

Audit Committee Meeting

July 2016



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

**TEACHER RETIREMENT SYSTEM OF TEXAS
BOARD OF TRUSTEES
AND
AUDIT COMMITTEE**

(Mr. Moss, Chairman; Ms. Charleston; Mr. Corpus; Dr. Gibson; & Ms. Palmer, Committee Members)

AGENDA

**July 29, 2016 – 10:30 a.m.
TRS East Building, 5th Floor, Boardroom**

*All or part of the July 29, 2016 meeting of the TRS Board of Trustees and Audit Committee may be held by telephone conference call as authorized under Section 551.130 of Texas Government Code. The committee and board intend to have a quorum physically present at the following location: **1000 Red River, Austin, Texas 78701 in the TRS East Building, 5th Floor, Boardroom.***

1. Consider approval of the proposed minutes of the June 17, 2016 committee meeting – Christopher Moss, Chair.
2. Consider recommending to the Board the selection of Grant Thornton as the auditor for a financial audit of the Teacher Retirement Investment Company of Texas Ltd. (TRICOT) and the State Auditor’s Office as the auditor for a financial audit of the TRS Comprehensive Annual Financial Report – Amy Barrett.
3. Receive a Status Report on the TRS-ActiveCare Readiness Review – Amy Barrett, Toma Miller, and Katrina Daniel.
4. Receive a report on the testing of the Executive Performance Incentive Pay Calculation – Amy Barrett and Toma Miller
5. Evaluate the performance of the Chief Audit Executive and consider a recommendation to the Board regarding the performance appraisal and compensation of the Chief Audit Executive – Brian Guthrie; Keith Robinson, Focus Consulting.

NOTE: The Board of Trustees (Board) of the Teacher Retirement System of Texas will not consider or act upon any item before the Audit Committee (Committee) at this meeting of the Committee. This meeting is not a regular meeting of the Board. However, because the full Audit Committee constitutes a quorum of the Board, the meeting of the Committee is also being posted as a meeting of the Board out of an abundance of caution.

TAB 1



**TEACHER RETIREMENT SYSTEM OF TEXAS
AUDIT COMMITTEE MEETING
June 17, 2016**

The Audit Committee of the Board of Trustees of the Teacher Retirement System of Texas met on Friday, June 17, 2016 in the boardroom located on the fifth floor of the East Building of TRS' offices located at 1000 Red River Street, Austin, Texas 78701. The following persons were present:

TRS Board Members

Christopher Moss, Audit Committee Chair
T. Karen Charleston, Audit Committee Member
David Corpus, Audit Committee Member
Dr. Greg Gibson, Audit Committee Member
Anita Smith Palmer, Audit Committee Member
R. David Kelly, Board Chair

TRS Staff

Brian Guthrie, Executive Director
Ken Welch, Deputy Director
Amy Barrett, Chief Audit Executive
Hugh Ohn, Director, Investment Audit Services
Jan Engler, Director, Benefit Audits
Dinah Arce, Senior Auditor, Internal Audit
Art Mata, Senior Internal Audit Consultant, Internal Audit
Cari Casey, Internal Audit Consultant, Internal Audit
Lih-Jen Lan, IT Audit manager, Internal Audit
Rodrigo Dominguez, Auditor, Internal Audit
Toma Miller, Senior Auditor, Internal Audit
Anandhi Mani, Senior Investment Auditor, Internal Audit
Lan Zhu, Intern, Internal Audit
Britt Harris, Chief Investment Officer
Barbie Pearson, Chief Benefit Officer
Melody Austin, Manager of Benefit Reporting
Don Green, Chief Financial Officer
Cindy Haley, Team Leader, Financial Reporting, General Accounting
Scot Leith, Director, Investment Accounting
Chris Cutler, Chief Information Officer
Carolina de Onís, General Counsel
Dan Junell, Assistant General Counsel
Beckie Smith, Assistant General Counsel
Heather Traeger, Chief Compliance Office, Legal Department
Katrina Daniel, Chief Health Care Officer

