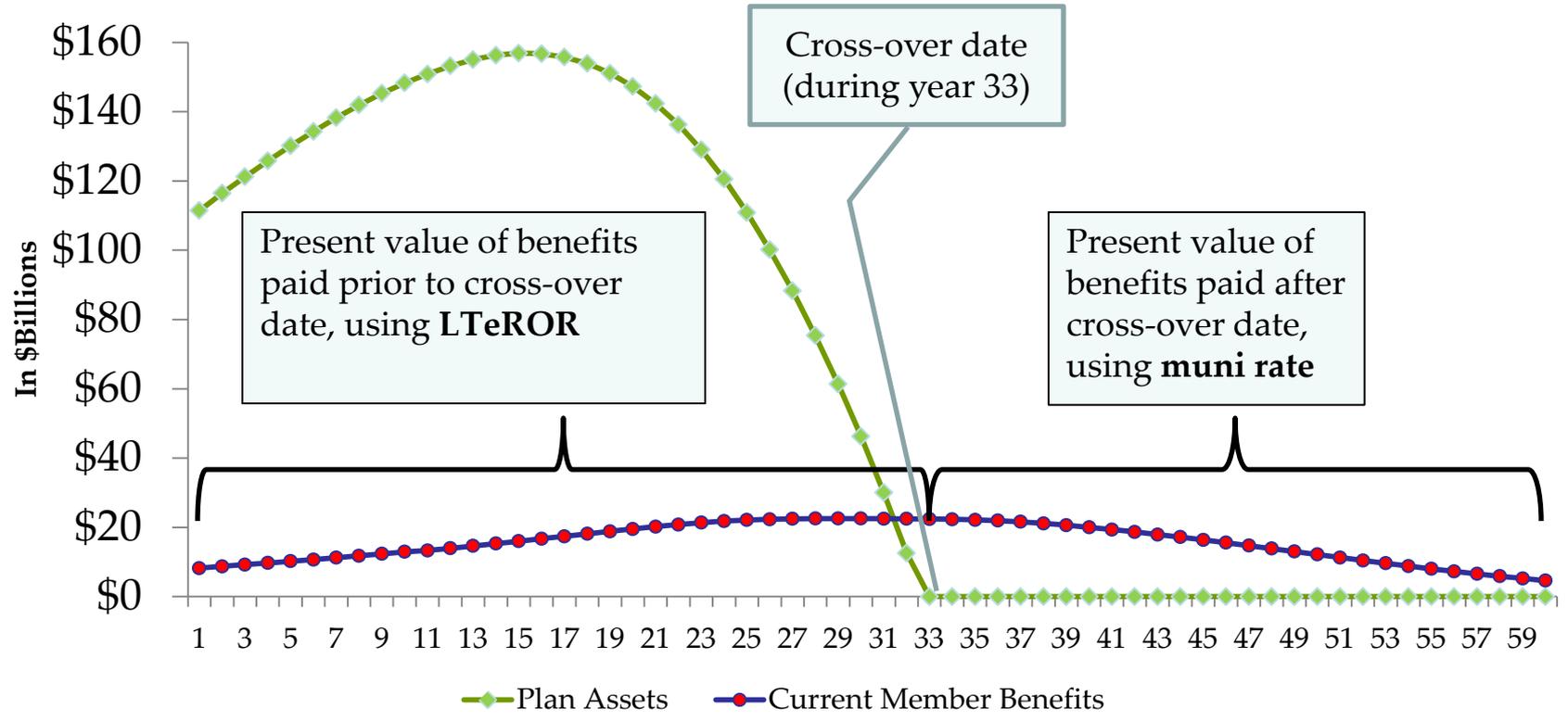
- ◆ The premise...

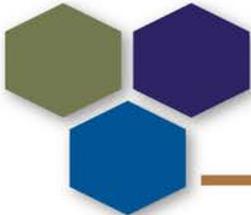
- ▶ The pension plan is primarily responsible for paying pension benefits to the extent the plan has sufficient assets
 - Assets invested with long-term investment horizon
- ▶ The employer is primarily responsible for paying benefits to the extent the plan does not have sufficient assets
 - From the general fund or bond revenues



Illustration

Governmental Entity ABC - Field Test Projection of Plan's Fiduciary Net Position (Plan Assets)

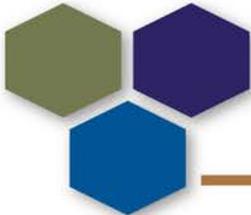




Funding Policy will dictate the discount rate

- ◆ By having a stronger funding policy, the cross-over date is pushed back, which will increase the blended discount rate and lower the NPL on the balance sheet
- Small increments in contributions can have very large impact on the NPL

Contribution Strategy	Discount Rate	Crossover Year	NPL based on Discount Rate
6.40%	6.00%	2045	\$73 B
7.40%	6.60%	2050	\$59 B
7.40% (EE/ER)	7.50%	2060	\$42 B
7.50% (EE/ER)	8.00%	NA	\$33 B



General Outcomes

◆ *Many plans contribute:*

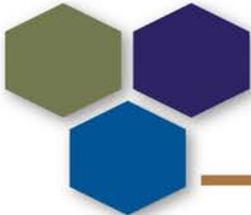
- Normal cost PLUS *closed* amortization payments
- These probably have discount rates = LTeROR

◆ *Many plans contribute:*

- Normal cost PLUS *open* amortization payments
- These almost always have discount rates less than LTeROR

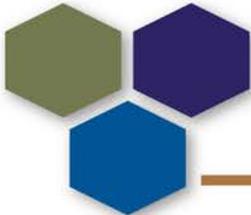
◆ *Other plans:*

- A flat statutory percent of pay, or
- Target cost methods, or
- Pursuant to a more complex model
- These might have discount rates lower than LTeROR



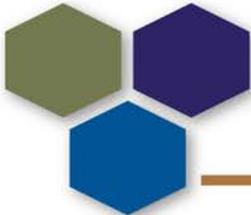
Attention to Funding Policy

- Plans and employers should get together to draft funding policies because:
 - No more ARC, a current de facto funding standard
 - Required Supplementary Information (RSI) section of the CAFR will include the disclosure of an Actuarially Determined Employer Contribution (ADC), if one is calculated, and compare it to the actual employer contribution made. This will become the source for researchers to find out whether a plan's funding policy requires contributions that are reasonable/systematic/actuarially based
 - The funding policy is the primary driver of whether and when there is a cross-over date for lowering the discount rate
 - Just because it is the right thing to do.



