

Audit Committee Meeting

June 2013



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

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

*(Christopher Moss, Chair; Ms. Charleston; Mr. McDonald; Ms. Palmer; & Ms. Sissney,
Committee Members)*

AGENDA

**June 14, 2013 – 8:00 a.m.
TRS East Building, 5th Floor, Boardroom**

A quorum of the Audit Committee (Committee) of the TRS Board of Trustees (Board) and the Board will be physically present for the Committee's June 14, 2013 meeting at the following location: 1000 Red River Street, Austin, Texas 78701 in the TRS East Building, 5th Floor, Boardroom. The Committee and Board intend to have a quorum of the Committee and Board physically present at that location. One or more members of the Committee or Board may participate remotely in the Committee meeting by telephone conference call under Texas Government Code Section 551.130.

- 1. Approve Minutes of April 19, 2013 Audit Committee Meeting**
 - Mr. Christopher Moss, Chair
- 2. Receive State Auditor's Office Report on Audit of Incentive Compensation**
 - Ms. Angelica Ramirez and Mr. Michael Clayton, State Auditor's Office
- 3. Receive Report on Internal Audit's External Quality Assurance Review**
 - Ms. Karin Hill, Chief Audit Executive, Texas Department of Assistive and Rehabilitative Services
- 4. Receive Status Report on Employer Audits and Consider Recommendation to the Board of Trustees Regarding Revisions to the Audit Plan for Fiscal Year 2013**
 - A. Status of the Employer Audit Project – Ms. Karen Morris
 - B. Proposed Revisions to Fiscal Year 2013 Audit Plan – Ms. Amy Barrett
- 5. Receive Internal Audit Reports**
 - A. Audit of Health Care Administration – Ms. Jan Engler, Ms. Dinah Arce, and Mr. Bob Jordan
 - B. Audit of Emerging Manager Program – Mr. Hugh Ohn and Mr. Stuart Bernstein; Jason Lamin, Lenox Park LLC
 - C. Quarterly Investment Testing (Agreed-Upon Procedures) – Mr. Hugh Ohn and Mr. Brian Gomolski
- 6. Receive Status of Prior Audit and Consulting Recommendations**
 - Ms. Amy Barrett
- 7. Receive Internal Audit Administrative Reports** – Ms. Amy Barrett

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 a quorum of the Board may attend the Committee meeting, 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
April 19, 2013**

The Audit Committee of the Teacher Retirement System of Texas met on Friday, April 19, 2013 in the 5th floor Board room. The following persons were present:

TRS Board Members

Christopher Moss, Audit Committee Chair
Nanette Sissney, Audit Committee Member
Anita Smith Palmer, Audit Committee Member
T. Karen Charleston, Audit Committee Member
R. David Kelly, Board Chair
Charlotte Clifton, Board Vice Chair
Todd Barth, 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
Terry Harris, Senior Investment Compliance Specialist, Internal Audit
Dorvin Handrick, Senior Information Technology Auditor, Internal Audit
Brian Gomolski, Senior Investment Auditor, Internal Audit
Toma Miller, Auditor, Internal Audit
Amy Morgan, Chief Information Officer
T.A. Miller, Deputy Information Officer
Chris Cutler, Manager, Network Infrastructure & Support, Information Technology
Noel Sherman, Manager, Client Services and Support, Information Technology
Britt Harris, Chief Investment Officer
Jerry Albright, Deputy Chief Investment Officer
Sylvia Bell, Director, Administrative Center, Investment Division
Jase Auby, Managing Director of Risk, Investment Division
Curt Rogers, Managing Director, Tactical Asset Allocation, Investment Division
David Veal, Chief of Staff to the Chief Investments Officer, Investment Division
Susan Wade, Professional Development Specialist, Investment Division
Carolina de Onis, General Counsel
Dennis Gold, Assistant General Counsel
Dan Junell, Assistant General Counsel

TRS Staff (cont'd)

Timothy Wei, Assistant General Counsel
Angela Vogeli, Assistant General Counsel
Cindy Haley, Team Leader, Financial Reporting, General Accounting
Scot Leith, Manager, Investment Accounting, General Accounting
Janet Bray, Director, Human Resources
Shunne Powell, Program Coordinator, Human Resources
Cindy Yarbrough, Organizational Development Specialist, Human Resources
Marianne Woods Wiley, Chief Benefit Officer
Tom Guerin, Manager, Benefit Counseling
Barbie Pearson, Assistant Manager, Benefit Counseling
Betsey Jones, Director, Health Care Policy and Administration
Bob Jordan, Director, TRS Health & Insurance Benefits
Yimei Zhao, Assistant Director of Finance, TRS Health & Insurance Benefits
Edward Esquivel, Assistant Director, TRS Health & Insurance Benefits
Howard Goldman, Director, Communications
Rebecca Merrill, Special Advisor to the Executive Director & Manager of Special Projects
Jay LeBlanc, Director, Risk Management & Strategic Planning
Michelle Pagán, ERM Specialist, Risk Management & Strategic Planning
Jay Masci, TEAM Program Manager, Provaliant
Wendy Sanchez, Financial System Replacement Program Manager, Provaliant
Andrea Anderson, TEAM Program Independent Program Assessment (IPA), Bridgepoint Consulting LLC
Michael Johnson, TEAM Program IPA, Bridgepoint Consulting LLC

Other Attendees

Emma Mayton, Texas Retired Teachers Association, Austin Retired Teachers Association
Ralph McClendon, State Auditor's Office
Sally Reaves, Sagebrush Solutions, LLC
Rene Hernandez, Protiviti Inc.
Joe Wojkowski, Protiviti Inc.
Victor Ferreira, Hewlett Packard
Andy Tonkovich, Hewlett Packard
Ernie Sanders, Hewlett Packard
David Runyan, Express Scripts Inc.
Carol Riley, Blue Cross Blue Shield of Texas
Ron Franke, Myers and Stauffer LC
Rodney Almaraz, Myers and Stauffer LC
Michael Dean, Myers and Stauffer LC
Steven Huff, Reinhart Boerner Van Deuren s.c.

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

1. APPROVE MINUTES OF DECEMBER 14, 2012 AUDIT COMMITTEE MEETING

On a motion by Ms. Nanette Sissney, the proposed minutes of the December 14, 2012 Audit Committee meetings were approved as presented.

2. RECEIVE ETHICS REPORTS

A. State Auditor's Office Report on Ethics Policies Follow-Up Audit

Mr. Ralph McClendon, State Auditor's Office, presented the results of the Follow-up Audit Report on the Ethics Policies for Trustee Investing Practices at the Employees Retirement System, the Teacher Retirement System, and the University of Texas Investment Management Company. He stated that the purpose of the audit was to review the implementation status of a prior audit conducted in April 2009. Of the 13 recommendations that were reviewed for TRS, he stated that 12 were fully implemented and one was substantially implemented. The one recommendation that was substantially implemented dealt with background checks. He stated that TRS made significant progress in considering and implementing that recommendation and was able to cover the risks identified in the initial audit.

B. TRS Ethics Ratings in the Survey of Employee Engagement

Ms. Amy Barrett reviewed the results of the ethical ratings contained in the Survey of Employee Engagement from August 2012 and prior years. In 2012, TRS scored a 4.10 (out of 5) for ethical climate compared to similar-size organizations that scored 3.95 and organizations with a similar mission that scored 4.0. In addition, TRS scores in this area have increased since the inception of the report in 1998 when TRS scored a 3.85, reflecting a positive trend in the ethical environment at TRS.

3. RECEIVE INDEPENDENT AUDIT REPORT ON TRS-ACTIVECARE SERVICE PROVIDERS

Ms. Sally Reaves, Sagebrush Solutions, LLC, presented the results of the independent audit of the TRS-ActiveCare service providers. The audit reviewed the claim administration services of medical plan administrators Blue Cross Blue Shield of Texas (BCBSTX), First Care, Valley Baptist, and Scott & White Health Plan. The audit also reviewed claim administration services for the pharmacy plan administered by Express Scripts Inc. (ESI). No significant findings resulted from the audit; however, three recommendations were made that included two recommendations regarding BCBSTX and one recommendation regarding ESI.

4. RECEIVE INTERNAL AUDIT REPORTS

A. Audit of Derivatives

Mr. Hugh Ohn gave an overview of the current and past derivatives audits conducted by Internal Audit. He stated that derivatives were initially being used to gain exposure to certain asset classes through total return swaps. However, over the past few years, their use has become more

complicated with the Investment Management Division (IMD) currently utilizing derivative instruments to manage risk and/or modify asset allocations as part of portfolio overlay strategies. Due to the complexity of the different models and derivative strategies being used, Internal Audit brought in outside consultants from Protiviti to provide expertise in these areas.

Mr. Joe Wojkowski, Protiviti, presented the results of the derivatives audit. He stated that the audit focused primarily on model governance and looked at the controls in place for the various models used in making derivatives investment decisions. Overall, no significant risks were identified during the audit and three recommendations were made to enhance controls.

B. Quarterly Investment Testing

Ms. Barrett reviewed the results of the quarterly investment testing. She stated that one exception was found this quarter regarding a wire transfer protocol not being followed. State Street bank failed to perform a call back regarding one transfer. No other issues were noted during the testing. Investment Accounting has taken the necessary steps to prevent this issue going forward.

C. Audit of Backup and Recovery

Rodney Almaraz, Myers and Stauffer LC, presented the results of the Audit of Backup and Recovery. He stated that the audit reviewed the policies and procedures in place within Information Technology concerning two primary functions: performing backups and recovering data backups. No significant risks were identified and three recommendations were made.

Mr. T.A. Miller stated that management reviewed the recommendations and decided to accept the risk associated with storing backup tapes within 10 miles of TRS and has implemented the other two recommendations.

D. Audit of Telephone Counseling Center Performance Measures

Mr. Michael Dean, Myers and Stauffer LC, presented the results of the Audit of Telephone Counseling Center Performance Measures. He stated that the audit had two main objectives. The first was to determine if the average speed of answer (ASA) performance measure is in accordance with the methodology presented in the TRS Strategic Plan. The second was to determine whether Telephone Counseling Center (TCC) governance is effective in managing speed of answer.

Mr. Dean stated that testing found significant issues with information accuracy produced by the Siemens OpenScape Contact Center application. These inaccuracies resulted in ASA figures being unreliable during fiscal year 2012 as well as September 2012. Issues with the ASA calculations were first discovered by TRS in February 2012, and were escalated to Siemens at that time. Siemens attributed the issue to programming errors that resulted in ASA numbers being overstated. Mr. Dean added that alternative calculations made by TRS during this period, though based on internal data and using reasonable methodology, may still be inaccurate because the calculations still relied in part upon data from OpenScape.

In regards to the governance of the TCC, Mr. Dean stated that testing found the governance processes to be effective in managing average speed of answer. He stated the results also indicated that service level is a more commonly used measure than average speed of answer in managing wait times.

Ms. Marianne Woods Wiley and Mr. Tom Guerin presented management actions taken and planned to address the audit results.

E. Semi-Annual Testing of Benefit Payments

Ms. Barrett reviewed the results of the Semi-Annual Benefits Payment testing. She noted that three minor errors were found. All three have been corrected. In addition, procedures have been put in place and staff training is occurring to prevent these types of errors going forward.

5. 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 expected to be implemented by August 2013. She noted that the outstanding recommendation regarding a State Street change will be addressed with the contract renewal in January 2013.

6. RECEIVE INTERNAL AUDIT ADMINISTRATIVE REPORTS

Ms. Barrett reviewed several standard administrative reports. She indicated that Internal Audit is on track to meet performance standards. She also noted that a couple of changes to the Audit Plan will be presented for approval at the June Audit Committee meeting. Ms. Barrett also informed the Committee that the Comptroller's Office will be performing a post-payment audit of TRS purchases and payments beginning in May. She stated that this audit is generally conducted every five years.

The meeting adjourned at 9:45 a.m.

Approved by:

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

TAB 2



John Keel, CPA
State Auditor

An Audit Report on

**Incentive Compensation at
the Teacher Retirement System,
the Permanent School Fund, and
the Employees Retirement
System**

April 2013
Report No. 13-033



An Audit Report on
***Incentive Compensation at
the Teacher Retirement System,
the Permanent School Fund, and
the Employees Retirement System***

SAO Report No. 13-033
April 2013

Overall Conclusion

Through their incentive compensation plans for plan year 2012, the Teacher Retirement System (TRS) and the Permanent School Fund (PSF) of the Texas Education Agency made incentive compensation awards to employees in accordance with their policies and procedures. However, both TRS and the PSF could strengthen their incentive compensation plan oversight by formally requiring annual approval or confirmation of those plans. Although the TRS board of trustees confirms the continuation of the TRS incentive compensation plan each year, the approved incentive compensation plan does not require that confirmation.

Similarly, although the commissioner of education approved the PSF incentive compensation plan, the commissioner was not required to do so.

The Employees Retirement System (ERS) did not always award incentive compensation in accordance with its policies and procedures. Auditors identified the following:

- ERS did not finalize its written incentive compensation plan until April 2012, which was seven months after the beginning of its plan year. On August 23, 2011, the board of trustees approved certain changes to the incentive compensation plan (see Appendix 2 for an excerpt from the board of trustees meeting minutes). However, ERS subsequently made additional changes and did not present those changes to the board of trustees. Those changes redefined how the amounts of incentive compensation would be calculated for the individuals in those positions for plan year 2012. Those changes modified the incentive compensation calculation metrics for 60 percent of the individuals eligible for incentive compensation.
- The ERS executive director was eligible to receive incentive compensation through the ERS incentive compensation plan. However, the ERS executive director received a one-time 50 percent merit increase of \$162,501 from the ERS board of trustees "...in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership...the interim benefits study, and her skills as a member of the internal investment committee..." ERS paid the executive

Incentive Compensation for Plan Year 2012

TRS, PSF, and ERS awarded a total of \$11,379,096 in incentive compensation to 174 employees through their incentive compensation plans for plan year 2012. Specifically:

- TRS awarded \$8,321,095 to 109 employees.
- The PSF awarded \$1,233,649 to 23 employees.
- ERS awarded \$1,824,352 to 42 employees.

director that merit increase in November 2012. See Appendix 3 for an excerpt from the board of trustees meeting minutes.

Summary of Management's Response

TRS and the PSF agreed with the recommendations in this report; ERS generally agreed with the recommendations in this report.

Summary of Information Technology Review

Auditors tested access controls over spreadsheets containing incentive compensation calculations at TRS, the PSF, and ERS and concluded that access controls at all three entities were adequate.

Summary of Objective, Scope, and Methodology

The objective of this audit was to determine whether incentive compensation at TRS, the PSF, and ERS was calculated and paid in accordance with policies and procedures.