TRS Staff (cont'd)

Yimei Zhao, Assistant Director of Finance, TRS Health & Insurance Benefits
Edward Esquivel, Assistant Director, TRS Health & Insurance Benefits
Jay LeBlanc, Director, Risk Management & Strategic Planning
Chris Bailey, Manager, Talent Acquisition and Compensation
Ruth Stephens, Intern, Human Resources
Catherine Christina, Intern, Human Resources

Other Attendees

Philip Mullins, Texas Retired Teachers Association
Ann Fickel, Texas Classroom Teachers Association
Ted Melina Raab, Texas American Federation of Teachers
Bill Barnes, Texas Retired Teachers Association
Max Ates, Fort Worth Independent School District
Michael Clayton, State Auditor's Office
Ben Keyfitz, State Auditor's Office
Benito Ybarra, Texas Department of Transportation
Neill Masterson, EY
Garrison Phillis, EY
Mark Quinn, Aetna
Greg Wood, Aetna
Tony Magliano, Aetna
Mike Nelson, Aetna
Carol Riley, Blue Cross Blue Shield of Texas

Audit Committee Chair Christopher Moss called the meeting to order at 8:01 a.m. with a quorum of committee members present.

1. APPROVE THE PROPOSED MINUTES OF THE APRIL 7, 2016 AUDIT COMMITTEE MEETING

On a motion by Ms. Palmer and seconded by Dr. Gibson, the proposed minutes of the April 17, 2016 Audit Committee meeting were approved as presented.

2. RECEIVE REPORTS ON THE TRS INTERNAL AUDIT QUALITY ASSURANCE AND IMPROVEMENT PROGRAM (QAIP)

A. External Assessment

Ms. Amy Barrett introduced Mr. Benito Ybarra of the Texas Department of Transportation who led the Internal Audit Quality Assessment Review (QAR) in April. Two other review team members not present included Chief Audit Executive of the Oregon State Treasury and Chief Audit Executive of the Texas Department of Insurance. The external QAR is required to be performed every three years under Government Auditing Standards. Mr. Ybarra reported that TRS Internal Audit passed the assessment and no findings were identified. A presentation slide listed leading practices and improvement recommendations. Mr. Ybarra thanked TRS for the great involvement of staff from the top all the way down through the organization.

B. Self-Assessment

Ms. Barrett presented the report of the internal Quality Assessment and Improvement Program (QAIP) that was led by Dinah Arce of Internal Audit. Ms. Arce identified improvement recommendations similar to those referred to by Mr. Ybarra. Ms. Barrett indicated that her team would follow up on those recommendations and report to the Board next quarter regarding the status of implementing those recommendations. The plan is to have everything implemented by next quarter. No questions were asked by members of the Committee.

3. RECEIVE REPORTS ON INVESTMENT AUDITS AND COMPLIANCE

A. State Auditor's Report on the Audit of Incentive Compensation at Selected Agencies

Mr. Michael Clayton, Audit Manager with the State Auditor's Office (SAO), discussed the audit report of incentive compensation plans of four state agencies, including TRS. Mr. Ben Keyfitz with the SAO presented detailed results of the audit and reported that TRS awarded about \$8.6 million to 138 employees and generally awarded and paid incentive compensation in accordance with its policies and procedures for plan year 2015. He also reported that TRS overpaid a total of \$2,236 to nine employees due to incorrect calculation. He said that TRS used a performance target that differed from what was documented in the plan resulting in the overpayment and that this was not detected by staff during the review. He reported that TRS made changes to the amount paid for plan year 2014 after the SAO conducted its audit and that the changes resulted in TRS paying an additional \$22,453 to one employee of which \$5,613 was incorrectly recorded in the general ledger as a one-time payment, rather than as incentive compensation. It was noted that the overall risk assessment for TRS is low and coded as green using the SAO coloring system.

Mr. Brian Guthrie commented that TRS is looking for an off-the-shelf product to help reduce the number of keystrokes and limit the opportunity for this kind of error to occur in the future. The plan is to implement this product this summer.