Lots More Work

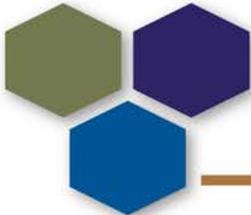
- By preparers of plan CAFRs
- By preparers of employer CAFRs
- By actuaries (likely two reports)
- By auditors



Communication Challenges

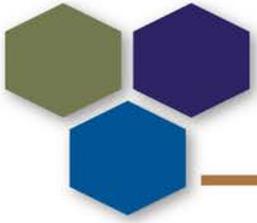
➤ Explaining:

- The new very large liability on balance sheet
- The annual changes in liability and pension expense, e.g., explaining why pension expense number is actually pension income in some years
- Why accounting numbers do not equal funding numbers; which ones are right?
- Why it costs so much to prepare



Disclaimers

- ◆ Circular 230 Notice: Pursuant to regulations issued by the IRS, to the extent this presentation concerns tax matters, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) marketing or recommending to another party any tax-related matter addressed within. Each taxpayer should seek advice based on the individual's circumstances from an independent tax advisor.
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- ◆ This presentation does not necessarily express the views of the sponsoring organization, or of Gabriel, Roeder, Smith & Company, and may not even express the views of the speakers.



QUESTIONS ??

TAB 3

TAB 3A

TEACHER RETIREMENT SYSTEM
Internal Audit Department

TO: Audit Committee Members, TRS Board of Trustees

FROM: Amy Barrett, Chief Audit Executive

SUBJECT: **TELEPHONE COUNSELING CENTER PERFORMANCE MEASURE
AUDIT PROJECT STATUS**

DATE: November 14, 2012 PROJECT: 13-102

Fieldwork is nearing completion on the Telephone Counseling Center (TCC) Average Speed of Answer (ASA) Performance Measure Audit, which is one of the areas identified in Internal Audit's *Fiscal Year 2013 Audit Plan*.

The Internal Audit department contracted with CliftonLarsonAllen LLP (CLA) with Ron Franke (Principal), Michael Dean (Project Manager), and Wayne Green (Team Member) to perform this audit project. Jan Engler is assisting the CLA auditors with this project.

TRS management is actively involved in the project and has provided a walk-through of the TCC department, interviews with TCC and Information Technology staff members, numerous monitoring and technical reports, data from the TCC call answering system, as well as analysis documents to assist with the audit work.

The CLA audit team is planning to provide the following reports:

- December 2012 – Audit Committee audit status presentation
- January 2013 – Final audit report released to management
- April 2013 – Audit Committee final audit report presentation

The audit objectives are to:

- Determine whether the calculation of the key performance measure for average speed of answer is in accordance with the methodology presented in the *TRS Strategic Plan* or a reasonable approximation of that methodology. Provide recommendations for enhancements to improve controls and increase accuracy of the average speed of answer performance measure.
- Determine whether TCC governance is effective in managing speed of answer by benchmarking current call center processes, data collected, and call center software functionality with industry practice and the available functionality of the existing software. Provide recommendations for enhancements to decrease ASA or otherwise improve management of TCC operations related to ASA.

TAB 3C

QUARTERLY TESTING – INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), WIRE TRANSFERS
CALENDAR QUARTER ENDED SEPTEMBER 30, 2012, EXCEPT AS NOTED

Business Objectives	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 and 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 October 31, 2012)
Business Risks	Board is not informed of key investment decisions and critical information	Approvals and fundings exceed delegated limits	Risks exceed Board established tolerances	Noncompliance is undetected or not timely resolved
Management Assertions	All required reports are made to the Board	Approvals and fundings are within limits and made for qualified managers	Programs are within risk limits	Investment activities comply with investment policies (proxy, securities lending, IPS)
Agreed-Upon Procedures	<ul style="list-style-type: none"> Compare Board reports to IPS requirements Obtain underlying supporting documentation for the following reports: <ul style="list-style-type: none"> - Derivatives - Risk Limits - Leverage 	<ul style="list-style-type: none"> Vouch Internal Investment Committee (IIC) approved investments to supporting documentation Verify approval limits of new investments 	<ul style="list-style-type: none"> Validate monitoring of securities lending program Validate IMD obtained reporting requirements of new managers/funds and summarized results Obtain senior management disclosures about known compliance violations Test supporting documentation for wire transfers 	Perform various compliance checks and monitor State Street's daily compliance reports
Test Results	<ul style="list-style-type: none"> All reporting requirements met, except one investment was approved by the IIC before being reported to the Board Documentation provides support for reports tested 	All supporting documentation exists	All other requirements of the IPS and SLP are met	No exceptions
Management Responses	We will report investment information to the Board before the IIC vote on future transactions.	None	None	None

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

November 16, 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), and procedures for wire transfers** as included in the *Fiscal Year 2013 Audit Plan*.

We performed the procedures listed below 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 our testing indicated that all compliance requirements have been met, except for the following:

- Information about an investment (“Project Fast”), which was approved by the Internal Investment Committee (IIC) on August 29, 2012, was not provided to the Board prior to IIC approval, as required in Article 1.7 section d.

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.

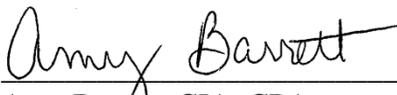
Had we performed additional procedures, or had we made an examination of the system of internal control, other matters might have come to our attention that would have been reported to

you. This report relates only to the procedures specified below 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



Brian T. Gomolski, CIA, CPA
Senior Investment Auditor



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



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

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"> • Obtain copies of all reports required to be reported to Board of Trustees and compare to reporting requirements per Investment Policy Statement (IPS). • Semi-annually, select the following reports and obtain supporting documentation: <ul style="list-style-type: none"> 1.7f – Derivatives 1.7g – Risk limit 1.7i – Gross and net leverage derived from hedge fund and strategic partners 	<ul style="list-style-type: none"> • Reports contained the required reporting information except: information about an investment (Project Fast) approved by the IIC on August 29, 2012 was not provided to the Board prior to IIC approval, as required in Article 1.7 section d. • Supporting documentation existed for the reports selected for testing. 	We will report investment information to the Board before the IIC vote on future transactions.
2	2	Article 2.6 – Verify that Investment Management Division (IMD) evaluated hedge fund classification.	<ul style="list-style-type: none"> • Select sample of approved investments in hedge funds and external managers. • Obtain analysis indicating whether each investment is hedge fund or not. If analysis is unavailable, inconclusive, or erroneous, report that result. • For any analysis requiring Board approval of classification, obtain Board minutes to verify whether approval was obtained. 	Selected sample of approved investments in hedge funds and external managers. All had analysis indicating whether investment was a hedge fund or not. No Board approval was required.	No response required.
3	2	Article 2.7h – Verify funds added to previously approved investments for purposes of rebalancing or adjusting risk did not exceed 2% of associated portfolios.	<ul style="list-style-type: none"> • Determine if Chief Investment Officer (CIO), Deputy CIO or Director of External Public Markets adjusted portfolios for the purposes of rebalancing or adjusting risks. • If funds added, did such additional investments or allocations exceed 2% of Hedge Fund Portfolio, External Manager Portfolio, or Other Absolute Return Portfolio (as 	There were no funds added during the quarter for the purposes of rebalancing.	No response required.