The scope of this audit covered incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

The audit methodology included collecting information and documentation from the audited entities; reviewing incentive compensation plans, policies and procedures, applicable statutes, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests. Auditors selected a judgmental sample of incentive compensation payments at each audited entity and verified that recipients tested were eligible to receive payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the plans. As noted above, auditors also tested access controls at the audited entities.

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Detailed Results

Chapter 1

TRS Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The TRS Incentive Compensation Plan

TRS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: *Pure View Report*, State Street Global Services.

The Teacher Retirement System (TRS) awarded incentive compensation for its plan year ended September 30, 2012, in accordance with its policies and procedures.

TRS awarded a total of \$8,321,095 in incentive compensation to 109 employees.¹ TRS awarded the most incentive compensation to its chief investment officer, who received \$483,754 payable over a two year-year period. That \$483,754 represented 6 percent of the \$8,321,095 in total incentive compensation that TRS awarded.

The TRS incentive compensation plan is based on a combination of investment performance and qualitative performance. The investment performance component compares investment performance with benchmarks and the performance of other large public funds. The qualitative performance component assesses performance in a variety of areas such as ethics, decision making and judgment, and analytical skills.

The TRS incentive compensation plan measures investment performance on both a one-year basis and a three-year basis. For the year ended September 30, 2012, TRS investments generated an excess positive return of 1.17 percent (117 basis points) over the benchmark for the three-year period and an excess positive return of 1.29 percent (129 basis points) over the benchmark for the one-year period. TRS's incentive compensation plan weights the three-year return twice as much as the one-year return. TRS met its goals for both the one-year and three-year periods; therefore, this triggered the awarding of incentive compensation.

To determine incentive compensation amounts, TRS followed the incentive compensation plan its board of trustees approved. However, the TRS incentive compensation plan does not require the board of trustees to confirm the continuation of that plan annually. Requiring formal confirmation of the continuation of the incentive compensation plan could help to ensure that the plan remains aligned with the intent of the board of trustees. It could also help ensure compliance with Rider 14, pages III-32 through III-33, General Appropriations Act (82nd Legislature), which specifies that the board of trustees may make performance incentive compensation payments "...based on investment performance standards adopted by the Board prior to the beginning of the period for which any additional compensation is paid."

¹ As of February 1, 2013, TRS paid employees \$4,160,547 of the \$8,321,095 it awarded; \$4,160,548 was due to be paid in 2014.

Recommendation

TRS should update its incentive compensation plan to include a requirement for the board of trustees to confirm the continuation of that plan prior to the beginning of each plan year.

Management's Response



www.trc.state.tx.us

800.223.8778
512.542.6400

Brian K. Guthrie
Executive Director
1000 Red River Street
Austin, Texas 78701-2698

April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: TRS Management Response to Audit of Incentive Compensation.

The following is TRS's management response to the recommendation noted in the State Auditor's Office Audit Report on Incentive Compensation.

Recommendation

TRS should update its incentive compensation plan to include a requirement for the board of trustees to confirm the continuation of that plan prior to the beginning of each plan year.

Management's Response

TRS agrees with the recommendation to include a requirement for the board of trustees to confirm the continuation of that plan. We will add language noting the required board of trustee confirmation beginning with the 2013-2014 incentive plan year.

Sincerely,

Brian Guthrie
Executive Director

The PSF Awarded Incentive Compensation in Accordance With Its Policies and Procedures

The PSF Incentive Compensation Plan

The PSF calculates investment returns for its incentive compensation plan on a gross-of-fees-paid-to-external-manager basis.

Source: Mellon Bank Performance Calculation Worksheet.

The Permanent School Fund (PSF) of the Texas Education Agency awarded incentive compensation for its plan year ended July 31, 2012, in accordance with its policies and procedures.

The PSF awarded a total of \$1,233,649 in incentive compensation to 23 employees.² The PSF awarded the most incentive compensation to its deputy chief investment officer, who received \$126,502 payable over a two-year period. That \$126,502 represented 10 percent of the \$1,233,649 in total incentive compensation that the PSF awarded.

The PSF incentive compensation plan compares investment performance with a target benchmark on a three-year rolling basis. The PSF calculates incentive compensation based on an employee's achievement of goals in fund performance, asset class performance, and portfolio performance. Because investment performance exceeded the benchmark, this triggered the awarding of incentive compensation. Specifically, the total fund investment performance:

- Exceeded the target benchmark by 0.70 percent (70 basis points) for the three-year period from August 1, 2009, to July 31, 2012.
- Exceeded the target benchmark by 0.52 percent (52 basis points) for the two-year period from August 1, 2010, to July 31, 2012.
- Exceeded the target benchmark by 0.52 percent (52 basis points) for the one-year period from August 1, 2011, to July 31, 2012.

The former commissioner of education suspended the PSF incentive compensation plan in August 2011 and reinstated it retroactively with no changes in June 2012. The PSF incentive compensation plan requires the commissioner of education to approve the list of participants who are eligible for the incentive compensation plan within 60 days of the plan's start date. However, because the incentive compensation plan was suspended at the beginning of the plan year, the PSF did not obtain that approval at the beginning of the plan year. The current commissioner of education approved the list of eligible participants on December 5, 2012.

The PSF incentive compensation plan also does not require the commissioner of education to formally approve the incentive compensation plan prior to the beginning of a plan year. Requiring formal approval of the incentive compensation plan could help to ensure that the plan aligns with the intent of the commissioner of education. It also could help ensure compliance with Rider 22,

² As of December 10, 2012, the PSF had paid employees \$616,825 of the \$1,233,649 it had awarded; \$616,824 was due to be paid in late 2013.

page III-11, General Appropriations Act (82nd Legislature), which specifies that payments from the incentive compensation plan "...must be based on investment performance standards set prior to the beginning of the period for which any additional compensation is paid."

Recommendations

The PSF should:

- Ensure that the commissioner of education approves the list of participants eligible for the incentive compensation plan within 60 days of the plan's start date.
- Update its incentive compensation plan to include a requirement for the commissioner of education to formally approve that plan prior to the beginning of a plan year.

Management's Response



1701 North Congress Ave. • Austin, Texas 78701-1494 • 512 463-9734 • 512 463-9838 FAX • www.tea.state.tx.us

Michael L. Williams
Commissioner

April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: TEA Management Response for an Audit of Incentive Compensation at the Teacher Retirement System, the Employees Retirement System, and the Permanent School Fund.

Dear Mr. Clayton:

The following responses are provided in relation to SAO recommendations:

- TEA management agrees with this recommendation and will establish procedures to ensure that the Commissioner timely approves the list eligible Incentive Compensation Plan Permanent School Fund (PSF) employees for each cycle.
- TEA management will consider combining the annual approval of eligible PSF plan participants with an annual approval of the plan by the commissioner of education. Global Governance Advisors, the consultant hired by TEA management, is making recommendations for amending the current plan language and this matter will be provided to them for their consideration.

Please let me know if you require anything further.

Sincerely,

A handwritten signature in blue ink, appearing to read "Lizzette C. González Reynolds".

Lizzette C. González Reynolds
Chief Deputy Commissioner

LCGR/cc

cc: Michael L. Williams
Holland Timmins
William Wilson

ERS Did Not Always Award Incentive Compensation in Accordance With Its Policies and Procedures

The ERS Incentive Compensation Plan

ERS calculates investment returns for its incentive compensation plan on a net-of-fees-paid-to-external-managers basis.

Source: ERS incentive compensation plan.

The Employees Retirement System (ERS) did not always award incentive compensation for its plan year ended August 31, 2012, in accordance with its policies and procedures.

ERS awarded a total of \$1,824,352 in incentive compensation to 42 employees.³ ERS awarded the most incentive compensation to its director of public equities, who received \$118,298 payable over a three-year period. That \$118,298 represented 6 percent of the \$1,824,352 in total incentive compensation that ERS awarded.

The ERS incentive compensation plan is based on a combination of investment performance and, for certain employees, qualitative performance. The investment performance component compares investment performance to a benchmark. The qualitative performance component assesses items such as an employee's development of hedge fund strategies and implementation of an emerging manager program. Although ERS did not meet its performance benchmark of 8.11 percent, the total fund performance was positive 8.04 percent (804 basis points), which triggered the awarding of incentive compensation.

Auditors identified the following:

- ERS did not finalize its written incentive compensation plan until April 2012, which was seven months after the beginning of its plan year. On August 23, 2011, the board of trustees approved certain changes to the incentive compensation plan (see Appendix 2 for an excerpt from the board of trustees meeting minutes). However, ERS subsequently made additional changes and did not present those changes to the board of trustees. Those changes redefined how the amounts of incentive compensation would be calculated for the individuals in those positions for plan year 2012. Those changes modified the incentive compensation calculation metrics for 60 percent of the individuals eligible for incentive compensation.
- The ERS executive director was eligible to receive incentive compensation through the ERS incentive compensation plan. However, the executive director received a one-time 50 percent merit increase of \$162,501 from the ERS board of trustees "...in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership... the interim benefits study, and her skills as a member of the internal investment committee..." ERS paid the executive director that merit increase in November 2012. While ERS asserted that merit increase was not paid

³ As of December 1, 2012, ERS paid employees \$912,602 of the \$1,824,352 it awarded; \$446,510 is due to be paid in late 2013, and \$446,510 is due to be paid in 2014.

through the incentive compensation plan, its accounting records indicated that ERS charged that merit increase to the expense object code used to record incentive compensation plan payments. The executive director's merit increase was the only non-incentive-compensation bonus charged to that expense object code during the plan year. See Appendix 3 for an excerpt from the board of trustees meeting minutes.

- ERS calculated two employees' incentive compensation based on the full plan year when those employees were not eligible to participate in the incentive compensation plan until November 2011, which was two months after the beginning of the plan year. As a result, those employees received a total of \$21,372 or 16.7 percent more in incentive compensation than they should have received. A third employee's incentive compensation should have been between \$56,762 and \$73,790; however, ERS awarded that employee \$37,460 in incentive compensation and did not provide documentation explaining that amount.
- The ERS incentive compensation plan does not require the board of trustees to formally approve the incentive compensation plan prior to the beginning of a plan year. This increases the risk that the incentive compensation may not align with the intent of the board of trustees.

Recommendations

ERS should:

- Finalize its incentive compensation plan prior to the beginning of a plan year.
- Calculate and award incentive compensation based on its incentive compensation plan, and consistently document its reasons for any deviation from that plan.
- Update its incentive compensation plan to include a requirement for the board of trustees to formally approve that plan prior to the beginning of a plan year.

Management's Response

ERS

EMPLOYEES' RETIREMENT
SYSTEM OF TEXAS

STATE AUDITOR'S OFFICE
1100 NORTH BRAY AVENUE, SUITE 1100, AUSTIN, TEXAS 78701-1100

April 23, 2013

State Auditor's Office
ATTN: Michael Clayton
P.O. Box 12067
Austin, Texas 78711-2067

Subject: SAO Incentive Compensation Audit – Management Responses

ANN S. BISHOP
EXECUTIVE DIRECTOR

CHERYL MACBRIEN
CHAIR

BRIAN D. BAUGHMAN
VICE-CHAIR

BOARD OF TRUSTEES
CYDNEY C. DONNELLY
YOLANDA GRIFFIN
TERRA HESTER
JUDERICK T. ROWE, JR.

In response to the State Auditor's Office recommendation to finalize its incentive compensation plan prior to the beginning of a plan year, the Employees Retirement System of Texas (ERS) considered the 2011 Incentive Compensation Plan (ICP) to be (1) the plan document adopted by the ERS Board of Trustees' (Board) as of August 19, 2008 (2008 Plan Document) and (2) the revisions adopted by the Board in the 2011 ICP Matrix (portions of what is documented in Appendix 2 of the report). The Board's motion (enclosed as item 15) adopting revisions to the 2008 Plan Document, in the form of the 2011 ICP Matrix, provided the delegation of authority to the Executive Director to document the revisions in a single plan document and make any additional revisions the Executive Director deemed necessary. The ICP adopted on August 23, 2011 revised the 2008 Plan Document for best practices by: (1) requiring investment division expenses to be netted before performance is calculated for award payments; (2) instituting a clawback¹; (3) providing more detailed documentation in the plan document of the calculation methodology; and (4) allowing awards to be earned during negative absolute trust fund performance, but paid only in a year with positive absolute trust fund performance. The changes made during fiscal year 2012 to individual incentive compensation calculation metrics were consistent with the 2011 ICP Matrix and authority delegated by the Board to the Executive Director.

In regards to the SAO's recommendation requiring the Board to formally approve the ICP prior to the beginning of a plan year, Section 7.3 of the Incentive Compensation Plan requires the Board of Trustees to review the plan at least every 5 years and any changes to the plan document would be presented to the Board of Trustees for review and approval. In response to recommendation, ERS will present a revision to Section 7.3 of the Incentive Compensation Plan to have the Board of Trustees affirm and approve the plan document prior to the beginning of a plan year. Per Section 4.4 of the Incentive Compensation Plan, the Executive Director will approve individual incentive compensation metrics.

¹ Section 6.9 of the ICP provides that under certain circumstances, an incentive compensation award paid to a plan participant may be reduced, forfeited and/or required to be repaid by the participant.

State Auditor's Office
April 23, 2013
Page 2

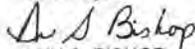
We are in agreement with the recommendation related to the overpayment of two individuals. ERS will pursue a clawback of the overpayments per Section 6.9 of the ICP. ERS has already begun implementing new procedures to ensure proper payment of Incentive compensation for employees who did not participate in the ICP for a full plan year. The enhancements include:

- Increased automation within the calculation process to prorate payment based on date of eligibility
- Enhancing the review process to include additional Investment Division review and approval
- Leverage SharePoint to provide quality documentation of the payout process.

The third employee's difference in the amount awarded was authorized under the discretion allowed in the ICP under Section 6.4. The authorization of discretion being utilized for the revised amount was documented by the Executive Director's approval of the final payment packet. A discretion documentation memo will be included in the future.

While the SAO reported a merit payment to the Executive Director was charged to the object code used to record incentive compensation plan payments, no instance of non-compliance was reported by the SAO nor recommendations related to this observation provided. For fiscal year 2012, the ERS Executive Director did not receive an award under the incentive compensation plan. As documented in Appendix 3 of the Report, the Board did award a merit payment to the Executive Director at its public Board meeting held on September 26, 2012. To ensure proper recording of this merit payment, ERS staff contacted the Texas Comptroller of Public Accounts (CPA) Fiscal Management Division for guidance. The CPA's Fiscal Management Division is responsible for establishing the State's accounting policies including codes used to record expenditures. The CPA's Fiscal Management Division suggested ERS record this payment under the newly established special pay code called the "ERS Bonus code." The ERS Bonus code was established to record bonuses for leadership positions in addition to incentive compensation payments. The CPA does not have a designated expenditure object code for incentive compensation payments, nor does the CPA restrict the ERS Bonus code only to payments made under the incentive compensation plan. Based on guidance from the CPA, ERS recorded this merit payment under the code as suggested.