B. Internal Audit's Testing of Performance Incentive Pay Calculations

Mr. Hugh Ohn of Internal Audit presented the report concerning the testing of incentive compensation calculations. Mr. Ohn indicated that this year's testing was more formal and was conducted in accordance with procedures agreed upon by the Chief Financial Officer (CFO). Ms. Barrett explained that Mr. Ohn has become familiar with the process and double-checks calculations before payment is made. Mr. Ohn added that the SAO audit is more comprehensive because it covers not only the calculations process, but also the entire payment cycle and process. Mr. Ohn stated that Internal Audit's testing stops after the calculations process and that the SAO focuses on the accuracy and effectiveness of controls. Mr. Ohn indicated that there are overlaps between the work of Internal Audit and the SAO in this area, but that there are also some differences in scope and testing methodologies.

Mr. Ohn reported that three areas were tested: participant eligibility and salary information; actual award amount; and integrity of Excel calculation worksheets. Two recommendations were reported.

In response to a question from Mr. Kelly regarding how the overpayments were handled, Mr. Ohn said that both Investment Accounting and Internal Audit independently verified the overpayments and that, once verified, staff worked with Human Resources, Payroll, and the CFO to make corrections the following month. Mr. Guthrie said a payroll deduction was entered in lieu of collecting the amount from the employee.

C. Quarterly Investment Compliance Testing (Agreed-Upon Procedures)

Ms. Barrett reported to the Board that Chief Compliance Officer, Heather Traeger, will be part of the compliance presentation to the Audit Committee going forward. She also reported that administration of the internal fraud and ethics hotline would be moved to Ms. Traeger's team. Ms. de Onís added that when the Bylaws come up for review, staff will recommend changing the name of the committee to the Audit and Compliance Committee.

Mr. Ohn reported the testing results for the first quarter of 2016. He indicated that no exceptions were identified. Ms. Traeger reported an internally identified Investment Policy Statement compliance violation involving a manager executing a currency forward with a non-ISDA counterparty. Ms. Traeger indicated that research revealed it was due to a programming issue that occurred when the manager switched from a legacy system to a new accounting system and that the issue has been resolved. There were no questions from Committee members.

Audit Committee Chairman, Mr. Chris Moss commented that bringing the functions together will work very well.

4. RECEIVE REPORTS ON TRS-ACTIVECARE OPEN ENROLLMENT AND BILLING ISSUES AND STATUS, INCLUDING MATTERS RELATED TO RISK MANAGEMENT, INTERNAL CONTROLS, AND INFORMATION SECURITY

Ms. Barrett provided background on TRS-ActiveCare and the numerous complaints regarding the open enrollment process that were brought to TRS' attention. Health Insurance Benefits suggested having an external firm review the open enrollment process and determine whether issues have been resolved by Aetna and WellSystems. Ms. Barrett explained the four items in the presentation package and their layouts, including a list of different issues, the status of work done, and a list of recommendations.

Ms. Barrett introduced Mr. Neil Masterson and Mr. Garrison Phillis with Ernst & Young (EY) and Mr. Greg Wood and Mr. Tony Magliano with Aetna. Mr. Masterson reported that the review included three weeks of field work in Tampa, Florida at WellSystems and site visits to five different school districts. Ms. Barrett joined to visit the school districts and Ms. Toma Miller of Internal Audit participated in the onsite field work. It was stated that field work in some areas was not completed due to the timing of Aetna's remediation efforts. EY representatives said that they are working with TRS and Aetna to identify follow up procedures to perform in early July prior to open enrollment.