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<p>appropriate) per investment on a monthly basis.</p> <ul style="list-style-type: none"> • Obtain documentation from IMD staff supporting rebalancing analytics. Report on exceptions. 		
4	2	Article 6 – Verify approved investments in emerging managers meet requirements	<ul style="list-style-type: none"> • Determine target allocation and maximum fund-of-funds mandates are met, as specified in Appendix C of the IPS • Test sample of approved investments and verify each is independent private investment management firm with less than \$2 billion, has a performance track record as a firm less than 5 years, or both. 	Target allocation and maximum fund-of-funds mandates are being met, as specified in Appendix C of the IPS. Investments tested are independent private investment management firms with less than \$2 billion or has a performance track record as a firm that is no more than 5 years or both.	No response required.
5	2	IPS Appendix B – Verify investments approved are within policy limits	<ul style="list-style-type: none"> • Select sample of approved investments and obtain tear sheet for each, observe whether the approved amounts are within authorized limits: <ul style="list-style-type: none"> a) Initial allocation – .50% b) Additional or follow-on – 1% c) Total Manager Limits – 3% d) Total limit each manager organization – 6% • Obtain documentation from IMD staff that supports the calculations of the authorized limits. • Inquire if any “Special Investment Opportunities” were made for the quarter, and if so: <ul style="list-style-type: none"> a) Obtain documentation that the Special Investment Opportunity was either a distressed situation or market dislocation. b) Obtain documentation that the CIO notified the Executive Director (ED) of each Special Investment Opportunity. 	For the sample selected for testing, no manager or partner organization exceeded the authorized limits and documentation existed for IMD staff calculations of authorized limits. There have been no investments in Special Investment Opportunities.	No response required.

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<p>c) Obtain documentation that CIO and ED requested comments from chairman of appropriate board committee and TRS consultants and advisers.</p> <p>d) Verify Special Investment Opportunity did not exceed \$1 billion.</p> <p>e) Verify that no further investment in a special Investment Opportunity was made until board reauthorized CIO's authority to designate a Special Investment Opportunity.</p>		
6	2	Appendix C – Verify approved investments in emerging managers were approved by Internal Investment Committee (IIC) and limits are within policy requirements.	<ul style="list-style-type: none"> • Select sample of approved investments in emerging managers and validate that each were approved by IIC. • Validate that each approved investment is minimum size of \$5 million. • Validate that total External Manager investment by TRS with each emerging manager did not exceed 40% of such emerging manager's assets under management. • Validate total investment raised by emerging manager into Private Equity (PE) or Real Asset (RA) investment did not exceed 40% of size of such fund. 	Investments tested in emerging managers were approved by IIC and met all limit requirements.	No response required.
7	3	IPS Addendum Appendix A Questionnaire (Political Contributions; Improper Influence; Placement Agents and Finders) - Verify existence of placement agent questionnaire for each new investment and	<ul style="list-style-type: none"> • For each investment selected for testing, verify that IMD obtained responses to the questionnaire. • Determine that IMD compiled responses to the questionnaires and reported all results to Board semi-annually. 	Each investment tested had a completed questionnaire and was included in the summary report to the Board.	No response required.

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
		inclusion in summary report to the Board.			
8	4	Compliance Report of Senior Investment Compliance Specialist (Sr. ICS) – Verify with Sr. ICS that all other policy requirements have been met.	Obtain the investment compliance report from the Sr. ICS of other non-compliance issues as a result of the custodian’s monitoring procedures.	Obtained the investment compliance report. Refer to Appendix B.	Refer to Appendix B.
9	3	Quarterly Disclosures – Verify all known non-compliance violations have been reported.	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 of any known compliance violations during testing period and there were no additional disclosures.	No response required.
10	3	Test authorizations of wire transfers – Verify wire transfers are authorized and properly supported.	Obtain wire transfer reports for testing period, select sample of wire transfers, and verify that supporting documentation exists for each.	All wire transfers tested were properly authorized and correct amounts were wired.	No response required.

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

APPENDIX B

COMPLIANCE WITH INVESTMENT AND RELATED POLICIES As of and for the three months ended October 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 4

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

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
11-306 Investments Performance Calculations and Reporting					
	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
12-303 Audit of External Private Market Investments					
	Identify Information for Trustees to Preclude Non-Compliance with Private Markets Prohibited Investments under the Board of Trustees Ethics	In Progress	Other Reportable	12/2012	
	Reconcile the partner capital statement with audited financial statements	In Progress	Other Reportable	10/2012	3/2013
	Consider discontinuing operation of the valuation committee	In Progress	Other Reportable	3/2013	
	Obtain IIC approval for investment proposals requiring board action	Implemented	Other Reportable	12/2013	10/2012
12-401 Building Security					
	Card access procedures should be formalized, documented, implemented and include roles and responsibilities	Implemented	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	6/2013

Significant to Business Objectives

	<ul style="list-style-type: none"> Past <i>original</i> estimated completion date No management action plan <u>or</u> No progress on management action plan
	<ul style="list-style-type: none"> Past <i>original</i> estimated completion date Progress on management action plan
	<ul style="list-style-type: none"> <i>Original</i> estimated completion date has not changed Progress on management action plan
	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"> Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date No management action plan <u>or</u> No progress on management action plan
	<ul style="list-style-type: none"> Past <i>original</i> <u>or</u> first <i>revised</i> estimated completion date Progress on management action plan
	<ul style="list-style-type: none"> Within <i>original</i> <u>or</u> first <i>revised</i> estimated completion date Progress on management action plan
	Satisfactory implementation of management action plan <u>or</u> Acceptance of risk by management

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

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
12-403	Audit of Compensation, Payroll and Position Control				
	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	

State Auditor's Office (SAO) Outstanding Recommendations:

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
SAO Audit Report, May 2012, on Incentive Compensation at the Teacher Retirement System, the Employees Retirement System, and the Permanent School Fund (reported at the June 2012 Audit Committee)					
	TRS should establish a performance target for its trade management group and update its incentive compensation plan to reflect that target.	Implemented	External SAO	9/2012	9/2012

TRS Internal Audit
Summary of Management Actions for Staff Recommendation for Backup Generator
December 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.

November 2012 Status Update: The generator was installed and successfully load tested during November 2012. On December 15, 2012 wiring to connect the generator to the data center will be completed and city power will be turned off to relocate the main power feed to the data center. During the city power outage the data center will be powered by the generator. In the future, power will automatically transfer to the generator should we experience a loss of city power.

TAB 5

TAB 5A



Brian K. Guthrie
Executive Director

www.trs.state.tx.us 800.223.8778
512.542.6400

1000 Red River Street
Austin, Texas 78701-2698

Amy L. Barrett, CIA, CPA
Chief Audit Executive

October 15, 2012

Honorable Rick Perry, Governor
Members of the Legislative Budget Board
Members of the Sunset Advisory Commission
Mr. John Keel, CPA, State Auditor
Mr. R. David Kelly, Chair, TRS Board of Trustees
Mr. Christopher Moss, Chair, TRS Board Audit Committee
Members of the Board of Trustees, Teacher Retirement System of Texas

Attached is the annual report of the Internal Audit department of the Teacher Retirement System of Texas (TRS). This report provides information on the audit plan, assurance, consulting, and advisory projects completed, audit recommendations, management actions, and other Internal Audit activities. It also meets the annual reporting requirement of the Texas Internal Auditing Act (Government Code, Chapter 2102.009 and 2102.0091).