Sincerely,


ANN S. BISHOP
Executive Director

Enclosures

retirees of \$2,500. Employees have the option to take Optional Life and AD&D plan of 1x, 2x, 3x or 4x earnings to a maximum of \$400,000. Life insurance is a fully insured program under a minimum funding arrangement. The AD&D program is fully insured.

CURRENT PARTICIPATION

Coverage	Members Participating	Life Insurance Volume
Basis Life	300,031	\$1,294,042,500
Basic AD&D (Actives Only)	217,587	\$1,087,935,000
Optional Life 1X earnings	47,514	\$1,963,930,000
Optional Life 2X earnings	113,496	\$9,963,644,000
Optional Life 3X earnings	5,401	\$867,449,000
Optional Life 4X earnings	20,421	\$4,096,912,000
Dependent Life	118,850	\$534,502,500
Voluntary AD&D	131,920	\$17,777,607,000
Short Term Disability	109,684	\$378,809,748
Long Term Disability	92,165	\$349,198,072

Mr. Rob Kukla reported that Benefit Contracts issued an RFP on June 9, 2011, requesting bids for life, AD&D and short and long-term disability coverage. Two bids were received for Life and AD&D insurance. Minnesota Life Insurance and Fort Dearborn Life. One bid was received for administration of the disability plans. ERS exercised its option within the RFP and will re-bid the short and long-term disability contract at a later date.

ERS staff in conjunction with Rudd & Wisdom received the bids for compliance with the RFP contracting and financial information. A financial comparison of the two bids show the administrative cost and the maximum liability in their projection. As a result on the RFP responses, their financial offering and service capabilities staff is recommending that ERS award the Life and Accidental Dismemberment to Minnesota Life effective January 1, 2012.

The Board then took the following actions:

MOTION made by Ms. Cheryl MacBride, seconded by Ms. Yolanda Griego, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas select Minnesota Life Insurance Company as the provider of all Group Term Life Insurance and Accidental Death and Dismemberment Insurance coverage's offered to the Texas Employees Group Benefits Program (GBP) members effective January 1, 2012.

XV. REVIEW, DISCUSSION AND CONSIDERATION OF PROPOSED REVISIONS TO INCENTIVE COMPENSATION PLAN TERMS

During the background discussion of this agenda item it was noted that ERS enlisted Investment Advisory Committee (IAC) Chair Vernon Torgerson, IAC Vice-Chair Milton Hixson and investment consultants from Hewitt EnnisKnupp to review ERS' current Incentive Compensation Plan (ICP) and make recommendation to assist ERS in offering more a competitive plan. The committee's

recommended changes to the ICP were presented to an internal review group consisting of Executive management and staff from Internal Auditing, Investments, Legal Services and Human Resources.

Ms. Ann Fuelberg then presented a list of issues related to the ICP³ for the Board's comments and consideration. Following Ms. Fuelberg's presentation of the various questions and issues, the Board took the following actions:

MOTION made by Mr. Craig Hester, seconded by Mr. Owen Whitworth, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas approve the proposed revised terms of the Incentive Compensation Plan to take effect upon the Executive Director's approval of all applicable performance standards and metrics, the manner of calculating and determining the payout of incentive compensation awards, and any other issues that are still under consideration following the Board's consideration of this agenda item, and include the Executive Director based on the same general terms as the Chief Investment Officer effective September 1, 2011. It was further moved that the Board of Trustees authorize the Executive Director to incorporate the Board's approved terms and revisions into the Incentive Compensation Plan, to reword and revise the Plan as necessary consistent with the Board's decision, the Investment Policy and applicable law, and thereafter implement the Plan as revised.

XVI. REVIEW, DISCUSSION AND CONSIDERATION OF PROPOSED OPERATING BUDGET FOR THE EMPLOYEES RETIREMENT SYSTEM OF TEXAS FOR FISCAL YEAR 2012

Mr. Larry Zeplin reported that while the fiscal year 2012 proposed operating budget is higher than the fiscal year 2011 forecast, at \$52.3 million, the fiscal year 2012 proposed operating budget remains relatively flat compared to the fiscal year 2011 approved budget in all areas. Mr. Zeplin highlighted the multiple major initiatives identified by ERS' strategic directions of Increasing Retirement Security, Optimizing the Group Benefits Program, Engaging Stakeholders, and Enhancing Agency Performance and Accountability.

Mr. Mike Wheeler, Chief Financial Officer, provided a comparison of the fiscal year 2011 operating budget forecast to the fiscal year 2012 proposed operating budget stating the fiscal year forecast is approximately \$4 million dollars, or 7.7%, below budget, and about 88% of that amount relates to vacant positions and unspent funds for the Incentive Compensation Plan. Consistent with state leadership's requirement to reduce budgets for fiscal year 2011, ERS filled vacant positions only if an immediate need could be justified.

Ms. Debbie Leatham, Manager of Budget & Special Projects, discussed financial reporting changes. Retiree insurance was removed from other salary costs consistent with other state agencies' reporting, and investment banking was added as a line item for more transparency and better comparison reporting.

Mr. Craig Hester congratulated Mr. Zeplin and the Finance staff for their hard work in presenting the budget document to the board. Ms. Cydney Donnell echoed Mr. Hester's comment and announced that ERS received the Government Financial Officers Association (GFOA) Certificate of Achieving Excellence in Financial Reporting. Mr. Zeplin then commented that ERS has received the GFOA Certificate of Excellence for 22 years in a row.

There being no further questions or discussion, the Board took the following action:

MOTION made by Ms. Cheryl MacBride, seconded by Ms. Yolanda Griego, and carried unanimously by the present members that the Board of Trustees of the Employees Retirement System of Texas approve the Fiscal Year 2012 Proposed Operating Budget, for the Employees

³ Exhibit C – Pages 13 – 25

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The objective of this audit was to determine whether incentive compensation at the Teacher Retirement System (TRS), the Permanent School Fund (PSF) of the Texas Education Agency, and the Employees Retirement System (ERS) was calculated and paid in accordance with policies and procedures.

Scope

The scope of this audit covered incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

Methodology

The audit methodology included collecting information and documentation from the audited entities; reviewing incentive compensation plans, policies and procedures, and other guidance related to incentive compensation; and analyzing and evaluating data and the results of tests.

Auditors selected a judgmental sample of incentive compensation payments at each entity and verified that recipients tested were eligible to receive payments, that data inputs used in calculations were correct, and that payment amounts were calculated correctly based on the terms of the plans. Auditors also tested access controls at the audited entities.

Auditors reviewed calculations, personnel files, payroll data, and externally reported fund performance results to determine whether the audited entities calculated and paid incentive compensation in accordance with policies and procedures. Auditors also tested access controls over the spreadsheets used in calculating incentive compensation for authorized personnel.

Auditors did not conduct data reliability assessments. Those assessments were not necessary for the purposes of this audit because data was used only as support for testing information available at the audited entities.

Information collected and reviewed included the following:

- Incentive compensation plan at TRS, the PSF, and ERS.
- Incentive compensation payment calculation spreadsheets for incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.

- Incentive compensation recipients' personnel files.
- Payroll data related to incentive compensation recipients.
- Investment performance reports from investment custodian banks.

Procedures and tests conducted included the following:

- Interviewed management and key personnel at TRS, the PSF, and ERS.
- Analyzed and recalculated incentive compensation payments for incentive compensation plan years ending September 30, 2012, at TRS; July 31, 2012, at the PSF; and August 31, 2012, at ERS.
- Reviewed and tested compliance with the audited entities' policies and procedures.

Criteria used included the following:

- Teacher Retirement System of Texas Performance Incentive Pay Plan.
- Texas Permanent School Fund Performance Incentive Pay Plan.
- Employees Retirement System of Texas Incentive Compensation Plan.
- Section 44, Article III, Texas Constitution and related statutes.
- Rider 14, pages III-32 through III-33, and Rider 22, III-11, General Appropriations Act (82nd Legislature).
- Attorney General opinions related to incentive compensation.

Project Information

Audit fieldwork was conducted from February 2013 through April 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The following members of the State Auditor's staff performed the audit:

- Michael O. Clayton, CPA, CISA, CIDA, CFE (Project Manager)
- Amadou N'gaide, MBA, CFE, CIDA (Assistant Project Manager)
- Roger Ferris, CPA
- Michelle Ann Duncan Feller, CPA, CIA (Quality Control Reviewer)
- Angelica M. Ramirez, CPA (Audit Manager)

Excerpts from August 23, 2011, ERS Board of Trustees Meeting Minutes

Below are excerpts from the minutes of the August 23, 2011, meeting of the Employees Retirement System board of trustees.

FINAL DRAFT 8/18/11

PUBLIC AGENDA ITEM - #15

EXHIBIT A

**MATRIX OF ICP ISSUES TO BE CONSIDERED BY BOARD OF TRUSTEES
AUGUST 23, 2011**

EXHIBIT C

Abbreviations Used: MC = McLagan; OC = Outside Counsel (Ice Miller)

Section references are to the ERS Incentive Compensation Plan with specific references to current policy annotated.

ISSUES	CURRENT POLICY	COMMENTS	RECOMMENDATIONS
		compensation TCDRS (\$17.7 Billion**): No incentive compensation Safekeeping Trust (\$49.4 Billion**): 30% - 100% Perm. School Fund (\$22.1 Billion*): 25% - 60% UTIMCO (\$17.2 Billion*): 25% - 200% *As of 8/31/10 **As of 12/31/10	
SECTION 4. ESTABLISHMENT OF PERFORMANCE GOALS AND PLAN FUNDING			
Earned Incentive Compensation Awards During Negative or Zero Trust Fund Returns	Neither earned nor paid when total trust fund returns are zero or less. (4.6)	<p>Investments: Awards <u>may be earned</u> for excess return even if negative or zero trust fund returns but <u>may not be paid</u> until a future Plan Year when there is positive trust fund performance.</p> <p>MC: During years when absolute returns are negative, about half of competitor public funds have a mandatory deferral feature. In about half of those public funds, boards retain the discretion to defer, reduce, eliminate or payout.</p> <p>OC: Preferable just to keep the limit based on positive trust fund performance and allow the Board and/or Executive Director to exercise negative discretion due to the trust's financial condition.</p>	<p>Revise Plan so awards <u>may be earned</u> for excess return even if negative or zero trust fund returns but <u>will not be paid</u> until the future Plan Year when there is positive trust fund performance.</p> <p>Earned awards may be deferred <u>up to 3 years</u> if payment cannot be made because of negative or zero trust fund performance. <u>After 3 years</u>, earned awards will be automatically forfeited.</p> <p>Refer to the earlier point regarding discretion.</p>

**PUBLIC AGENDA ITEM - #15
EXHIBIT A
MATRIX OF ICP ISSUES TO BE CONSIDERED BY BOARD OF TRUSTEES
AUGUST 23, 2011**

EXHIBIT C

Abbreviations Used: MC = McLagan; OC = Outside Counsel (Ice Miller)

Section references are to the ERS Incentive Compensation Plan with specific references to current policy annotated.

ISSUES	CURRENT POLICY	COMMENTS	RECOMMENDATIONS
		<p>Deferral periods for incentive compensation are consistent with Dodd-Frank even outside of times of negative performance.</p>	
<p>Simplify Performance Standards/Metrics</p>	<p>Not specifically addressed in the current Plan. Approved at the beginning of each Plan Year. (Section 4)</p> <p>Currently Investments presents spreadsheet for review and approval by Executive Director prior to each Plan Year</p>	<p>Investments: Performance standards should be simplified and documented at a high-level in the Plan with focus on measuring for total trust, asset class and individual portfolio performance during the one, three and five year discrete time periods.</p> <p>Change will add clarity and transparency to performance measurement while reducing the complexity of metrics used previously</p> <p>Asset class performance will be directly based on the asset class/strategies in the Active Risk Budget incorporated in the Investment Policy.</p> <p>MC: ERS should exercise discipline in not adding additional investment-related sub-goals, especially given that, with initiatives already split into one year and three year components, and then into total fund, asset class and portfolio components, and then into relative and risk-adjusted components, the final weighted components are fairly small bordering on inconsequential.</p>	<p>Revise Plan to adopt a high-level structure for the performance standards/metrics with weightings for total trust, asset class and individual portfolio performance as an appendix to the Plan.</p> <p>Investments will provide this appendix for review and approval by the Executive Director prior to the effective date of the revised Plan to avoid issues raised by Art. III, § 44 of the Texas Constitution and applicable Attorney General Opinions that require performance standards/metrics to be in effect prior to service being performed.</p> <p>Prior to each Plan Year Investments will provide a more detailed listing of performance standards for each individual participant, including a discretionary component for certain positions, in adequate time for approval by the Executive Director prior to the beginning of the Plan Year and consistent with the appendix in and the terms of the Plan and the Active Risk Budget in the Investment Policy</p>

Excerpt from September 26, 2012, ERS Board of Trustees Meeting Minutes

Below is an excerpt from the minutes of the September 26, 2012, joint meeting of the Employees Retirement System investment advisory committee and board of trustees.

The next steps for the asset allocation include benchmarks, risk management, implementation considerations and policy revisions. These items will be taken up at the December Working Session on December 6 – 7, 2012.

There were no questions or further discussion, and no action was required on this item.

II. ADJOURNMENT OF THE INVESTMENT ADVISORY COMMITTEE

The ERS Investment Advisory Committee adjourned at 11:34 a.m.

III. EXECUTIVE SESSION

At 12:12 p.m., Chair Cheryl MacBride announced that the Board of Trustees (Board) will meet in Executive Session in accordance with Section 551.074, Texas Government Code, to review and consider the duties, performance and compensation of the ERS Executive Director; and to discuss the appointment of the Internal Auditor. The Board will not be interviewing applicants for the Internal Auditor position at this time. Thereafter, the Board may consider appropriate action in open session, and in accordance with statute, a certified agenda will be kept of the Executive Session.

The Executive Session concluded at 1:27 p.m., at which time the Trustees returned to open session. Chair Cheryl MacBride stated that while in Executive Session, no action, decision or vote was taken by the Board. She then opened the floor for a motion.

Trustee Craig Hester stated that in consideration of the Executive Director's management and oversight of ERS, its five retirement programs, and accomplishments in 2012 in the areas of strategy and leadership, a copy of which we would like attached to the minutes², the interim benefits study, and her skills as a member of the internal investment committee, he would like the Board of Trustees to consider the following motion:

MOTION made by Craig Hester that the Board of Trustees of the Employees Retirement System of Texas award ERS Executive Director Ann Bishop an increase in her annual compensation by 4.167% of her Fiscal Year 2012 annual salary effective October 1, 2012. I further move that the Executive Director receive a merit payment equal to 50% of her Fiscal Year 2013 annual salary effective October 1, 2012.