Ms. Katrina Daniel thanked Ms. Barrett and EY for their work and reported that Aetna has completed a lot of work since December and shown a strong commitment to improve the situation and take ownership of issues. She said that there is guarded optimism that the

billing and enrollment process will be much smoother than last year. She indicated that one underlying application has some limitations, but that Aetna and WellSystems have worked closely to develop manual workarounds and automated features that will provide for long range solutions. She also reported on discussions concerning improving the reliability of information and setting a new baseline for the Affordable Care Act to passive enrollment to reduce the number of data points. She also said that one other change to improve the situation would be to end the enrollment period sooner to allow for time to make sure that the data is clean, cards are issued, and all other measures are taken before coverage actually begins. Ms. Daniel stated that staff will implement a reporting process throughout the enrollment to stay on top of the progress of the enrollment and review complaints and completion rates. She also indicated that staff will be looking at trends and the discrepancy report to make sure that the error rate and volume of problem are not growing. Finally, she mentioned that staff will better communicate with benefit administrators and conduct training to make sure that benefit administrators engage their employees, ensure information that is entered into the system is correct, and stay on top of their billing to ensure accuracy.

Mr. Wood of Aetna indicated that Aetna also has guarded optimism for this open enrollment. He said two things Aetna wanted from the audit were: validation of the recovery plan they put into place and identification of gaps in Aetna's plan. On both counts, the audit was a success from Aetna's perspective. Mr. Wood discussed short-term and medium-term planned actions for areas, including enhancements with the MESA vendor, enhanced MESA reporting, and that the enhancements are being tested and scheduled for release prior to July 1. He explained that the discrepancy report is a key control allowing Aetna and school districts to identify differences between their systems and take proactive action to resolve those differences. He stated that all short- and medium- term planned actions will be completed before open enrollment. For long term and automation solutions, he said that Aetna is working aggressively with the portal vendor to increase the throughput without having to undertake manual intervention on MESA transactions.

Ms. Barrett indicated that a status report of the follow up testing will be presented to the Audit Committee at the July committee meeting and that next year there may be some additional follow-up work concerning some long term issues, to include certain data vulnerability issues. Ms. Barrett also complimented Ms. Miller, stating that she is good with operations and she makes sure that policies and procedures are in good shape, and that everyone knows what they are supposed to be doing.

Dr. Gibson asked a questions about the timeline horizons in one of the charts and Board Chairman Kelly asked whether TRS needs to monitor the process during the enrollment. Ms. Daniel responded that, in addition to the weekly call with Aetna and WellSystems, staff has put into place a pulse report that will measure how things are going and allow for things that are out of line to be addressed early on.

5. RECEIVE REPORTS ON EMPLOYER AUDITS

A. Summary of Employer Audit Reports

B. Audit of Manor Independent School District

C. Audit of Liberty Hill Independent School District

D. Audit of Beaumont Independent School District

E. Audit of Daingerfield-Lone Star Independent School District

Ms. Barrett stated that four reporting entity audits have been completed. Ms. Dinah Arce explained the audit process of reporting entity and the one-pager summary report for the new trustees. Mr. Mata reported on problems that were discovered, including incorrect usage by districts of the state minimum salary schedule, the failure to subtract federal fund salary dollars from the TRS salary when computing the minimum report contribution, paying statutory minimum contributions for new members, and miscoding district employees in the payroll system. He said that the complexity of the statutory minimum formula contributes to the inaccurate reporting and payments by districts and that districts are too dependent on software providers and internal payroll systems in performing calculations. He also stated that in determining the eligibility of active members and the calculation of TRS-Care surcharges, districts need to track the hours worked by active members and rehired retirees because many retirees hired were misclassified and some errors were found in the areas of contracted workers. Some situations were referred to the Legal department to further review and make determinations.

Ms. Barbie Pearson reported on the process used for resolving identified issues with reporting entities, saying that staff reviewed the audit report summary and cross-checked calculations with those of Internal Audit to verify the corrections that were needed before reaching out to the districts. She also stated that staff work with the districts for those identified in the audited month, but also go back to every submitted report to determine if any additional corrections are needed.

Ms. Barrett commented that 15 REs had been audited, the most common errors concerned the pension surcharge and TRS-Care surcharge for returned retirees that surcharges were being under-reported and therefore under-collected, and that other areas of concern include the statutory minimum calculation that impacts the amount of employer contribution and the non-OSADI contribution. She indicated that staff would report back in September regarding more targeted work that may take place, especially in the area of employment after retirement, to see if monies can be recouped.