The work performed by TRS Internal Audit contributes toward accountability, integrity, and good management practices within TRS operations. Fiscal year 2012 projects contributed to the improvement of risk management, control, and governance processes. Internal Audit issued 6 assurance and 11 agreed-upon procedures reports, followed-up and reported quarterly on the status of all outstanding audit recommendations, as well as performed advisory services in Benefit Services, Health Care, Investments, Finance, Information Technology, and Executive areas.

Thank you for your continued support of TRS and the important role that internal auditing serves in supporting effective risk management, control, and governance processes.

For further information about the contents of this report or to request copies of Internal Audit reports, please contact Amy Barrett at (512) 542-6559.

Sincerely,

Brian Guthrie
Executive Director

Amy L. Barrett, CIA, CPA
Chief Audit Executive

cc: Executive Council Members
Internal Audit Staff Members

Teacher Retirement System of Texas
Internal Audit Annual Report for Fiscal Year 2012

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Teacher Retirement System of Texas Internal Audit Annual Report for Fiscal Year 2012

EXECUTIVE SUMMARY

Purpose of Report

This report meets the *Texas Internal Auditing Act* requirement for state agency internal auditors to prepare and distribute an annual report (Government Code, Chapter 2102 as amended by H.B. 2485 during the 78th Legislature). This is the twenty-second such report prepared by TRS since the statutory requirement became effective in 1991.

The report contains information on the fiscal years 2012 and 2013 audit plans and projects completed during fiscal year 2012. The report is based on work completed during the period September 1, 2011 through August 31, 2012.

Report Format

This report consists of the executive summary and the six parts listed below:

- Part I** Internal Audit Plan for Fiscal Year 2012
- Part II** External Quality Assurance Review
- Part III** List of Consulting Engagements and Non-Audit Services Completed
- Part IV** Internal Audit Plan for Fiscal Year 2013
- Part V** External Audit Services
- Part VI** Reporting Suspected Fraud and Abuse

Teacher Retirement System of Texas - Mission Statement

Internal Audit is strongly committed to the mission of the Teacher Retirement System.

The mission of the Teacher Retirement System of Texas is:

“Improving the retirement security of Texas educators by prudently investing and managing trust assets and delivering benefits that make a positive difference in members’ lives”

Internal Audit – Strategic Plan for Fiscal Years 2012 - 2016

Our internal audit strategic plan lists the Internal Audit mission and vision statement.

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.

Our **vision** is to provide *trusted assurance and valued advice* to our stakeholders who include the TRS Board of Trustees, the TRS Board Audit Committee, and executive management. We have included our strategic plan in the **Appendix** to this executive summary.

Our strategic plan ensures the following objectives are met:

Teacher Retirement System of Texas

Internal Audit Annual Report for Fiscal Year 2012

- Projects and other activities add value to the organization
- Plans are consistent with the organization’s goals
- Activities are communicated and approved
- Resources are appropriate, sufficient, and effectively deployed to meet future needs

We achieved our significant objectives and initiatives planned for fiscal year 2012. In fiscal year 2013, we plan to review and update our strategic plan objectives and initiatives so that our plan will continue to meet the above objectives and stay aligned with TRS’ strategic plan.

Part I: Audit Plan for Fiscal Year 2012

Fiscal Years 2012-2014 Audit Plan was approved by the TRS Audit Committee and the Board of Trustees in September 2011. This section lists the fiscal year 2012 planned projects and their completion status as well as special projects completed that were not listed in the original audit plan.

Internal Audit plans its work in an effort to assist TRS in managing risk. The Audit Plan focused on the following areas: Benefit Services, Investments, Health Benefits, Financial Services, Information Technology, and Executive.

Audits and other projects represent a broad scope of professional internal audit practice and include work in the areas of risk management, control, and governance.

Fiscal Year 2012 Internal Audit Performance Measures

The TRS Board and executive management measure the performance of Internal Audit based on established criteria. Internal Audit’s performance measures relating to its targets during fiscal year 2012 and their completion status are as follows:

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

**Teacher Retirement System of Texas
Internal Audit Annual Report for Fiscal Year 2012**

Target Performance	Status
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

Part II: External Quality Assurance Review

Our most recent external quality assurance review was completed in April 2010 by representatives of the State Agency Internal Audit Forum and another public pension fund. A summary is included in this section of the report. The review concluded that the TRS Internal Audit department continues to fully comply with the *IIA International Standards*, *Government Auditing Standards*, and the *Texas Internal Auditing Act*.

The next external quality assurance review (QAR) is scheduled for January 2013 and will be reported at the April 2013 Audit Committee meeting. The QAR team consists of three volunteers with broad experience in Texas state government and public pension plans.

Part III: Consulting Engagements and Non-audit Services Completed

During fiscal year 2012, Internal Audit did not perform any formal consulting projects resulting in formal recommendations to management. Internal Audit provided advisory services as listed on pages I-12 through I-14 in **Part I** of this report.

Part IV: Audit Plan for Fiscal Year 2013

The *Fiscal Year 2013 Audit Plan* is included in this section and continues to focus on risk management, control, and governance processes that support TRS mission. The audit plan includes a table of assurance, consulting and advisory projects mapped to enterprise risks.

Part V: External Audit Services

TRS procured four external services in fiscal year 2012 as listed in this section of the report.

Part VI: Reporting Suspected Fraud and Abuse

Since 2006, TRS has taken many actions, as listed in this section of the report, to implement the fraud detection and reporting requirements of the General Appropriations Act and the Texas Government Code. Internal Audit has included an audit project in the *Fiscal Year 2013 Audit Plan* to identify the highest areas of fraud risks and related controls and validate that controls are sufficient and working to mitigate fraud risks.

Teacher Retirement System of Texas
Internal Audit Annual Report for Fiscal Year 2012

Contact

For more information or additional copies of this report, please contact Chief Audit Executive, Amy Barrett, at (512) 542-6559.

APPENDIX

TRS Internal Audit Strategic Plan
2012 - 2016

*Trusted Assurance,
Valued Advice*



Looking Towards the Future

TRS INTERNAL AUDIT STRATEGIC PLAN: 2012 – 2016

Our 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.

Our Vision

We strive to provide *trusted assurance and valued advice* through our services to the Board of Trustees, the Audit Committee, and executive management:

- Assurance that TRS' risk management, governance, and control processes support achievement of TRS mission and business objectives
- Advice and consultation for improving processes through business partnerships and collaboration

Our Stakeholders

One of our priorities is to assess key stakeholder expectations, identify gaps, and implement a comprehensive strategy for improvement. Our primary stakeholders include:

- TRS Board of Trustees, and the Board Audit Committee
- Executive Director
- Executive Management

STRATEGIC GOALS

Our four strategic goals were developed to ensure that Internal Audit supports the changing needs of TRS' stakeholders in achieving business goals and objectives. These goals represent a strategy for enhancing our contribution to TRS' risk management, improving internal audit business knowledge, sharing information on emerging trends, and promoting improved communication with our stakeholders and business partners.