The motion was subsequently seconded by Trustee Yolanda Griego and carried unanimously by the members of the Board of Trustees.

The foregoing is a true and accurate statement of the action taken by the Board of Trustees regarding the compensation of ERS Executive Director, Ann S. Bishop.

IV. ADJOURNMENT OF THE BOARD OF TRUSTEES

The Board of Trustees adjourned at 1:29 p.m.

² Exhibit B – Page 10 - 20

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Thomas “Tommy” Williams, Senate Finance Committee
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Harvey Hilderbran, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Teacher Retirement System

Members of the 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
Mr. Brian Guthrie, Executive Director

Texas Education Agency

Members of the State Board of Education

Ms. Barbara Cargill, Chair
Mr. Thomas Ratliff, Vice Chair
Mrs. Mavis B. Knight, Secretary
Mr. Lawrence A. Allen, Jr.
Mrs. Donna Bahorich
Mr. David Bradley
Mr. Ruben Cortez, Jr.
Dr. Martha M. Dominguez
Ms. Patricia Hardy
Mr. Tom Maynard
Ms. Sue Melton
Mr. Ken Mercer
Mrs. Geraldine “Tincy” Miller
Ms. Marisa B. Perez
Mr. Marty Rowley
Mr. Michael Williams, Commissioner of Education

Employees Retirement System

Members of the Employees Retirement System Board of Trustees

Ms. Cheryl MacBride, Chair
Mr. Brian D. Ragland, Vice-Chair
Ms. Cydney Donnell
Ms. Yolanda Griego
Mr. I. Craig Hester
Mr. Frederick E. Rowe, Jr.
Ms. Ann Bishop, Executive Director



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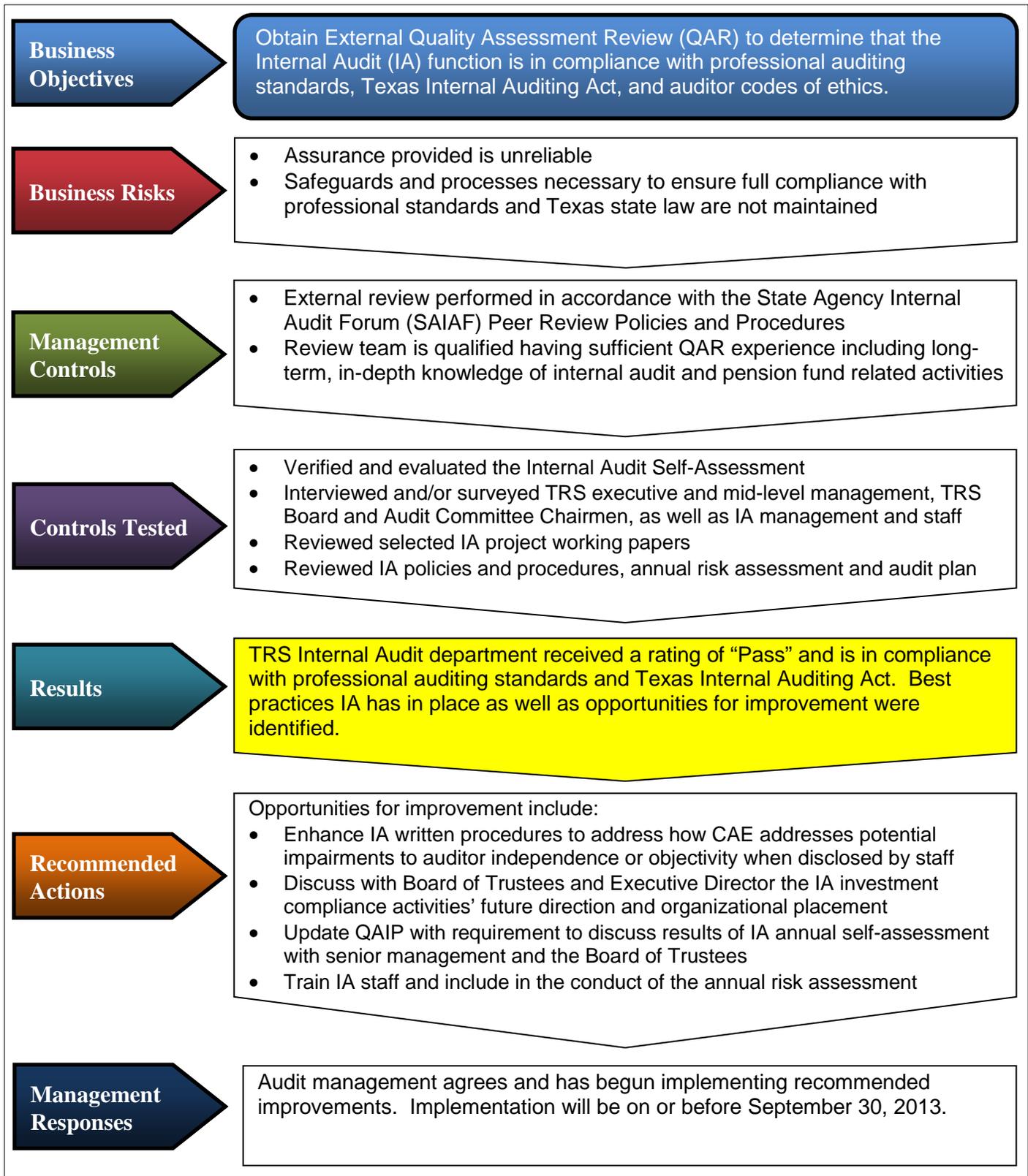
To report waste, fraud, or abuse in state government call the SAO Hotline: 1-800-TX-AUDIT.

TAB 3

INTERNAL AUDIT EXTERNAL QUALITY ASSURANCE REVIEW

JUNE 2013

TRS Internal Audit Department



Legend of Results:

Red - Significant to TRS
Yellow - Other Reportable Issue

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

**REPORT ON THE
EXTERNAL QUALITY ASSURANCE REVIEW
OF THE TEACHER RETIREMENT SYSTEM'S
INTERNAL AUDIT DEPARTMENT**

June 2013



Performed by

Karin Hill, CIA, CGAP, CRMA
Director of Internal Audit
Texas Department of Assistive and Rehabilitative Services

Jennifer Hymel
Director of Compliance and Assurance
Texas County and District Retirement System

Nicki Russell, MPA, CIA, CPA
Internal Auditor
Missouri State Employees Retirement System

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OVERALL OPINION

Based on the information received and evaluated during this external quality assurance review, it is our opinion that the Teachers Retirement System of Texas' Internal Audit Department receives a rating of "**Pass**" and is in compliance with the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* and Code of Ethics, the United States Government Accountability Office (GAO) *Government Auditing Standards*, and the Texas Internal Auditing Act (*Texas Government Code*, Chapter 2102). This opinion means that policies, procedures, and practices are in place to implement the standards and requirements necessary for ensuring independence, objectivity, and proficiency of the internal audit function.

We found that the Internal Audit Department is independent, objective, and able to render impartial and unbiased judgments on the audit work performed. The staff members are qualified, proficient, and knowledgeable in the areas they audit and the Department is supported in obtaining additional expertise as necessary. Individual audit projects are planned using risk-based internal auditing; audit conclusions are supported in the working papers; and findings and recommendations are communicated clearly and concisely.

The Internal Audit Department is well-managed internally. In addition, the Department has an effective relationship with the Board of Trustees and is well respected and supported by management. Surveys and interviews conducted during the quality assurance review indicate that management considers Internal Audit an integral part of the overall agency operations and finds that the audit process and report recommendations add value and help improve the agency's operations.

ACKNOWLEDGEMENTS

We appreciate the courtesy and cooperation extended to us by the Chief Audit Executive, Internal Audit staff, the Chairmen of the Board of Trustees and the Audit Committee, the Executive Director, and the senior managers who participated in the interview process. We would also like to thank each person who completed surveys for the quality assurance review. The feedback from the surveys and interviews provided valuable information regarding the operations of the Internal Audit Department, its effectiveness, and its relationship with management.



Karin Hill, CIA, CGAP, CRMA
Director of Internal Audit
Texas Department of Assistive and Rehabilitative Services
QAR Team Lead

5/17/2013

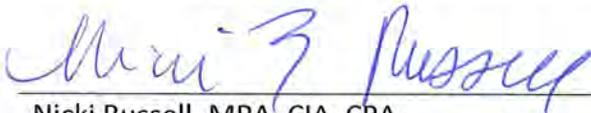
Date



Jennifer Hymel
Director of Compliance and Assurance
Texas County and District Retirement System

5/16/2013

Date



Nicki Russell, MPA, CIA, CPA
Internal Auditor
Missouri State Employees Retirement System

5-6-2013

Date

BACKGROUND

The Institute of Internal Auditors (IIA) *Standards for the Professional Practice of Internal Auditing*, U.S. Government Accountability Office (GAO) *Government Auditing Standards*, and the Texas Internal Auditing Act (Act) require that internal audit functions obtain external quality assurance reviews to assess compliance with standards and the Act and to appraise the quality of their operations. Government auditing standards require these reviews at least every three years. A periodic external quality assurance review, or peer review, of the internal audit function is an essential part of a comprehensive quality assurance program. This quality assurance review was performed in accordance with the State Agency Internal Audit Forum's (SAIAF) guidelines.

The most recent external quality assurance review for the Teacher Retirement System was performed in 2010. That review included five recommendations for improvement; the Internal Audit Department has implemented all of the recommendations that were made in that report.

OBJECTIVES, SCOPE, AND METHODOLOGY

The primary objective of the quality assurance review was to evaluate the Teacher Retirement System's Internal Audit Department's compliance with auditing standards and the Texas Internal Auditing Act. Additional objectives included identifying best practices as well as areas where improvements may be needed. The review covered all completed audit and management assistance projects performed by the Teacher Retirement System's Internal Audit Department from September 1, 2011 through August 31, 2012.

To accomplish the objectives the review team:

- Reviewed, verified, and evaluated the self-assessment prepared by the Internal Audit Department
- Reviewed, analyzed, and evaluated responses to an online survey administered to select management
- Interviewed the Chief Audit Executive (CAE), Internal Audit staff, the Executive Director, ten senior managers, the Chairman of the Board and the Chairman of the Audit Committee
- Reviewed and evaluated audit working papers
- Reviewed Internal Audit's policies and procedures, annual risk assessment, annual audit plan, and other relevant documents

DETAILED RESULTS

The results of the quality assurance review for the Teacher Retirement System's Internal Audit Department are presented in the order of the IIA's *Standards for the Professional Practice of Internal Auditing*. No significant weaknesses were identified during the review that would prevent the Department from fulfilling its responsibilities. The detailed results include best practices the Department has in place as well as some opportunities for improvement that it may wish to consider.

IIA Code of Ethics

Ethical conduct and the IIA's Code of Ethics are clearly an expectation and priority of the CAE and all of her staff. The Code of Ethics is referenced in the Department's Charter, which is posted on its website and the annual certification of independence, which every auditor signs, references the Code of Ethics as well. During interviews, management routinely commented on the ethics of the entire audit department and 11 of the 12 respondents to the survey rated them as "Good" or "Excellent" in their demonstration and promotion of ethical behavior.

Standard 1000: Purpose, Authority, and Responsibility

The Internal Audit Department has developed a Charter, which was most recently adopted in September 2012, and posted on the Department's website. The Charter defines assurance and consulting services and recognizes the mandatory nature of the IIA's Definition of Internal Auditing, the Code of Ethics, and Standards. It outlines the purpose, authority and responsibility of the Department, which includes the expectations of agency staff to provide information. In addition to establishing the standards being used in the performance of audits, the Charter has an appendix that includes the IIA and GAO's Codes of Ethics.

In addition to the Charter, the Internal Audit Department has developed a mission and vision that are consistent with the IIA's definition of internal auditing and outline what management and the Board of Trustees can expect from the Department. The mission and vision are included below:

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.

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*

Standard 1100: Independence and Objectivity

The Internal Audit Department is organizationally situated to report to the Board of Trustees. The Chief Audit Executive reports functionally to the Board and administratively to the Executive Director. To ensure independence and objectivity is maintained, each auditor reviews and signs a Certification of Independence annually and reviews the independence and objectivity standards as part of the planning process of each audit. However, review of policies and procedures identified that the Department does not have written procedures or expectations for staff in the event that there is a concern of impairment to independence or objectivity and how to remedy it.

One of the staff assigned to the Internal Audit Department is solely dedicated for conducting investment compliance work. The CAE has accepted that responsibility, effectively manages her staff to ensure their independence and objectivity, and the approved Internal Audit Charter acknowledges the activity by specifically stating that the Department "provide[s] support to the internal investment compliance program" and that "Compliance duties are not considered operational duties." However, according to the IIA in its position paper "*The Three Lines of Defense in Effective Risk Management and Control*" issued in January 2013, a compliance function to monitor various specific risks such as noncompliance with applicable laws and regulations is established by management to "ensure the first line of defense [management/internal controls] is properly designed, in place, and operating as intended." This paper goes on to say that compliance functions have "some degree of independence from the first line of defense, but they are by nature management functions." "Therefore, the second line of defense serves a vital purpose but cannot offer truly independent analyses to governing bodies regarding risk management and internal controls." As long as Internal Audit is responsible for this function, the department is not able to provide management or the Board

assurance on the effectiveness of the agency's investment compliance program activities conducted by Internal Audit such as monitoring trade pre-clearance requirements and the watch list of companies where TRS staff has knowledge of material non-public information. In addition, more robust compliance activities were identified as an area for improvement during one interview; increasing this activity in the Internal Audit Department would likely impact their ability to maintain their independence in this area.

Discussion with management and the results of the survey conducted for this review identified that management considers the department to be independent and objective. Those interviewed noted that audit staff has processes designed to assist with their objectivity and 11 of 12 who completed the survey rated the Department as "excellent" or "good" on the auditors' objectivity.

Recommendation: The CAE should enhance existing department written procedures to include how the CAE should address potential impairments to auditor independence or objectivity when disclosed by audit staff.

Response: The CAE agrees with this recommendation. Procedures requiring disclosure of potential impairments to independence will be updated to include current practices for addressing disclosed potential impairments. Implementation date will be on or before September 30, 2013.

Recommendation: The CAE should dialogue with the Board of Trustees and the Executive Director to determine the best course of action regarding compliance activities for the Investment Division.

Response: The CAE agrees with this recommendation. As part of a self-assessment of investment compliance activities scheduled for the fourth quarter of Fiscal Year 2013, staff will discuss current and desired compliance activities with stakeholders and determine the need for organizational change, if any. Implementation date to report results of the self assessment will be on or before September 30, 2013.