Dr. Gibson suggested that the strategic partnership with the education service centers and the Texas Association of School Business Officials (TASBO) could benefit from these efforts. Ms. Barrett agreed, stating that TRS was invited to speak to TASBO when the audit project was kicked off. She also stated that there are opportunities to extend audit coverage to software applications maintained at the regional service centers. Ms. Pearson added that staff would develop more comprehensive training materials and payroll reporting procedures manuals.

6. RECEIVE REPORTS ON OUTSTANDING RECOMMENDATIONS

A. Status of prior employer audit recommendations

Ms. Pearson reported on the status of recommendations, stating that they are shown as “closed” for the audited month reported, and that the majority of corrections found will be on the June report that comes in July.

B. Status of prior audit and consulting recommendations

Ms. Barrett reported on the status of all other audit recommendations, stating that all are making satisfactory progress. She stated that one item in orange is about to be implemented and will turn green in the next report and that some items in blue are scheduled to be reviewed and validated in a follow-up audit next year.

7. DISCUSS OR CONSIDER INTERNAL AUDIT ADMINISTRATIVE REPORTS AND MATTERS RELATED TO GOVERNANCE, RISK MANAGEMENT, INTERNAL CONTROL, COMPLIANCE VIOLATIONS, FRAUD, REGULATORY REVIEWS OR INVESTIGATIONS, NEW AND OUTSTANDING COMPLAINTS, FRAUD RISK AREAS, AUDITS FOR THE ANNUAL INTERNAL AUDIT PLAN, OR AUDITORS' ABILITY TO PERFORM DUTIES

Ms. Barrett stated that Internal Audit is on track to complete all audits in the Audit Plan. She reminded the Committee to look at the Chief Audit Executive's personal goals and the status of these goals. She advised the Committee that the federal government is increasing their oversight and audits of HIPAA-covered entities. She stated that the Office of Civil Rights of the U.S. Health and Human Services has contacted TRS for purposes of updating our information. Ms. Barrett indicated that Internal Audit will include in next year's audit plan a gap assessment, so that TRS will be prepared in case TRS is notified of an audit.

She also advised the Committee that staff is preparing for next year's annual audit plan and asked the Committee to reach out to her or contact Mr. Moss if they have any concerns or requests. Finally, Ms. Barrett introduced two new full time staff members, Mr. Rodrigo Dominguez and Ms. Anandhi Mani, both of who are in Mr. Ohn's investment audit team, and one new Intern, Ms. Lan Zhu.

The meeting adjourned at 9:27 a.m.

Approved by the Audit Committee of the Board of Trustees of the Teacher Retirement System of Texas on the 29th day of July 2016.

Attested by:

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

TAB 2

MEMORANDUM

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

FROM: Amy Barrett, Chief Audit Executive; Jerry Albright, Managing Director, TRICOT

SUBJECT: Approval of financial auditors for FY16 financial statements

DATE: July 29, 2016

Request

TRS is seeking a recommendation by the Audit Committee to the TRS Board of Trustees to authorize selection and engagement of independent auditors for the financial audits of the following:

- Teacher Retirement Investment Company of Texas Ltd. (“TRICOT”) (TRS London Office subsidiary), for its initial year ending August 28, 2016.
- TRS Comprehensive Annual Financial Report (CAFR) for the year ending August 31, 2016

Under Sec. 825.214, Government Code, a person employed to perform a financial audit of the retirement system must be selected by and report to the board of trustees. Under Section 825.103(d), the retirement system has exclusive power and authority to engage professional services when pension assets are used to pay for them.