- Goal 1 Provide Assurance on Key Risk Mitigation
- Goal 2 Develop Internal Audit Resources - People, Processes, and Technology
- Goal 3 Provide Education on Emerging Risks and Controls
- Goal 4 Enhance Communication regarding Audit Activities and Initiatives

The **table** below identifies the objectives and related initiatives for each goal, and identifies the fiscal year(s) in which certain initiatives are conducted.

TRS INTERNAL AUDIT STRATEGIC PLAN: 2012 – 2016

Goals, Objectives, and Initiatives		FY 12	FY 13	FY 14	FY 15	FY 16
Goal #1: Provide Assurance on Key Risk Mitigation						
Objective G1.1: Plan for high level internal control opinion on key controls for significant risks						
Initiative						
G.1.1.1	Perform assessment of TRS control environment and governance, including information technology governance			AP ¹		
G.1.1.2	Perform assessment of Enterprise Risk Management (ERM) Program including fraud risk management		AP			
G.1.1.3	Assess control activities including process monitoring controls and identify population of key controls for top TRS risks in coordination with ERM, and the Risk Oversight Committee (ROC)	AP	AP	AP		
G.1.1.4	Assess information and communication processes and systems	AP	AP	AP		
G.1.1.5	Assess overall monitoring processes for TRS				SP ²	
G.1.1.6	Conduct validation tests of key controls, and report to senior management and the Board Audit Committee				SP	SP
Objective G1.2: Assess cost-benefit of conducting reporting entity audits						
G.1.2.1	Study the results of other pension plans' reporting entity audits, gather information within TRS, and assess existing TRS controls	AP				
G.1.2.2	Pilot audits of reporting entities and assess results		AP			
G.1.2.3	Review benefits of the pilot, determine resources needed to initiate and sustain reporting entity audits			AP		
G.1.2.4	Present to senior management and the Audit Committee a "stop/go" recommendation, and determine next steps based on the Audit Committee's recommendation to the Board			AP		
Objective G1.3: Provide advisory services to support TEAM Program implementation						
G.1.3.1	Participate in TRS Enterprise Application Modernization (TEAM) executive steering committee as non-voting member	AP	AP	AP	SP	SP
G.1.3.2	Provide services as requested by senior management and/or the Board Audit Committee	AP	AP	AP	SP	SP
Objective G1.4: Provide assurance on benefits, information technology, and investment internal control processes and recommend improvements						
G.1.4.1	Conduct activities to validate key controls for benefits business processes	AP	AP	AP	SP	SP
G.1.4.2	Develop and implement ongoing auditing and monitoring procedures for information security	AP	AP	AP	SP	SP
G.1.4.3	Conduct activities to validate key controls for investment processes, including validation of State Street compliance system	AP	AP	AP	SP	SP
G.1.4.4	Ensure effectiveness and efficiency of Investment Compliance Program	AP	AP	AP	SP	SP
Objective G1.5: Increase data mining of compliance risks						
G.1.5.1	Develop and implement testing plan for significant compliance risks in TRS rules and laws	AP	AP	AP	SP	SP
G.1.5.2	Develop and implement testing plan for legislative, actuarial and other changes	AP	AP	AP	SP	SP
Goal #2: Develop Internal Audit Resources – People, Processes, and Technology						
Objective G2.1: Implement Quality Assurance and Improvement Program (QAIP)						
G.2.1.1	Perform annual Internal Audit self-assessment of compliance with professional	AP	AP	AP	SP	SP

¹ Scheduled in 2012 – 2014 Audit Plan (AP)

² Strategically planned for future audit plan (SP).

TRS INTERNAL AUDIT STRATEGIC PLAN: 2012 – 2016

Goals, Objectives, and Initiatives		FY 12	FY 13	FY 14	FY 15	FY 16
	standards					
G.2.1.2	Develop and implement reporting process for communicating QAIP results to senior management and the board	AP	AP	AP	SP	SP
G.2.1.3	Obtain external quality assurance review		AP			SP
Objective G2.2: Implement Auditor Core Competency Framework						
G.2.2.1	Using the Institute of Internal Auditors (IIA) guidance, incorporate auditor core competency requirements into auditor evaluations, perform gap assessment on training needs, develop training plans, implement performance pro	AP	AP	AP		
G.2.2.2	Develop new auditor orientation program	AP				
G.2.2.3	Improve business knowledge, and develop and implement electronic repository of business unit procedures and key documents	AP	AP	AP	SP	SP
Objective G2.3: Enhance team building and performance rewards within Internal Audit Department						
G.2.3.1	Hold annual Internal Audit retreat	AP	AP	AP	SP	SP
G.2.3.2	Recognize and celebrate accomplishments of individuals and teams (peck of thanks and bushel of fun)	AP	AP	AP	SP	SP
Goal #3: Provide Education on Emerging Risks and Controls						
Objective G3.1: Provide training and communication on internal control best practices, emerging risks, and Internal Audit's role						
G.3.1.1	Develop and implement internal controls training for management and new employees as part of Human Resources manager training program and new employee orientation	AP				
G.3.1.2	Update Internal Audit intranet site to include relevant risk and control topics and maintain relevant information	AP	AP	AP	SP	SP
G.3.1.3	Make periodic presentations to the leadership team on emerging risks, and publish and post articles on emerging risks and mitigation strategies		AP	AP	SP	SP
G.3.1.4	Provide training to the Audit Committee on relevant topics		AP		SP	
Objective G3.2: Coordinate Internal Audit activities with internal governance, risk management, and control functions						
G.3.2.1	Participate in the ROC and present periodic audit agenda items	AP	AP	AP	SP	SP
G.3.2.2	Partner with the ERM program and the ROC and share information on risks and controls	AP	AP	AP	SP	SP
Goal #4: Enhance Communication regarding Audit Activities and Initiatives						
Objective G4.1: Formalize customer and stakeholder feedback process						
G.4.1.1	Issue client survey after every engagement, incorporate feedback to improve staff skills and audit processes	AP	AP	AP	SP	SP
G.4.1.2	Schedule regular meetings with board members, executives, and staff	AP	AP	AP	SP	SP
G.4.1.3	Obtain independent feedback using human resources staff, incorporate feedback to improve staff skills and audit processes	AP	AP	AP	SP	SP
Objective G4.2: Increase two-way communication and understanding of management's needs and audit activities						
G.4.2.1	Hold regularly scheduled meetings with audit customers	AP	AP	AP	SP	SP
G.4.2.2	Provide Executive Council briefings and feedback sessions on upcoming initiatives, audit projects, and Audit Committee presentations	AP	AP	AP	SP	SP
G.4.2.3	Provide periodic "internal" memorandums on risk and control topics	AP	AP	AP	SP	SP
G.4.2.4	Periodically invite business unit managers/team leaders to Internal Audit staff meetings	AP	AP	AP	SP	SP