Standard 1200: Proficiency and Due Professional Care

Combined, the ten Internal Audit staff have almost 75 years of tenure at TRS; many years of accounting, auditing, and management related experience; and 26 professional certifications. Staff members attend training to build and enhance the knowledge, skills, and abilities of the department as well as to maintain their certifications. The CAE and staff routinely look for new trends and developments in the pension fund and investment industries and training

opportunities to ensure they are prepared to respond to any changes. If the department does not have the expertise to audit a specific area, the CAE co-sources audit work with external entities and assigns audit staff to work with the vendors to benefit from knowledge sharing. Staff members are encouraged to participate in professional organizations and have given presentations to the IIA and the Internal Audit Leadership Development Program, hosted by a group of Austin area CAEs, on topics such as strategic planning for internal audit functions and quality assurance improvement plans.

Standard 1300: Quality Assurance and Improvement Program

Review of the Quality Assurance and Improvement Program (QAIP) determined that it is comprehensive and meets the requirements of this Standard. The Internal Audit Department's QAIP consists of five components:

Policy and Procedures

The policy and procedures establish the expectation that a QAIP will be maintained and each of the other components are detailed with activities, have staff assigned responsibility, the frequency of the required activity, and estimated due dates. They are clear and concise, and are followed by detailed explanations of the requirements of the program.

Audit Function Management

This includes a list of requirements that collectively cover the management of the Department. Activities on this list range from the annual review of policies and procedures to ensuring the external assessment is obtained every three years. Each activity is assigned to at least one audit staff member.

One of the activities in this section is performance measurement. Review of the performance measures used by the Internal Audit Department identified that they are goal oriented and do not measure performance in a manner that allows the CAE to compare performance over a period of time.

Internal Assessment

One of the required activities in the Internal Assessment component is to annually complete a documented self-assessment using the current Texas SAIAP's Self-Assessment Program. This document not only guides the user through a review of the IIA's Standards, but also through the requirements of the GAO's Standards and the Texas Internal Auditing Act. The self-assessment completed to prepare for this review also utilized this process. Any issues

or opportunities to improve that are identified during this process are tracked in TeamMate, the audit management software system, in the same manner as audit recommendations to management. The QAIP specifically includes an activity to review the results of the self-assessment with the audit staff; however, it does not include a step to discuss the results with senior management and the Board of Trustees, as required by Standards. Results of the self-assessment are reported each year to the board and management and are posted on the TRS intranet and internet.

The Department's self-assessment in preparation for this review was conducted in two phases; the first utilized a group of graduate students from the University of Texas (UT) McComb's School of Business and the second was completed by a UT undergraduate summer intern student. Both student teams were coached and supervised by an Audit Manager on staff.

External Assessment

The final section of the QAIP is the completion of an external assessment every three years, which is the requirement that this review satisfies. To ensure this assessment is conducted by individuals familiar with the types of work performed by the Internal Audit Department the CAE arranges for this team to consist of persons with experience in Texas State government as well as pension fund auditing.

Recommendation: The CAE should include the requirement to discuss the results of the annual internal assessment with senior management and the Board of Trustees as activities in the QAIP.

Response: The CAE agrees with this recommendation. We will update our QAIP activities to include the requirement to communicate the results of the annual internal assessment with senior management and the Board of Trustees. Implementation date will be on or before September 30, 2013.

Standard 2000: Managing the Internal Audit Activity

The Internal Audit Department is well managed; the CAE has implemented policies and procedures to guide staff, and has developed templates for use in TeamMate that ensure working papers are consistently completed and meet the requirements of Standards.

The Department conducts a risk assessment to establish its three-year audit plan, which is updated annually as needed; however, discussion with audit staff and management identified concerns about the level of involvement each has in this process. Further discussion with the CAE identified that the risk assessment and plan development process has been evolving from a

coverage-based focus, when she first became the CAE, to the current risk-based focus. By ensuring audit staff understand and participate in the risk assessment, the CAE can increase their knowledge of the process, provide additional insight into why certain areas are selected for audit coverage, and expose staff to tasks that assist their development for higher levels of responsibility.

Management reported that their opportunity for input is on the draft audit plan. As discussed above, the risk assessment process has been evolving at TRS; the CAE provided documentation of the results of interviews conducted for the risk assessment to develop the fiscal year 2013 audit plan, which included nine trustees and 11 members of executive management. By continuing this process and ensuring management understands the relationship between the risk assessment and the audit plan as well as how their respective functions fit into the assessment, the CAE will continue to strengthen management's overall understanding of the process as well as fine-tune how their input is collected and considered. In addition to the audit plan, the CAE prepares a five-year strategic plan. This plan identifies four strategic goals, each with their own objectives, and projected timing for inclusion on the audit plan.

The CAE manages her staff resources and contracts for audit services (which usually include a knowledge-share component) to ensure the approved audit plan is completed. While management understands the independence of the audit department and does not question decisions to contract for expertise, the review team consistently heard concerns or questions about whether this was a result of needing the additional expertise or whether more work was being scheduled than there were resources to complete it. This is another example where involving management in discussions on the risk assessment earlier in the process and ensuring they fully understand any directions being given by the Board of Trustees could increase awareness and improve processes.

The CAE ensures the Chair of the Audit Committee and executive management are kept apprised of the Department's activities and progress on the approved audit plan as well as on risk exposure and control issues identified during audit work or considered possible based on industry trends or evolvments.

During interviews, one manager noted that "Internal Audit is on the same page as the rest of the organization" and another stated that "coverage seems to be systematic and is good," but added that he would "like to see more best practice identification." Comments of this nature further support the opinion that the Department is meeting the needs of the agency and adding value.

Recommendation: The CAE should train staff and include them in the conduct of the annual risk assessment.

Response: The CAE agrees with this recommendation. Most internal audit staff members have significant experience in conducting the annual risk assessment; however, newer staff members have not been included in recent years. In order to facilitate knowledge transfer and staff development, Internal Audit staff will be included in the annual risk assessment for Fiscal Year 2014 and going forward. Implementation date is September 30, 2013.

Standard 2100: Nature of Work

As discussed above, the Internal Audit Department develops its audit plan based on a risk assessment. It conducts audit work of both financial and operational areas and includes evaluation of effectiveness and efficiency of operations, safeguarding of assets, and compliance with laws and regulations. TeamMate templates have been developed to guide the documentation of staffs' consideration of the potential for fraud as well as that of the risk assessment. This provides for consistency and ensures the requirement is met.

In addition, the CAE's access to executive management and the Board of Trustees ensures the opportunities to voice concerns about governance, risk management, and control issues as they arise. Several managers interviewed discussed the Department's professionalism and willingness to provide information and concerns as close to "real time" as possible.

Standard 2200: Engagement Planning

The CAE assigns staff to audits based on their knowledge, skills, and abilities, and dedicates additional resources as needed. Review of work papers identified documentation of thorough planning by audit staff. Detailed templates take staff through the process of gathering information, identifying risks, and developing objectives appropriate for the audit assignment. Additionally, the Department uses an "Objectives, Risks, and Controls Matrix" to document the objectives and controls to be tested. This was identified by the review team as an effective approach to summarizing the planning stage of the audit and considered a best practice.

The CAE must review and approve the audit program before the assigned auditor can complete the planning phase of the audit. While some managers interviewed voiced concerns about staff possibly not fully understanding the business objectives being audited, they also stated that the department does a good job at working to understand the processes and planning their audits.

Standard 2300: Performing the Engagement

Review of the self-assessment and additional work papers identified that the Internal Audit Department conducts adequate analysis and review to obtain sufficient, reliable, relevant, and useful information to meet the established objectives and draw supportable conclusions. Working papers are detailed but to the point; they are specific and tied back to the objectives. TeamMate provides a systematic way to organize the work papers to allow ease of review and understanding.

Standard 2400: Communicating Results

Results of work completed by the Internal Audit Department are communicated throughout the audit so as not to surprise management when the report is written. Audit clients are provided an opportunity to give feedback and input on the draft report and recommendations, and their responses to the recommendations are included in the final report. Almost 90 percent (88%) of survey responses to questions pertaining to reporting rated the Internal Audit Department as either “Excellent” or “Good” in this area.

In addition to communicating with the audit clients throughout the project and as the report is being written, the final report is presented to the Audit Committee of the Board of Trustees and then, in accordance with the Texas Internal Auditing Act, distributed to the Governor’s Office, the Legislative Budget Board, the Sunset Commission, and the State Auditor’s Office. The Department also posts audit reports on the agency’s intranet and internet.

Standard 2500: Monitoring Progress

The status of recommendations is tracked in TeamCentral, a module of TeamMate, where management can access the system and report when implementation is complete. The Internal Audit Department color-codes audit recommendations based on their significance and the impact their implementation or non-implementation can have on the agency’s business objectives and goals, and reports the status of recommendations to the Audit Committee.

Standard 2600: Resolution of Senior Management's Acceptance of Risks

Although none of the individuals interviewed knew of a situation where management was accepting more risk than the CAE felt appropriate, all understood that such an instance would prompt communication to the Board of Trustees. This can be attributed to the communication practices that have been established between the Internal Audit Department and management.

BEST PRACTICES

During the conduct of this review, a number of best practices were identified. Some of these are:

- The inclusion of the Code of Ethics as attachments to the Charter which is posted on the agency's Intranet.
- The combination of expertise in the team obtained by the CAE to conduct the External Quality Assurance Review.
- The use of TeamStore and development of templates in TeamMate to increase efficiency and consistency between individual auditors in the audit process.
- The "Objectives, Risk, and Control Matrix" developed to summarize the planning phase of the audit.
- The creation of the "one pager" as a cover sheet for detailed reports.
- The development and monitoring of the Internal Audit Strategic Plan for each fiscal year's initiatives.

TAB 4

TAB 4A

MEMORANDUM

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

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

SUBJECT: Status of the Employer Audit Project

DATE: June 14, 2013

Background

The Employer Audit Project is included in the *Fiscal Year 2013 Audit Plan*. At the December 2013 Audit Committee, we reported the following activities performed or planned:

- Internal Audit met with several members of the Executive Committee and management to identify top risk areas that could be reviewed during employer audits. Audit tests were developed and consideration was given to potential audit issues that could arise including possible impacts to employers, active members and retirees, and TRS operations. We continued to gather feedback from executive management and business areas.
- Internal Audit will begin to explore with management the possibility of developing employer self-audit tools to assist employers in assessing their compliance with TRS Laws and Rules, as well as explore the possibility of piloting employer audits.

Project Direction

Based on management's feedback, employer audits will not be piloted this fiscal year but resources will be applied to employer communications regarding future audits by TRS as well as the development and implementation of self-audit tools for employers.

The employer self-audit program materials will focus on the following top risk areas identified by management:

- Pension Surcharges
- TRS-Care Surcharges
- Employment After Retirement

The employer self-audit project would allow more information to be gathered from employers to assist in refining audit tests and procedures as well as allow TRS management to establish processes for handling issues identified through employer audits.

Employer Self-Audits

The objectives of the employer self-audits are to provide employers the following:

- Emphasis on the vital role the employer plays in helping TRS to provide benefits and services to our members and retirees
- Step-by-step instructions on how to conduct audits of employer processes and verify the completeness and accuracy of the information and contributions the employer sends to TRS
- Education on the impact to the employer, individual employee, and TRS qualified plan status due to non-compliance with TRS Laws and Rules

The following tasks are underway or planned for the remainder of fiscal year 2013 and into fiscal year 2014. **These tasks will involve the coordinated efforts of Internal Audit, Benefit Accounting, Legal Services and Executive management.** The timeline allows for Benefit Accounting to manage fiscal year-end closeout processes for employer reporting activities and to train employers on legislative changes.

Planned Fiscal Year 2013 Tasks	Estimated Target Date
Finalize <i>draft</i> self-audit materials for Pension Surcharge, TRS-Care Surcharge, and Employment after Retirement	June 2013
Obtain executive review and approval of drafts and next steps	June 2013
Determine process and procedures for consistent handling of issues/errors reported by employers to TRS as result of self-audits	July 2013
Potential Fiscal Year 2014 Tasks	Estimated Target Date
Pilot self-audits on select group of employers (public schools and charter schools) for feedback; refine self-audits based on feedback	November 2013
Train TRAQS coaches and other areas as needed	November – December 2013
Develop and roll out communications to employers	December 2013 – January 2014
Prepare for launch of self-audits on employer page on TRS website	January 2014
Launch self-audits on TRS website	February 2014

TAB 4B

MEMORANDUM

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

FROM: Amy Barrett, Chief Audit Executive

SUBJECT: Proposed Revisions to Fiscal Year 2013 Audit Plan

DATE: June 14, 2013

Per the approved *Fiscal Year 2013 Audit Plan*, amendments to the approved Audit Plan deemed to be significant will be submitted to the Audit Committee for recommendation to the Board of Trustees for approval. The State Auditor’s Office also requires notification of material changes to the Audit Plan. Below is a list of proposed changes for your consideration:

Proposed Changes to Fiscal Year 2013 Audit Plan¹

Project	Proposed Change	Reason	Substitution
Ethics and Communications Policies Compliance Audit	Cancel	Ethics follow-up audit conducted by the State Auditor’s Office (report issued)	Investment Compliance Self-Assessment
Procurement and Contracting Audit	Cancel	Post payment audit conducted by Comptroller of Public Accounts (fieldwork began in May)	Health Care Administration Audit – additional time required
Employer Reporting Audit	Revise	Staff requested additional time to communicate audit initiatives to employers and determine processes for consistent handling of issues identified	In coordination with Benefit Accounting and Legal Services, develop employer self-audits in three areas: <ul style="list-style-type: none"> • Pension Surcharge • TRS-Care Surcharge • Employment After Retirement

¹ Changes proposed will not impact TRS Internal Audit’s ability to meet its performance measure: Execute 80% of [original] audit and agreed-upon procedures projects.