Background

In 2015, TRS opened a wholly-owned subsidiary in London to assist in sourcing private investment opportunities. Although TRS determined that there is no requirement for a financial audit of the subsidiary as it meets the audit exemption in the UK Companies Act 2006 based on its size and revenue, TRS staff believe that an audit by independent auditors experienced in conducting similar audits would be prudent given the unique nature of the entity. Using the responses to the latest Audit Services Request for Qualifications, TRS Internal Audit identified two qualified and willing firms to conduct the audit (Grant Thornton and Weaver) and solicited relevant information from both. Staff from Investments, Accounting, and Internal Audit reviewed the information and identified a vendor, Grant Thornton, whom we are recommending conduct the TRICOT financial audit. Although we do not believe that the engagement of a financial auditor for TRICOT requires board or SAO approval under existing statutes, TRS is coordinating TRICOT’s audit engagement with the SAO.

Additionally, since the board’s formal approval for the selection of the SAO to perform the CAFR audit has not been recorded in the board’s more recent minutes, we also request authorization for the selection of the SAO to conduct the Fiscal Year 2016 CAFR audit.

TAB 3

CONFIDENTIAL PRIVATE DOCUMENT - NOT SUBJECT
TO PUBLIC DISCLOSURE - GOVERNMENT CODE §
552.139 relating to exception to disclosure for government
information relating to security issues for computers.

TAB 4

TESTING OF EXECUTIVE PERFORMANCE INCENTIVE PAY PLAN CALCULATION

Plan Year Covering December 1, 2015 through June 30, 2016

TRS Internal Audit Department

Business Objectives	To calculate and award performance incentive compensation amounts accurately and in accordance with the Executive Performance Incentive Pay Plan
Business Risks	<ul style="list-style-type: none">• Incorrect performance or benchmark data used• Incorrect formulas included in calculation worksheets• Mathematical errors• Manual entries or overrides
Management Assertions	<ul style="list-style-type: none">• Correct metrics, peer group performance, and qualitative scores are used for calculations• Calculation worksheets contain correct formulas are free from mathematical errors
Agreed-upon Procedures	<ul style="list-style-type: none">• Obtain performance variables from source data• Develop calculation worksheets to include correct formulas for independent calculation of performance variables• Verify whether independently calculated performance results match calculation results performed by Human Resources department.• Reconcile any identified difference and provide observations for process improvements to Human Resources management
Test Results	No exceptions noted. Calculated a 5% incentive award.
Management Comment	Not Applicable

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



July 27, 2016

Janet Bray, Plan Administrator

Subject: Report on Independent Testing of Executive Performance Incentive Pay Plan Calculation

We have completed the **Testing of Executive Performance Incentive Pay Plan Calculation** effective for the period from December 1, 2015 through June 30, 2016. We performed the procedures that were agreed to by you as summarized in the table below.

AGREED-UPON PROCEDURES AND RESULTS

Independent Calculation Procedure	Result
1. Obtained performance variables from source data	Obtained all variables.
2. Developed calculation worksheets to independently calculate the incentive award using performance variables obtained.	Created calculation worksheets.
3. Compared independently calculated performance results with results calculated by Human Resources department	Calculated a 5% incentive award
4. Reconciled and reported any identified difference as well as provided observations for plan process and calculation improvements to the plan administrator and plan interpreter	No differences noted.

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 management of the departments specified in this report. Consequently, we make no representations regarding the sufficiency of the procedures performed either for the purpose for which this report has been requested or for any other purpose.

Internal Controls

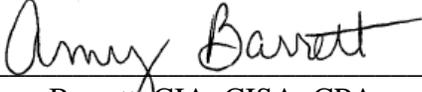
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas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

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

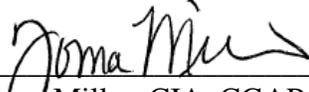
This report is intended solely for information and use by TRS management, the Board of Trustees, and legislative oversight agencies, and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is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

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We express our appreciation to management and key personnel of the Human Resources and Legal Services departments for their cooperation and professionalism shown to us during this project.



Amy Barrett, CIA, CISA, CPA
Chief Audit Executive



Toma Miller, CIA, CGAP
Senior Internal Auditor



Jan Engler, CIA, CISA, CFE
Director of Benefit Audits