TAB 5B

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

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

Status of Fiscal Year 2013 Planned Assurance, Consulting, and Advisory Services as of November 2012

Title	Type	Status
Executive		
Ethics and Communications Policies Compliance Audit	Audit	
Fraud Risk Identification and Prevention Audit	Audit	
Internal Ethics and Fraud Hotline Administration	Advisory	Ongoing
Fraud, Waste, and Abuse Prevention (FWAP) Committee	Advisory	Ongoing
Meetings Attendance	Advisory	Ongoing
Special Requests	All	Ongoing
Team-Related Initiatives		
Independent Program Assessment Support	Advisory	Ongoing
Team Committee Participation	Advisory	Ongoing
Benefit Services Division		
Telephone Counseling Center Performance Measures	Audit	In Progress
Benefit Payment Testing (financial audit)	Audit	Complete
Benefit Payment Testing	Agreed-Upon Procedures	
Benefit Processing Surprise Inspection	Advisory	Complete
Health Care Division		
Health Care Administration Audit	Audit	In Progress
Health Care Vendor Update Meetings	Advisory	Ongoing
Vendor and Auditor Selection Observation	Advisory	
Information Technology Division		
Backup and Recovery Audit	Audit	
Health Insurance Portability and Accountability Act (HIPAA) IT Security Rule Recommendations Implementation and Validation	Audit	
Internal Network Vulnerabilities Scan	Agreed-Upon Procedures	Complete
Network Penetration Test; Security Risk Assessment Review	Advisory	

Status of Fiscal Year 2013 Planned Assurance, Consulting, and Advisory Services as of November 2012

Title	Type	Status
Technology Committee Meetings Attendance	Advisory	Ongoing
Finance Division		
Employer Reporting Audit	Audit	In Progress
Procurement and Contracting Audit	Audit	
1099 Reporting and Payment Processing	Advisory	In Progress
Budget Transfer Inspection	Advisory	
Accounting Standards Changes Monitoring	Advisory	Ongoing
Financial Audit Coordination	Advisory	Complete
Investment Management Division		
Investments Selection and Monitoring (Emerging Managers)	Audit	
Derivatives Audit	Audit	
Investment Policy Compliance Testing (quarterly)	Agreed-Upon Procedures	Complete
Contractual Allowance Identification	Consulting	In Progress
Incentive Compensation Review	Advisory	
Employee Trading Policy Compliance Monitoring	Advisory	Ongoing
Emerging Risks Monitoring	Advisory	Ongoing
Investment Committees Attendance	Advisory	Ongoing
Travel Inspection	Advisory	
Internal Audit Department		
External Quality Assurance Review*	Audit	In Progress
Annual Internal Audit Report	Audit	Complete
Audit Recommendation Follow-up	Audit	Ongoing
Audit Plan	Advisory	
Audit Committee Meetings Preparation	Advisory	Ongoing
Internal Audit Strategic Plan	Advisory	In Progress

*The External Quality Assurance Review is scheduled for the week beginning January 28, 2013.

Fiscal Year 2013 Internal Audit Advisory Services¹ September – November 2012

BENEFIT SERVICES
<p>TEAM PROJECT</p> <ul style="list-style-type: none"> • Executive Steering Committee Participation • Business Rules Committee Participation • Monthly meetings with TEAM Project Manager • Core Management Team: Standing Prioritization Review Meeting • Independent Program Assessment – Vendor Evaluation and Selection Coordination • Compilation of State Auditor’s findings on Texas and North Carolina State Agencies’ Information Systems Projects <p>OTHER</p> <ul style="list-style-type: none"> • Surprise Inspections of Benefit Processing
HEALTH BENEFITS
<ul style="list-style-type: none"> • Health Plan Administrator (HPA) and Pharmacy Benefit Manager (PBM) Vendor Quarterly Update Meeting Participation
INVESTMENTS
<ul style="list-style-type: none"> • Personal Trading Monitoring, Weekly Meetings with Legal Services, Quarterly Reporting to Executive Director • Monthly Securities Lending Update Meetings Participation • Internal Investment Committee (IIC) Attendance • Investment Management Division (IMD) Staff Meeting Attendance • Monthly Council of Compliance Officers Conference Calls – provide relevant information to IMD • Initiation of Periodic Update Meetings with Chief Risk Officer • Participation in Policy Discussion to Comply with Proposed Commodity Futures Trading Commissions (CFTC) Rule under the Dodd-Frank Act
FINANCIAL SERVICES
<ul style="list-style-type: none"> • Coordination of State Auditor’s Office TRS Comprehensive Annual Financial Report (CAFR) • Flowcharting the 1099 Process
EXECUTIVE
<ul style="list-style-type: none"> • Coordination of State Auditor’s Office Follow-up Audit of TRS Ethics Policies • Hot Line Call Facilitation • Executive Requests • Social Media Advisory Committee • Fraud, Waste and Abuse Prevention Committee
INFORMATION TECHNOLOGY
<ul style="list-style-type: none"> • Enterprise Security Project Team • McAfee Full Disk Encryption Impact Analysis Discussions • Information Security Manual Review • Backup and Recovery Audit Statement of Work Development

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

**Internal Audit Performance Measures - Fiscal Year 2013
1st Quarter Ending November 30, 2012**

Target Performance	Status
1. Plan and execute employer audit activities with significant direction and input from TRS subject matter experts	On Task
2. Facilitate and monitor timely hiring and coordination of TEAM Independent Program Assessment vendor	On Task
3. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests)	On Task
4. Complete external quality assurance review with no significant compliance exceptions	On Task
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	On Task
6. Enhance value through allocating time for special requests throughout the year	On Task
7. Identify and utilize at least two internal or external resources to train and mentor audit staff in employer reporting and information technology	On Task
8. Systematically monitor emerging investment issues and impact to TRS via the investment compliance program	On Task
9. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services	On Task
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	Achieved

Legend: Target Status

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

Teachers Retirement System of Texas
Internal Ethics and Fraud Hotline
Incident Report Activity Summary
1/1/2010 (inception) through 11/30/2012

Time Period	Number of Calls	Status
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
09/01/2012-11/30/2012	1	Resolved

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
1st Quarter
Fiscal Year 2013

1. COSO to Issue Update to its Internal Control - Integrated Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five private sector organizations that is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence. The original COSO Internal Control – Integrated Framework (ICIF) was released in 1992. Recognizing technological and business developments along with increased corporate risks, the need to codify existing principles and supporting attributes, as well as provide expanded guidance on non-financial reporting, COSO issued an updated framework for public comment in early 2012. In September 2012, COSO released a revised ICIF that incorporates input received during the earlier comment period, along with a guidance document for Internal Control over Financial Reporting (ICEFR). The final document will be issued in early 2013. For more details, see the attached “Internal Controls: That was Then, This is Now.”