TAB 5

TAB 5A

HEALTH CARE ADMINISTRATION OF TRS-CARE AUDIT

May 28, 2013

TRS Internal Audit Department

Business Objective	Provide health care benefits in compliance with statutory requirements for TRS-Care while providing coverage that is comparable to other Texas governmental health plans		
Business Risks	Reliance on vendors	Ineffective administration and management processes	Failure to comply with TRS laws/rules/regulations/policies and procedures
Management Controls or Compliance Requirements	<ul style="list-style-type: none"> Monitoring <ul style="list-style-type: none"> - External audits of vendors - Vendor reports - Day-to-day contact with vendors 	<ul style="list-style-type: none"> Control environment <ul style="list-style-type: none"> - Job descriptions - Training/cross-training - Staff meetings Risk assessment Control activities <ul style="list-style-type: none"> - Policies and procedures - Transaction processing - Management reports - Restricted access 	<ul style="list-style-type: none"> Information and communication requirements <ul style="list-style-type: none"> - TRS reports to State - Reports from vendors
Controls Tested	<ul style="list-style-type: none"> Monitoring <ul style="list-style-type: none"> - Vendor monitoring processes including performance guarantees, claims processing - Vendor reports/analysis review - Independent audits of vendor controls/contract compliance - Written policies and procedures - Staff meetings and training 	<ul style="list-style-type: none"> Control environment <ul style="list-style-type: none"> - Job descriptions/staff performance evaluations - Training/cross-training, staff meetings Risk assessment Control activities <ul style="list-style-type: none"> - Policies/procedures/processing/access controls/enrollment and eligibility reports, premiums, claims premium deductions 	<ul style="list-style-type: none"> Information and communication requirements <ul style="list-style-type: none"> - Contractual provisions - Group plan handbook - Reports from vendors - Reports, certifications, studies to State
Results	<p>Positive Findings:</p> <ul style="list-style-type: none"> Staff are knowledgeable of health care industry, interacts daily with vendors, customer focused, networks with peers Regularly engage independent external audits of health care providers Staff maintain worksheets/reconciliations, proactively initiate best practices/audit recommendations Awarded 2013 TRS Shining Example Award for Team Excellence 		
	Monitoring controls are effective. However, monitoring of non-financial contract terms was not clearly assigned and without written procedures.	Administration and management controls are effective. However, five new enrollments out of 30 tested contained errors.	TRS is in compliance with TRS Rules and Laws tested.
Recommended Actions	Formalize non-financial contract monitoring procedures	Strengthen processes for plan enrollment/coverage changes	None
Management Responses	Management will risk assess contract monitoring/assign responsibilities; work with vendors to organize reports; formalize contract modifications	Management will implement supervisory review; formalize report oversight; develop written procedures; ensure training requirements are met; develop system access review process	N/A
Legend of Results:	<p> Red - Significant to TRS Orange - Significant to Business Objectives Yellow - Other Reportable Issue Green - Positive Finding or No Issue </p>		

May 28, 2013

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

EXECUTIVE SUMMARY

We have completed the audit of the Health Care Administration of TRS-Care (health plan for retired members and dependents), as included in the *Fiscal Year 2013 Audit Plan*. The business objective related to the TRS-Care health plan administration is as follows:

Provide health care benefits in compliance with the statutory requirements for TRS-Care while providing coverage that is comparable to other Texas governmental health plans.

Based on our audit results, we determined that management controls are operating effectively to achieve the business objective and we noted numerous positive findings. We did not identify any significant issues. However, we identified opportunities to improve contract monitoring of non-financial terms, internal processes for enrollment, required training, and system access. We recommend that management:

- Formalize procedures for monitoring non-financial contract requirements, such as reporting requirements for the number of claims processed, pre-certifications, and providers
- Strengthen internal processes and procedures related to enrollment and coverage changes
- Ensure staff members complete all mandatory training
- Enhance management assessment of system access for transitioning employees

Results of our procedures are presented in more detail in the **Results and Recommendations** section (pages 4-10). The audit objective, scope, methodology and conclusion are described in **Appendix A** (pages 11-13), TRS-Care fast facts appear in **Appendix B** (page 14), and the Health and Insurance Benefits organizational chart is located in **Appendix C** (page 15).

BACKGROUND

The Health and Insurance Benefits (HIB) department is led by Director, Bob Jordan, who reports to the Director of Health Care Policy and Administration, Betsey Jones. The current staff of 22 consists of counselors, member service support, program management, finance, and administrative assistants. At this time, there are an additional six vacant positions to be filled. The staff is cross-trained to handle both TRS-Care (retired members and dependents) and TRS-ActiveCare (active members and dependents) activities.

TRS-Care was established in 1985 by the Texas legislature and is funded by health care premiums; active member, state and reporting entity contributions; investment earnings; and federal revenue. TRS, as trustee of the fund, administers the plan in accordance with the Texas Insurance Code, Chapter 1575. The total net assets amount for fiscal year (FY) 2012 was over \$741 million.

For FY 2012, TRS contracted with Aetna and Caremark to administer the medical care and prescription drug benefits, respectively. During that year, there was an average of 223,287 participants in the Plan. Claims expenses totaled \$1,142,131,410 (medical care at \$687,987,585 and prescription drug at \$454,143,825). In FY 2013, TRS contracted with Aetna to administer medical care and Express Scripts, replacing Caremark, as the prescription drug benefit administrator.

The Plan offers three coverage tiers – TRS-Care 1, TRS-Care 2, and TRS-Care 3. TRS-Care 1, the catastrophic plan, is free to eligible retirees but offers minimum coverage and the deductible is higher. Within TRS-Care 2 and TRS-Care 3 plan level, there exists a standard medical plan and a standard prescription plan, as well as a Medicare Advantage medical plan and a Medicare Part D prescription plan. When a retiree or dependent turns 65 and is eligible for Medicare, TRS-Care becomes secondary coverage to Medicare. Recently, the TRS-Care and TRS-ActiveCare (active employee health care plan) departments were merged into one business unit (department). Since that time, the department has been cross-training staff to support both department areas.

On January 1, 2013 TRS implemented four new Medicare plan options for Medicare eligible retirees and their dependents. The addition of the new plans required multiple communication outreach efforts, creating a milestone increase in retiree interactions. As the new plans are more complex to understand and involve more intensive enrollment choices for TRS-Care retirees, TRS Health Benefits Counselors were faced with supporting retirees through this transition. The change equated to a significant increase in workload for all parties involved.

Within the last year, the Health and Insurance Benefits department has experienced record counts in TRS-Care correspondence requests and phone calls. As of November 1, 2012 TRS-Care inquiries and requests received by mail alone were 87.6 % higher than the previous year at almost 10,000 pieces of correspondence. TRS-Care call volumes more than doubled as of November 1, 2012 at 117.5% higher than at this time the previous year. Since January 2013, TRS Health Benefits Counselors have talked to 53,499 retirees compared to 28,459 in the previous year for this same time period. This equates to a 53% increase in retiree interactions since January 2013.

Source: Health and Insurance Benefits department (unaudited)

BUSINESS OBJECTIVES, RISKS, AND CONTROLS

For the audit of Health Care Administration, we obtained information about the following business objective, as well as the related risks and the controls management established to mitigate these risks:

Business Objective	Provide health care benefits in compliance with the statutory requirements for TRS-Care while providing coverage that is comparable to other Texas governmental health plans		
Business Risks	Reliance on vendors	Ineffective administration and management processes	Failure to comply with TRS laws/rules/regulations/policies and procedures
Management Controls	<ul style="list-style-type: none"> • Monitoring of vendor <ul style="list-style-type: none"> ○ external audits ○ vendor reports ○ day-to-day contact with vendors 	<ul style="list-style-type: none"> • Job descriptions and staff evaluations are up-to-date, training/cross-training, staff meetings • Risk Assessment • Policies and procedures for processing/changing enrollment • Management reports • Restricted access 	<ul style="list-style-type: none"> • TRS reports to State • Reports from vendors
Controls Tested	<p>Obtained evidence of:</p> <ul style="list-style-type: none"> • How key vendor services are monitored and vendor reports, review of Statements on Standards for Attestation Engagements (SSAE 16¹) monitoring of vendors' performance guarantees • Implementation of previous audit recommendation • Written policies and procedures • External audits • Vendor disaster recovery plan • Completeness and accuracy of claims • Staff meetings • How issues are escalated 	<p>Obtained evidence of:</p> <ul style="list-style-type: none"> • Job descriptions and staff evaluations are up-to-date • Training, cross-training, staff meetings • Business unit's Enterprise Risk Management • Written procedures • Management oversight reports • Restricted system access/segregation of duties <p>Test a sample of transactions for eligibility, premiums, compliance with laws/rules</p>	<p>Obtained evidence of:</p> <ul style="list-style-type: none"> • Monitoring of vendor contracts • Group Plan Handbook includes required information per Insurance Code • Reports from vendors in compliance with Insurance Code • Reports filed with appropriate regulatory bodies

¹ Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization*

RESULTS AND RECOMMENDATIONS

OVERALL RESULTS

Based on our audit results, we determined that management controls are operating effectively to achieve the business objective and we noted numerous positive findings. We did not identify any significant issues. However, we identified opportunities to improve contract monitoring of non-financial terms, internal processes for enrollment, required training, and system access. We recommend that management:

- Formalize procedures for monitoring non-financial contract requirements, such as reporting requirements for the number of claims processed, pre-certifications, and providers
- Strengthen internal processes and procedures related to enrollment and coverage changes
- Ensure staff members complete all mandatory training
- Enhance management assessment of system access for transitioning employees

Additionally, other matters outside of Health and Insurance Benefits operations came to our attention during fieldwork. We issued a separate side issue memo to General Accounting management regarding the approval of payments of invoices. We also issued a memo to Information Technology relating to current procedures for system access requests for new hires and current employees moving from one position to another.

POSITIVE RESULTS

A. Staff knowledge of health care industry

- Staff are knowledgeable of the health care industry, maintain cooperative working relationships with TRS health care vendors, and are customer focused
- Staff take advantage of networking opportunities with other plan administrators
- Staff demonstrate active engagement in health plan vendors' quarterly update meetings
- Expertise is obtained when needed from external consultants and TRS Legal staff

B. Proactive initiatives and best practices

- Staff maintain key worksheets and reconciliations to track benefit plan financial status
- Efforts have already begun on creating a contract monitoring checklist to help ensure complete monitoring of vendors' non-financial contractual requirements
- During the course of the audit, a Quality and Training Specialist position has been developed and staffed to address the need for secondary review
- Staff make notes on the face of the TRS-Care application form, 700A, that assists the TRS counselors in the event of subsequent discussions with members
- Awarded the 2013 TRS Shining Example Award for Team Excellence in Customer Service

C. External audits

- Independent external audits of health care providers are conducted on a regular basis (every other year) to cover all plan years

SIGNIFICANT RESULTS²

No significant issues and recommendations were identified.

OTHER REPORTABLE RESULTS

1. Formalize procedures for non-financial contract monitoring

Results of our testing indicated that a formal process is not in place for monitoring vendor compliance with non-financial contractual requirements such as reporting requirements for the number of claims processed, pre-certifications, and providers. Performance guarantees are monitored and penalties collected when necessary; however:

- a. Monitoring duties are not clearly assigned to staff
- b. Written procedures for monitoring non-financial contract requirements do not exist
- c. Some staff members with contract monitoring responsibilities lack familiarity with certain required information located in the health plan vendors' quarterly reports
- d. Minor contract reporting requirements have not been enforced or amended when deemed no longer beneficial

As a result, the potential exists that some non-financial contract requirements may not be met or disclosed.

Recommendation

We recommend that management:

- a. Perform a risk assessment of contract terms to determine which terms should be routinely monitored; then, develop and apply written procedures to guide staff in contract monitoring activities
- b. Make specific assignments and provide training to staff for monitoring each high-risk contract term
- c. Request that health plan vendors clearly identify the required reporting information in each quarterly report
- d. Ensure changes to contractual requirements are formally documented in writing as addenda to the contract

² A significant result is defined as a control weakness that is likely to create a high risk of not meeting business objectives if not corrected.

Management Responses

Management agrees with the recommendations.

- a. – c. Last year a new position for a Contract Monitoring and Reporting Specialist was created, but that person was immediately diverted to assist with the implementation of the new Medicare products. HIB is now returning the focus to finalizing contract monitoring and reporting by charging the HIB Assistant Director for Finance with this task. The Assistant Director will assign responsibilities to individuals, perform a risk assessment, develop written procedures, match content of current vendor reports to information required by the contract, and provide trainings as needed by March 31, 2014.
- d. All existing modifications to vendor contracts that were deemed to be minor and technical in nature are currently memorialized in mail or email communications. Management will work with TRS Legal to formalize the minor modifications in the next contract revisions as they are implemented, by September 30, 2014.

2. Strengthen internal processes and procedures related to plan enrollment and coverage changes

Results of testing found that internal operational processes and procedures related to enrolling members and updating requested changes to coverage are in need of being updated and/or formalized. We found that:

- A. Secondary/supervisory review of the enrollment and coverage change process does not exist
- B. Written procedures need to be developed or updated to be consistent with current practice

These findings are related to the merger of TRS-Care and TRS-ActiveCare, recent heavy call volume and an increased staff workload attributed to TRS-Care plan changes, all of which caused limited resources and balancing priorities. Thus, management efforts to fine-tune the enrollment and change processes have been delayed.

Results are detailed below:

- A. No formalized process exists for secondary/supervisory review of manual transactions during the enrollment and change process. Testing of 30 new enrollment transactions occurring during 2012 found five errors on new enrollment transactions that might have been identified and corrected with a secondary/supervisory review process in place:
 - One incorrect spouse social security number out of six in sample (24 transactions did not require input of social security numbers as they were for members where social security numbers are pre-populated)
 - One error causing an ineligible member to be enrolled because a previous denial of coverage was overlooked when new 700A form was worked
 - Three incorrect effective dates because the original 700A forms were not processed when initially received

None of these five errors resulted in a disadvantage to TRS-Care members or dependents.

Additionally, we found that while many internal reports are generated and reviewed by staff, management has not provided staff guidance or clearly defined the purpose of these activities. Management identified the review of internal reports as an important monitoring function; however, discussions with staff revealed a need for further oversight and guidance to ensure:

- Programming used to generate the reports is updated and adequately captures the desired information
- Staff has a clear understanding of the purpose of each report and the monitoring activities to be performed

Recommendation

We recommend that management:

- a. Develop and implement a formalized process for secondary/supervisory review of manual transactions related to the enrollment and coverage change process. The process should include establishing an error rate tolerance, testing to ensure processing is within tolerance, and additional reviews when error rate is outside of actual tolerance. Moreover, error information obtained through error rate monitoring should be used to provide more focused training for staff with enrollment processing responsibilities.
- b. Develop and implement a formalized process for guidance and supervisory oversight of monitoring activities related to internal reports.

Management Responses

Management agrees with the recommendations.

- a. A new position for a Quality and Training Specialist has just been created and staffed, so the recommendations related to secondary review of transactions will be implemented to ensure quality and completeness of TRS-Care enrollment and coverage changes made by staff by March 31, 2014.
 - b. The HIB Member Service Team Leader under the direction of HIB Assistant Director for Operation is charged with the responsibility of formalizing the processes related to internal mainframe exception report review and supervision. The estimated implementation date is March 31, 2014.
- B. Several current practices are not documented in policies or procedures. These include the following:
- Steps to be taken during the enrollment or coverage change process to ensure that a member is eligible for coverage or that the requested change is in compliance with TRS laws and rules
 - Steps to be taken when initiating a retroactive coverage change that results in a premium underpayment by the member
 - Appropriate action to be taken in the event staff encounters an enrollment or change request for their own family member or other close relationships

In addition, we found two instances where updates are needed to ensure that policies and procedures align with each other and with current practices. These include:

- Written policies and procedures regarding the maximum age for dependents are not updated to reflect the current practice of allowing dependents to remain covered until age 26 as required by the Affordable Care Act.
- Written policies and procedures regarding the optional 90 day deferment period allowed for coverage effective date has not been updated.