2. Revisions to Internal Audit Standards to Take Effect

The Institute of Internal Auditors (IIA) has announced changes to the *International Standards for the Professional Practice of Internal Auditing (Standards)*. The revised *Standards*, considered mandatory under The IIA’s International Professional Practices Framework (IPPF), will go into effect Jan. 1, 2013. In total, 18 revisions were made, which are intended to improve the professional practice of internal auditing worldwide. Key changes to the *Standards* include:

- Clarifying the responsibilities of internal auditors, the chief audit executive (CAE), and the internal audit activity for conforming with the *Standards*
- Increasing focus on the Quality Assurance and Improvement Program requirements and clarifying ways in which conformance may be achieved
- Clarifying the CAE's role in communicating unacceptable risk
- Explicitly requiring timely adjustments to the internal audit plan
- Ensuring the audit plan covers risks to achieving strategic objectives
- Adding more examples of what constitutes “functional reporting to the board”
- Adding the definitions of "overall opinion" and "engagement opinion" to the Glossary, as well as changing the definition of "board"

3. AICPA Redrafts Guidance on External Auditor’s Use of Internal Audit’s work

The American Institute of Certified Public Accountants (AICPA) is redrafting its guidance on the external auditor’s consideration of the Internal Audit function in an audit of financial statements. The purpose is to clarify and converge with the International Accounting and Assurance Standards Board’s (IAASB) International Auditing Standard (IAS) 610, which addresses the same topic. The updated standard will address the external auditor’s responsibilities when they expect to use the work of Internal Audit as part of the audit evidence obtained, and also the external auditor’s responsibilities if considering using Internal Audit to provide direct assistance.

INTERNAL CONTROLS

That Was Then, This Is Now



**COSO Updates
its 1992 Classic
Internal
Control-Integrated
Framework**

BY ROBERT B. (BOB) SCOTT

Originally issued in 1992, the COSO Internal Control-Integrated Framework has been internationally recognized as the conceptual anchor any organization needs to develop a strong system of internal control. A proposed update, which should be finalized in early 2013, is expected to leave many of the framework's timeless concepts untouched but add detail to address the changing environment. In applying this new framework, state and local governments should keep in mind the unique aspects of their operating environments, including political, legal and operational.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)¹ issued the original framework to provide guidance and thought leadership about what constituted good internal control within an organization. It has become a global resource, translated into seven languages. But no document can remain relevant without addressing the rapid changes occurring in organizations, including:

- Increasing expectations of strong governance and oversight.
- Globalization of markets and operations.
- Reliance on rapidly changing technology.
- Increasing complexity of rules, regulations, and standards.
- Increasing expectations for preventing and detecting fraud.

An effort began in 2011 to update the integrated framework, beginning with a survey of stakeholders, continuing with an exposure draft of proposed changes, and ultimately culminating in the proposed update, to be issued in early 2013. This article will discuss the original framework, the proposed changes, and areas state and local government should consider when applying the framework.

NOT JUST A FINANCE THING

The beauty of COSO's integrated framework is its simplicity and how broadly it can be applied across organizations. Based on the belief that good internal controls are necessary for the long-term success of all organizations, COSO takes internal controls beyond the finance department and sets them squarely on the shoulders of every employee from the governing board down. If asked to name an internal control, most of us would probably say "segregation of duties." Few,

if any, would go with "long-term strategic plan." However, given COSO's emphasis on organizational success and the tone at the top, one could argue that detailed controls within individual areas start with strategic goals from the governing board that define what success means for the organization. In other words, it's easy to develop controls to mitigate poor segregation of duties, but an organization that doesn't have a direction is a much harder problem to solve.

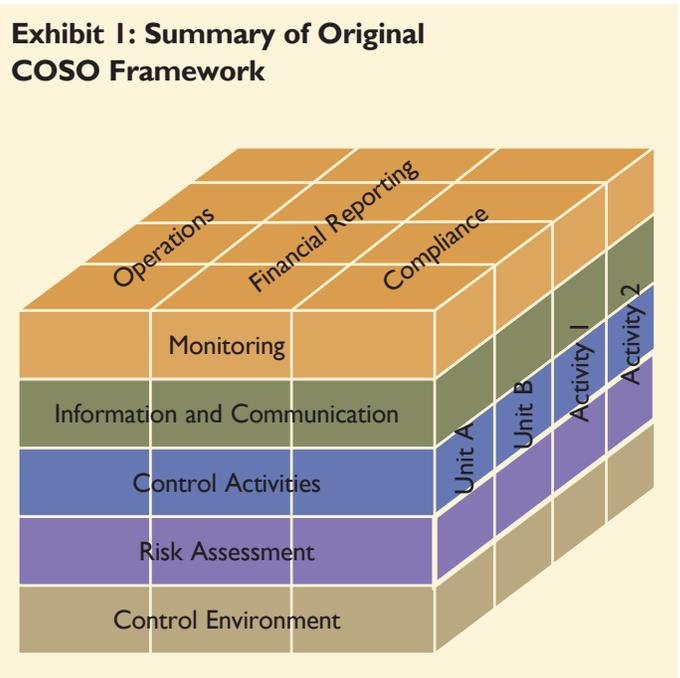
The original 1992 framework is best summarized by "the cube" shown in Exhibit 1.

The proposed update, which should be finalized in early 2013, is expected to leave many of the framework's timeless concepts untouched but add detail to address the changing environment.

In its simplest form, the framework consists of five elements designed to accomplish three basic categories of objectives. These elements and the related objectives span the entire organization, both in terms of departments and specific activities. COSO starts with the control environment, which is a function of many factors, but ultimately the responsibility and product of top management and the governing board. These individuals must set

the tone, example, and expectations that will trickle down throughout the organization.

The organization needs to constantly assess the risks and challenges it faces. Just as most people wouldn't walk



down a steep, rocky slope with their eyes closed, no organization should be blind to the potholes, rocks, and other hazards in its path. However, it doesn't do much good to be aware of hazards if you don't take appropriate actions to avoid, confront, or reduce them. Therefore, COSO creates a strong link between the risks identified and the control activities needed to address them. Controls vary significantly by the risk identified and the activity, area, and organization. There is no one right answer that can be applied to all organizations, and multiple approaches can often accomplish the same goal.

Regardless of the control activities chosen, their effectiveness depends on communication. The organization has to make sure employees understand why the controls are needed, how important they are, and the consequences to both the organization and specific employees if they are not followed. If employees don't understand the purpose of a control and therefore see it as "red tape," they are much less likely to follow the guidelines than they would be if the purpose were clear to them. The values of the organization should be clear to employees, along with the behaviors

In applying this new framework, state and local governments should keep in mind the unique aspects of their operating environments, including political, legal and operational.

expected of them. This information should be clearly communicated in written policies, verbal affirmations of those policies, and, most importantly, through the actions of those in authority.

The fifth element is monitoring. How many of us put a control in place and expect it to still be effective years later, in spite of reorganizations, employee turnover, and new

technology? Just as we need to constantly evaluate risks, we also need to constantly evaluate the effectiveness of our controls. This monitoring process completes the loop, bolstering and supporting both the control environment and risk assessment.

The five elements relate directly to the three organizational objectives of operations, financial reporting, and compliance. Operations are simply the goals, objectives, and activities of the organization — or, expressed another way, its reason for existence. Financial reporting tells the financial story of the organization; it must be done in a way that complies with related rules and conventions for completeness, and most of all, it should never be misleading. Finally, all organizations have a myriad of rules and regulations they must comply with. Compliance can be either financial or operational in nature, and internal controls must address them all.

BRAVE NEW WORLD

The survey responses received by COSO at the start of the process made it clear that most respondents viewed the basic framework as timeless. This information led to an update approach that would add detail and emphasis to the original framework without replacing its elements or the objectives. See Exhibit 2 for a summary of the updates.

The update focused not on replacing any of the original elements but on increasing users' understanding of these principles. It is no coincidence that the control environment is the element associated with the most stated principles, as COSO believes that this must be both the beginning, middle, and end of an effective control strategy.

Under risk assessment, the first two principles are noteworthy in that COSO sees them as significant enough to merit individual mention. The risk of fraud within an organization



Exhibit 2: A Summary of COSO Framework Updates

Codification of 17 principles embedded in the original framework

Control Environment	1. Demonstrates commitment to integrity and ethical values
	2. Exercises oversight responsibility
	3. Establishes structure, authority, and responsibility
	4. Demonstrates commitment to competence
	5. Enforces accountability
Risk Assessment	6. Specifies relevant objectives
	7. Identifies and analyzes risk
	8. Assesses fraud risk
Control Activities	9. Identifies and analyzes significant change
	10. Selects and develops control activities
	11. Selects and develops general controls over technology
Information and Communication	12. Manifests via policies and procedures
	13. Uses relevant information
Monitoring Activities	14. Communicates internally
	15. Communicates externally
	16. Conducts ongoing and/or separate evaluations
	17. Evaluates and communicates deficiencies

should be a focus for every finance officer, as schemes and the nature of the fraud constantly evolve. And change, by its nature, creates weaknesses and vulnerabilities. Just as generals are said to often fight the previous war, finance officers tend to deploy controls designed for yesterday's environment.

The control activities principle regarding general controls over technology stands out. COSO chose not to emphasize all controls over technology, as specific ones are included under other control activities. The pervasiveness of technology throughout today's organizations means that controls related to specific applications cannot be effective if general controls over technology are not in place — technology can have its own unique environment.

The principles related to communication make it clear that this element must be comprehensive, focused, and occurring in all directions. The final two principles related to monitoring emphasize its ongoing nature and that monitoring must be communicated and acted on to be effective.

APPLYING THE FRAMEWORK TO GOVERNMENT

While the elements and related principles of the framework are universal, the emphasis on and importance of specific controls changes with the characteristics of individual indus-

tries. Government is no exception. Government finance officers need to consider factors that make our entities unique.

Politics and Elected Officials. No other industry has the potential for rapid turnover of the governing board that government has. Most state and local officials are elected for two- to three-year terms, and there are no experience or educational requirements to run for office. This means it's important for appointed officials — particularly finance officers — to contribute to the tone at the top.

State and Local Laws and Regulations. Government's unique powers of taxation, governance, and public purpose, combined with the federal form of government, create voluminous amounts of regulation that can vary significantly by jurisdiction. Finance officers need to remember that their financial statements should be understandable and complete nationwide.

Demand for Transparency and the Web. Public entities have a solemn obligation to operate in the sunshine, including making information readily available on our websites. We should never forget, however, that too much information can be exploited by identity thieves or those wishing to defraud the government. Careful attention should be paid to the information posted on websites and the protections placed on them.



We Want You to enjoy safety and return on your large-dollar deposits

Access multi-million-dollar FDIC insurance and earn interest, both through a single, easy-to-manage relationship. And say “goodbye” to tracking collateral values on an ongoing basis.

Ask your financial institution if it offers the ICSSM and CDARS[®] services, or visit www.insuredcashsweep.com or www.cdars.com, to choose from the thousands that do.



Use of the ICS and CDARS services is subject to the terms, conditions, and disclosures set forth in the applicable program agreements, including the applicable Deposit Placement Agreement. Limits apply, and customer eligibility criteria may apply. ICS program withdrawals are limited to six per month. ICS is a service mark, and CDARS is a registered service mark, of Promontory Interfinancial Network, LLC.

Disconnect Between Revenues and Expenses.

Departments often see no relationship between the revenues they collect and the size of their budgets. As a result, revenue collection and controls to ensure that all revenues due are collected are often a low priority. Finance officers need to work hard on communicating the importance of revenue collection to the entire operation.

Diverse, Unique, and Remote Operations. Even the smallest city has more potential for having more diverse operations than a large publicly held corporation has. This diversity of operations often creates “silos” — separate departments that can have their own unique environments. Top management needs to make special efforts to integrate uniform controls throughout the organization, penetrating any areas that might be operating somewhat separately from other departments or agencies in the organization. Finance officers need to visit remote operations and extend monitoring well beyond the finance department.

CONCLUSIONS

COSO is evaluating the approximately 100 comment letters it received on the changes it proposed. Comments included concerns that the update might be overly focused on large companies, as opposed to smaller entities, not-for-profit organizations, and governments. Respondents also felt that the COSO should elaborate on the role of internal audits. The organization will consider the need for additional input before it releases the update, but it is still planning on the early 2013 issuance. In addition to the updated framework, COSO will provide companion documents on applying the framework for internal control over external financial reporting and for evaluating the overall effectiveness of internal control. ■

Note

1. The sponsoring organizations are the American Institute of Certified Public Accountants, American Accounting Association, Financial Executives International, Institute of Internal Auditors, and the Institute of Management Accountants.

ROBERT B. (BOB) SCOTT is chief financial officer/assistant city manager for the City of Carrollton, Texas, where he is responsible for all aspects of the city’s financial operations. He is also a member of the GFOA’s Executive Board. Scott has extensive experience in accounting and financial reporting issues, having served on various GASB review committees and taskforces.

Internal Audit Staff Quarterly Accomplishments

- Karen Morris earned the Certification of Risk Management Assurance (CRMA).
- Amy Barrett, Lih-Jen Lan, and Dinah Arce attended the Association of Public Pension Fund Auditors (APPFA) fall conference.
- Karen Morris, Lih-Jen Lan, and Dorvin Handrick attended the ConSec 2012 Southwest Regional Symposium on Business Continuity, Information Security and IT Audit.
- Hugh Ohn and Brian Gomolski attended the Alternative Investments Conference hosted by McCombs School of Business Centers.
- Lih-Jen Lan and Brian Gomolski attended the TeamMate User Forum.
- Terry Harris, Jan Engler, and Brian Gomolski attended the Institute of Internal Auditor's Southern Regional Conference.
- Jan Engler served on the Golden Apple Selection Committee for the 2012 Employee Awards.
- Stephen Henry, former Internal Audit Intern, has accepted a position within the accounting department at LyondellBasell following his graduation from the University of Texas at Austin this spring.