Recommendation:

We recommend that management:

- a. Develop written procedures that clearly identify what information should be reviewed by staff during the enrollment and coverage change process to ensure compliance with TRS laws and rules.
- b. Develop written procedures to identify the steps staff should follow when making a retroactive change in coverage that results in a premium underpayment by the member.
- c. Develop a written policy regarding staff's ability to process enrollment or change requests for their own family members or close relationships.
- d. Update written policy and procedures regarding the maximum age for dependents to be consistent with current practices.
- e. Align written policy and procedures regarding the allowable deferment of coverage effective date.

Management Responses

Management agrees with the recommendations.

- a. Management acknowledges that while written procedures currently exist, they are not as complete and formal as desired. An overall revision of the policies and procedures for HIB was initiated last year, but sidelined due to resource limitations related to the implementation of the new Medicare products. Management will resume the efforts to finalize developing written procedures, which will be completed by March 31, 2014.
- b. Written procedures related to retroactive changes will be incorporated in the policies and procedures manual noted in response (a.) above.
- c. Written procedures related to any transaction involving a family member will be incorporated in the policies and procedures manual noted in response (a.) above.
- d. Management agrees to update the written policies and procedures to reflect current practice, which complies with federal law, which will be completed by March 31, 2014.
- e. Written procedures related to enrollment deferrals will be incorporated in the policies and procedures manual noted in response (a.) above.

3. Ensure staff members complete all mandatory training

Established training processes are not being consistently followed. Our testing found that two employees hired November 1, 2012 did not complete required compliance training within 30 days of beginning employment. This included Fraud, Waste, and Abuse Prevention training as well as Health Insurance Portability and Accountability Act (HIPAA) training.

The Human Resources department is responsible for ensuring that new employees are notified of the completion requirements for these online training courses. Normal protocol is for employees to receive an email with information about the required training and for management to be notified if employees fail to meet the required deadlines. In the case of these two employees, Human Resources department was implementing a new process and the employees were not sent the notification email regarding the required training. Subsequently, management was not notified of their failure to complete the training. However, given that both employees were hired to directly work with, and had access to, protected health information, management has a responsibility for ensuring the employees receive HIPAA training when beginning employment.

Recommendation

We recommend that management:

- a. Ensure staff are brought up to date on all mandatory training.
- b. Work with Human Resources department to establish a method for tracking initial and on-going HIPAA training to ensure compliance with federal guidelines regarding refresher training and updates regarding changes to federal regulations or state privacy laws.

Management Responses

Management agrees with the recommendations.

- a. & b. Management will immediately work with Human Resources to receive training completion notices to ensure that 1) HIB staff members are up to date on all mandatory training and 2) all initial and on-going HIPAA training is tracked for compliance purposes. HIB management will review all employees training with Human Resources to ensure that all outstanding requirements for existing employees are completed by July 1, 2013.

4. Enhance Management Assessment of System Access for Transitioning Employees

Although management completed the required annual assessment of staff access for 2012, three transitioning employees had access privileges that exceeded what was needed for their job functions during 2013. Two of the three employees were brought from other departments to assist HIB temporarily with the very heavy workload and call volume. However, when management requested access for these persons, a more restricted access command used to verify a refund (but not to release a refund) was inadvertently included in the request. Verifying refunds was not part of their routine job duties and it is unlikely that a refund would have been directed to either employee for verification.

The third of the three employees assumed more responsibilities as their position changed (twice) within the department and management did not reassess the access privileges with each move. The result was that the employee maintained access privileges from the prior positions that included the ability to make benefit changes, which was no longer in line with his primary role and responsibilities within the area.

The required annual access review helps identify and prevent inappropriate employee access privileges. However, a detailed assessment of access privileges for employees that change positions within the department or move from one department to another is needed to maintain system access that aligns with current job duties.

Recommendation

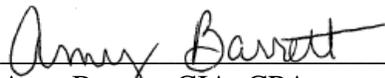
We recommend that management carefully assess employee access privileges to ensure alignment with new job duties and follow TRS' established process for system access requests whenever staffing changes are made within the department.

Management Responses

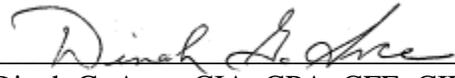
Management agrees with the recommendation, but notes that some changes submitted to IT Security Administration were not implemented timely. Going forward, whenever HIB makes access adjustment requests for new or existing staff members, we will request that IT Security Administration send us the adjustment outcome. We will compare this outcome with our initial requests to determine discrepancies and follow-up actions. The estimated implemented date is July 31, 2013.

* * * * *

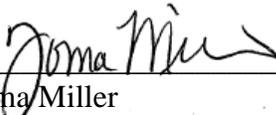
We appreciate Health and Insurance Benefit management and staff for their cooperation, courtesy, and professionalism extended to us during this audit. We also appreciate support provided by the General Accounting, Human Resources, and Information Technology departments.



Amy Barrett, CIA, CPA
Chief Audit Executive



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



Tonia Miller
Internal Auditor



Jan Engler, CIA, CISA, CFE
Audit Manager

APPENDIX A

AUDIT OBJECTIVE, SCOPE, METHODOLOGY, AND CONCLUSION

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

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

AUDIT OBJECTIVE

The audit objective was to determine whether internal controls are in place and are working effectively to achieve the business objectives stated below and mitigate significant risks to meeting that objective.

Provide health care benefits in compliance with the statutory requirements for TRS-Care while providing coverage that is comparable to other Texas governmental health plans.

SCOPE

The audit included tests performed only for TRS-Care:

- Tested controls related to three risks - reliance on vendors, failure to comply with TRS Laws and Rules, and ineffective administration and management processes
- Tested controls over four key business activities - eligibility/enrollment and changes, premiums and collections, vendor claims payments, customer service.
- Validated vendor services for Aetna and Express Scripts, Inc.
- Validated segregation of duties related to financial activities (as a follow-up from the Health Care Payments and Collections Audit done in FY 2010)
- Reviewed access controls to the health insurance system used and monitoring of access controls

The time period for testing controls and transactions was calendar year 2012. The time period for testing reports prior to calendar year 2012 was on an as-needed basis (for example, reports that are not required annually but rather biennially). System access analysis was conducted for current staff access to the internal health insurance system during April and May 2013.

The audit scope did not include:

- Employer reporting and compliance
- TRS-Care Plan contributions
- Information Technology systems testing
- Compliance with federal laws applicable to TRS-Care

- Direct billing of health care premiums
- Activities and processes outside of the four business activities identified above
- Vendor services monitored/audited by external auditors and actuary

METHODOLOGY

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

- Reliance on vendors:
 - Documented how key vendor services are monitored and test controls
 - Obtained examples of analysis of vendors' data/services reports and evidence of management review
 - Obtained and reviewed copy of vendors' disaster recovery plan
 - Obtained evidence of implementation of previous audit recommendation relating to the review of claims invoices
 - Discussed with management how they review third-party internal controls reports known as SSAE 16 reports and inquired about resolution of issues
 - Obtained and reviewed copy of business unit's written procedures for monitoring controls, obtained evidence of review
- Ineffective administration and management processes:
 - Obtained evidence of segregation of duties
 - Obtained copies of departmental written policies and procedures
 - Obtained copies of job descriptions and inquired whether they are up-to-date
 - Inquired whether staff evaluations are up-to-date
 - Observed evidence of staff cross-training
 - Obtained evidence of review of access controls, including access to set up and make changes to member record, benefits, premiums, etc.
 - Obtained evidence of how compliance with laws and rules regarding enrollment is achieved
 - Obtained evidence of review of exception reports
 - Failure to comply with laws/rules/regulations/policies and procedures - obtained evidence for enrollment, eligibility, and changes, as follows:
 - a. Business unit's written policies and procedures
 - b. Evidence of how compliance is achieved
 - c. Evidence of monitoring controls over accuracy of automatic premium deductions
 - d. Evidence of how management ensures completeness and accuracy of claims
 - e. Documentation of staff meetings and training
 - f. Documentation of how issues are escalated

CONCLUSION

Based on our audit results, we determined that management controls are operating effectively to achieve the business objective and we noted numerous positive findings. We did not identify any significant issues. However, we identified opportunities to improve contract monitoring of non-financial terms, internal processes for enrollment, required training, and system access. We recommend that management:

- Formalize procedures for monitoring non-financial contract requirements such as reporting requirements for the number of claims processed, pre-certifications, and providers
- Strengthen internal processes and procedures related to enrollment and coverage changes
- Ensure staff members complete all mandatory training
- Enhance management assessment of system access for transitioning employees

APPENDIX B
TRS-Care Fast Facts Month at a Glance: April 2013

TRS-Care

Inception: Fiscal Year 1987

Member Satisfaction (2012) 94.9%

Enrollment

Retirees 176,460

Dependents 49,426

Total 225,886

Care 1 13.9%

Care 2 18.7%

Care 3 67.4%

Incurred Claims (millions)

Medical-Aetna \$ 687.6

Rx-Caremark 454.5

Total \$ 1,142.1

Actuarial Valuation

Unfunded Liability (UAAL): \$26.8 billion

Funded Ratio 2.70%

Annual Required Contribution as % of Expected Payroll 7.47%

Contribution Rates

State 0.50%

Employee 0.65%

District 0.55%

Total 1.70%

Monthly Premium Rates - Retiree or Surviving Spouse Only (FY 2013)

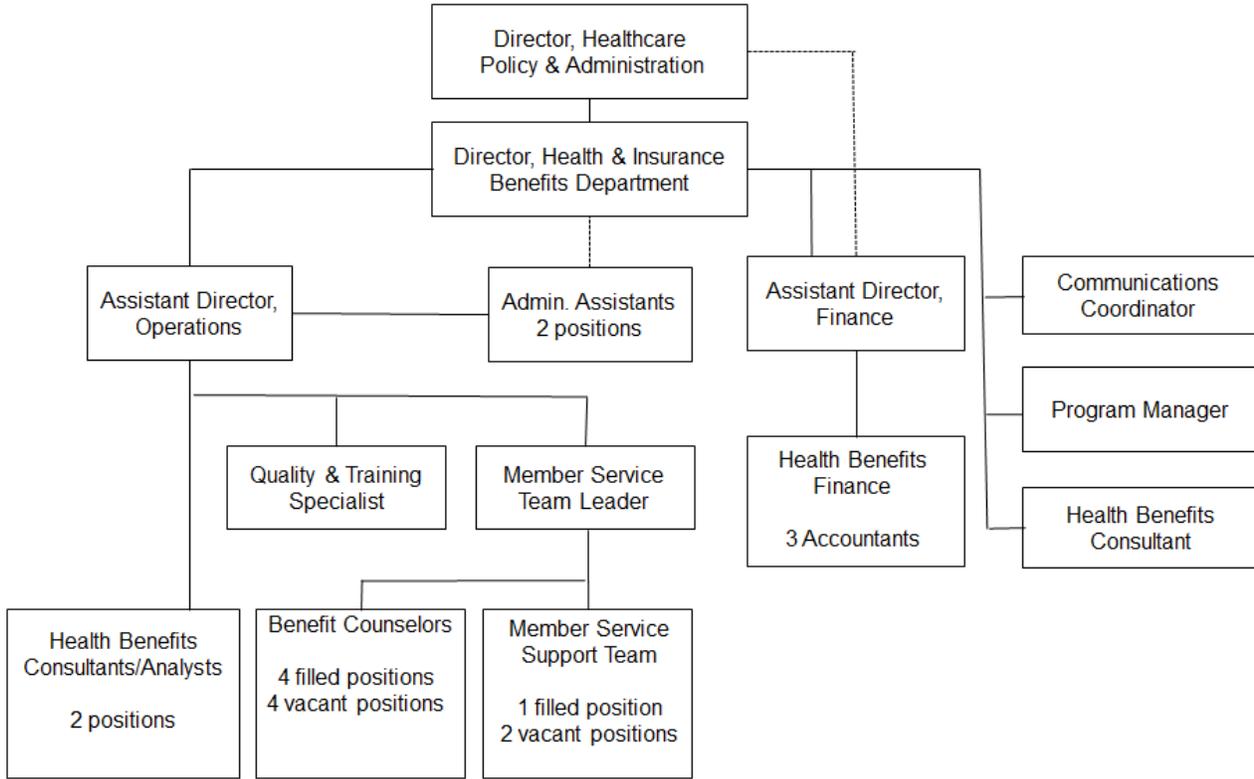
	Care 1	Care 2		Care 3	
		20-29 Years	30+ Years	20-29 Years	30+ Years
With Medicare Advantage	\$ 0	\$ 55	\$ 45	\$ 85	\$ 75
With Medicare A&B	\$ 0	\$ 70	\$ 60	\$ 100	\$ 90
With Medicare B Only	\$ 0	\$ 155	\$ 145	\$ 230	\$ 215
Not Eligible for Medicare	\$ 0	\$ 200	\$ 190	\$ 295	\$ 280

Source: Fast Facts Month at a Glance: April 2013

Year Ended 8/31/12

APPENDIX C

Health and Insurance Benefits Department Organizational Chart



TAB 5B

AUDIT OF EMERGING MANAGER PROGRAM

May 28, 2013

TRS Internal Audit Department

Business Objectives	Prudently invest allocated funds in emerging managers to generate positive returns	Develop a deep pipeline of high quality managers by maintaining strong relationship	Establish monitoring policies for emerging manager investments
Business Risks	<ul style="list-style-type: none"> Lack of Trustee or management commitment or support Inadequate staff resources Lack of diversification Selecting unqualified advisors or managers 	<ul style="list-style-type: none"> TRS program unknown to the EM community Reputational risk EM capacity risk TRS fund-of-funds manager or evaluators' poor customer service to EMs 	<ul style="list-style-type: none"> No policies, procedures, or guidelines to follow Not following policies, procedures, or guidelines Failure to detect or act on poor performance
Management Controls	<ul style="list-style-type: none"> Legislative and Trustee oversight Investment Policy Statement (IPS) Target allocation in IPS Due diligence 	<ul style="list-style-type: none"> Program promotion efforts Customer service and communication efforts Capacity analysis Due diligence before hiring Continuous monitoring 	<ul style="list-style-type: none"> Written policies, procedures, or guidelines Use of external manager and evaluators Third-party reporting of investment returns
Controls Tested	<ul style="list-style-type: none"> Reports provided to the Legislature and Trustees Policy definition of emerging manager (EM) Capital commitment plan Due diligence performed by fund-of-fund manager and evaluators 	<ul style="list-style-type: none"> Program promotion efforts, including EM conference TRS Communication efforts Capacity analysis Staff's due diligence and management approval before hiring fund-of-funds manager and evaluators 	<ul style="list-style-type: none"> Written monitoring policies Quarterly reports prepared by manager and evaluators Monthly investment performance reports prepared by the custodian
Results	Management controls are operating effectively. However, opportunities exist to enhance controls.	Management controls are operating effectively. However, opportunity exists to enhance customer service.	Management controls are operating effectively.
Recommended Actions	<ul style="list-style-type: none"> Closely monitor the fund-of-funds manager's situation and its portfolios Revise IPS to be consistent with the funding plan 	<ul style="list-style-type: none"> Improve the fund-of-funds manager and evaluator's responsiveness to prospective EMs 	None
Management Responses	Management agrees with the recommendations and will continue to monitor the fund-of-funds manager and update the IPS.	Management agrees to meet with fund-of-funds manager and evaluators to better understand the issue, and take action, if deemed necessary.	N/A

Legend of Results: Red - Significant to TRS Orange - Significant to Business Objectives
Yellow - Other Reportable Issue Green - Positive Finding or No Issue

May 28, 2013

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

EXECUTIVE SUMMARY

We have completed the audit of *Emerging Manager Program*, as included in the *Fiscal Year 2013 Audit Plan*. As part of this project, Internal Audit engaged an external specialist (Lenox Park LLC) to obtain expertise in investment due diligence. Management's business objectives related to the TRS Emerging Manager Program are as follows:

- To prudently invest allocated funds in emerging managers to generate positive risk-adjusted returns for TRS, utilizing a rigorous due diligence process (Prudent Investing)
- To develop a deep pipeline of high quality emerging managers by maintaining a strong relationship with partners, evaluators, and key industry contacts (Customer Relationships and Outreach)
- To establish policies and procedures for monitoring emerging manager investments (including partners, evaluators, and emerging managers) to ensure that the emerging manager portfolio is positioned to capture positive performance going forward (Portfolio Monitoring)

Based on our audit results, we determined that management controls are operating effectively to achieve business objectives. Investment Management Division (IMD) management has been prudently investing allocated emerging manager funds. In addition, TRS is viewed as a significant participant and market-leading investor in the emerging manager community. During our audit, no significant issues were identified. However, we identified opportunities to enhance controls related to: (a) close monitoring of the fund-of-funds manager's situation and its portfolio, (b) responsiveness of the fund-of-funds manager and evaluators to prospective emerging managers, and (c) revising the policy of emerging manager fund allocation based on the net asset value rather than the commitment amount.

Results of our procedures are presented in more detail in the **Results and Recommendations** section (page 9). The audit objective, scope, methodology and conclusion are described in **Appendix A** (page 13).

BACKGROUND

The TRS Emerging Manager Program started in November 2004 when the Board of Trustees (Board) approved a commitment of \$100 million to a fund-of-funds private equity manager recommended by the management of the Investment Management Division (IMD). The goal of the program was to provide growth opportunities to small startup asset managers. At the time, the program also emphasized the importance of investing in emerging asset managers owned by minority, women, and historically underutilized individuals. Subsequently the Board approved additional funds to the same firm in a fund-of-funds structure in 2005. Under this structure, the external firm is responsible for sourcing, performing due diligence, hiring, monitoring, and reporting on emerging managers for TRS.

In 2009, the 81st Texas Legislature specified in the rider to the Appropriations Act that TRS shall make a good faith effort to expand its emerging manager program to hire qualified emerging fund managers. It further stated that TRS shall report back to the 82nd Legislature on the methods and results of TRS' efforts to hire emerging fund managers, including data disaggregated by race, ethnicity, gender, and fund size.

Based on this legislative direction, the Board expanded the Emerging Manager Program in 2009 by adopting formal Emerging Manager language in the Investment Policy Statement (IPS) and approving additional funds to bring the total allocation to the Emerging Manager Program to \$1.65 billion, which (if fully funded) would represent approximately 1.9% of the market value of total TRS investments. Furthermore, the Board specified the following target asset allocations for the Emerging Manager Program assets as part of the policy:

Portfolio	Target Allocation (in millions)
External Public Markets Portfolio	\$250
Private Equity Portfolio	\$950
Real Assets Portfolio	\$450
TOTAL	\$1,650

To invest additional funds allocated for the Emerging Manager Program, the Investment Management Division initiated a "direct" investment program by hiring external evaluators of emerging managers, in addition to its existing fund-of-funds program ("indirect" program). Under the direct program structure, external evaluators are responsible for identifying, performing due diligence, and recommending prospective emerging managers to TRS, as well as monitoring and reporting performance of hired emerging managers. TRS is responsible for approving prospective emerging managers recommended by evaluators and monitoring evaluator performance. Currently, one fund-of-funds manager and four evaluators are assisting IMD staff in managing the TRS Emerging Manager Program. As of March 31, 2013, the amounts committed to these managers are as follows (in millions):

Asset Class	Indirect Program	Direct Program				TOTAL
	Manager	Private Equity Evaluator	Real Asset Evaluator	Public Equity Evaluator	Hedge Fund Evaluator	
Private Equity	\$750	\$165				\$915
Real Assets	\$200		\$213			\$413
Public – Long Only				\$95		\$95
Public – Hedge Fund					\$91	\$91
TOTAL	\$950	\$165	\$213	\$95	\$91	\$1,514

Definition of an Emerging Manager

Article 6 of the IPS generally defines an emerging manager as a newer, independent private investment management firm that manages less than \$2 billion, or has a performance track record as a firm shorter than five years, or both. It further states that whether a management firm is an “emerging manager” depends on all of the facts and circumstances. The IPS also states that emerging managers can include, but are not limited to, minority, women, and disabled veteran-owned or -controlled organizations. Conversely, not all minority, women, and disabled veteran-owned or -controlled are necessarily considered emerging managers for the purposes of this program.

Organizational Structure of the Emerging Manager Program

Since 2010, TRS has maintained a dedicated Emerging Manager Program team within the IMD. The team, reporting to the Deputy Chief Investment Officer, consists of three full-time dedicated staff. All three team members are responsible for interacting with existing and prospective emerging managers as well as managing relationships with fund managers and evaluators.

Other IMD groups, such as Investment Operations and External Public Markets (EPU), provide support for Emerging Manager Program staff in overseeing individual evaluators and emerging managers. Investment Accounting, located under the TRS Chief Financial Officer, is responsible for overseeing the valuation of emerging manager investments as well as approving cash movements to emerging managers. In addition, the TRS custodian (State Street Bank) acts as the book of record for TRS investments, and therefore, is responsible for recording values of TRS investments in emerging managers.

Emerging Manager Process Map for the Direct Investing

The investment process for the direct investment part of the Emerging Manager Program includes Strategic Planning, Pipeline Review, Internal Investment Committee (IIC) Review and Approval, and Portfolio Monitoring as major steps. See **Appendix B** (page 15) for specific tasks performed under each step involved in the emerging manager process map. Since the indirect part of the program is delegated to the fund-of-funds manager, most of these steps are performed by the manager.

TRS Investments in Emerging Managers

As of March 31, 2013, TRS committed \$1.514 billion and the net asset value was \$799.5 million. The breakdown of the net asset value is as follows (in millions):

Asset Class	Indirect Program	Direct Program				TOTAL
	Manager	Private Equity Evaluator	Real Asset Evaluator	Public Equity Evaluator	Hedge Fund Evaluator	
Private Equity	\$433.6	\$11.3				\$444.9
Real Assets	\$82.6		\$40.9			\$123.5
Public – Long Only				\$134.2		\$134.2
Public – Hedge Fund					\$96.9	\$96.9
TOTAL	\$516.2	\$11.3	\$40.9	\$134.2	\$96.9	\$799.5

BUSINESS OBJECTIVES, RISKS, AND CONTROLS

For the audit of the Emerging Manager Program, we obtained information about IMD management’s three business objectives, as well as the related risks and the controls management established to mitigate these risks:

Business Objective	Inherent Risks (without considering controls)	Management Controls	Controls Tested
To prudently invest allocated funds in emerging managers to generate positive risk-adjusted returns for TRS, utilizing a rigorous due diligence process (Prudent Investing)	(1) Lack of Trustee commitment or upper management support regarding the benefits of the emerging manager program	A) Legislative directive (included in the Appropriations Act Rider, 81 st Legislature) B) Legislative and Trustee oversight, including (biannual or annual) reporting requirements C) Target emerging manager allocation included in Appendix C of the Investment Policy Statement (IPS)	<ul style="list-style-type: none"> • Emerging Manager Program report provided to the 82nd Legislature • Completeness of policy elements, including emerging manager definition, program elevation or graduation, Historically Underutilized Businesses (HUB) qualifications
	(2) Insufficient level of staff resources allocated to the emerging manager program	A) Use of external evaluators for due diligence and monitoring purposes B) Use of an external partner (i.e., Credit Suisse) to delegate program responsibilities	<ul style="list-style-type: none"> • Due diligence performed by evaluators • Due diligence performed by partners
	(3) Failure to invest allocated funds or diversify assets into different asset classes as specified in the investment policy	A) Total target emerging manager allocation specified in the IPS B) Management’s plans to commit/invest allocated funds to emerging managers C) Management’s monitoring of funds committed and invested D) Annual reporting required to Trustees regarding funds committed and invested	<ul style="list-style-type: none"> • Diversification of assets – comparison of actual asset classes committed/invested vs. targets set in Appendix C of the investment policy • Management’s plans to commit/invest funds to emerging managers (including any plan to commit over the allocated amount)
	(4) Not meeting or making progress toward meeting program goals in terms of investment performance, amount of funds invested, number of relationships established, etc.	A) Management’s plans to commit/invest funds to emerging managers B) Periodic (monthly, quarterly, or annual) monitoring of fund performance in terms of investment returns, dollars committed/invested, number of managers hired, etc. C) Reports presented to the Legislature and Trustees regarding the progress of the TRS Emerging Manager Program D) Peer comparison, showing an advanced position of TRS Emerging Manager Program in terms of size, investment performance, number of managers, number of consultants, dedicated team, breadth of asset allocation, level	<ul style="list-style-type: none"> • Monitoring of fund performance, including investment returns, dollars committed/invested, number of managers hired, etc. • Benchmark with other pension funds (as part of a survey) • Cost analysis of the Emerging Manager Program (prepared by the Investment Management Division)

Business Objective	Inherent Risks (without considering controls)	Management Controls	Controls Tested
		<ul style="list-style-type: none"> of transparency, etc. E) Cost effectiveness of the TRS emerging manager program 	
	(5) Qualified emerging managers not considered for selection	<ul style="list-style-type: none"> A) Intake and referral process established by both internal TRS staff and outside partners/evaluators for inquiring managers B) Partners/evaluators database of emerging managers 	<ul style="list-style-type: none"> • Intake and referral by TRS staff to partners/evaluators • Partners' or evaluators' emerging manager database
	(6) Selecting managers not meeting the emerging manager definition	<ul style="list-style-type: none"> A) Emerging manager definition included in the IPS B) Emerging manager definition included in the contract with partners and evaluators C) Review of managers selected by partners (for the Indirect Program) D) Review and approval by the Internal Investment Committee (IIC) for the Direct Program 	<ul style="list-style-type: none"> • Emerging manager definition included in the contract • IIC review and approval process
	(7) Selecting managers without adequate due diligence on key topics (including verification of track records, going concern issue, reference checks, background checks, etc.)	<ul style="list-style-type: none"> A) Written contract with evaluators requiring due diligence B) IIC approval before hiring emerging managers for the Direct Program C) Due diligence policies and procedures established at partners and evaluators 	<ul style="list-style-type: none"> • Partner's and evaluator's due diligence policies and practices
	(8) Results of due diligence not adequately documented	<ul style="list-style-type: none"> A) Written contract with evaluators requiring support for due diligence B) IIC minutes C) Documentation policies of partners and evaluators D) TRS internal policies documenting due diligence results 	<ul style="list-style-type: none"> • Due diligence documentation policies of partners and evaluators • TRS internal policies documenting due diligence results
	(9) Improper or undue influence used during the manager evaluation or selection process	<ul style="list-style-type: none"> A) Ethics and conflicts of interest policies of partners and evaluators B) Conflict of interest covered during due diligence C) Required disclosure on conflict of interest 	<ul style="list-style-type: none"> • Conflict of interest coverage as part of due diligence • TRS conflict disclosure form (Appendix F of the IPS) completed
	(10) Relying too much on partners or evaluators (including key person risk)	<ul style="list-style-type: none"> A) Internal TRS staff's monitoring activities B) Access to other partners and evaluators available in the market C) Investment Accounting's monitoring of emerging managers' financial statements D) IIC approval before hiring an emerging manager E) Independent financial and performance reporting performed by the TRS custodian 	<ul style="list-style-type: none"> • Internal TRS staff's monitoring activities

Business Objective	Inherent Risks (without considering controls)	Management Controls	Controls Tested
	(11) Headline risk caused by a failure of an emerging manager or scandals involving a manager (including fraud or unethical business dealings)	A) Monitoring by internal staff and external partners/evaluators B) Performance reporting required to a third party custodian C) Annual financial statement audit required (for private markets managers) D) Ethics disclosure required E) Compliance certification required F) Termination clause included in the contract	Tested in other sections
	(12) Emerging manager program being administered (by TRS or partner) is violating laws, regulations, and/or program policies and procedures	A) Monitoring by internal staff and external partners/evaluators B) Trustees and management oversight C) Compliance required as part of investment management agreement D) Annual compliance certification required E) Manager's adoption of Institutional Limited Partner's Association (ILPA) terms	Tested in other sections
To develop a deep pipeline of high quality emerging managers by maintaining a strong relationship with partners, evaluators, and key industry contacts (Customer Relationships and Outreach)	(13) TRS Emerging Manager Program not known to the emerging manager or consultant community	A) Program promotion efforts by TRS B) Annual Emerging Manager Conference C) Publications in trade magazine	<ul style="list-style-type: none"> Program promotion efforts by TRS Annual Emerging Manager Conference
	(14) Qualified emerging managers not wanting to do business with TRS due to poor reputation (Reputational risk)	A) Program promotion efforts by TRS B) Promotion efforts by partners or evaluators	<ul style="list-style-type: none"> Promotion efforts by partners and evaluators
	(15) Lack of qualified emerging managers to choose from (Capacity risk)	A) Emerging manager capacity analysis performed by TRS B) Access to partner's or evaluator's network or database of emerging managers C) Allocation of additional funds to existing emerging managers (i.e., elevation) D) TRS' promotion efforts regarding program expansion, including publications in trade magazine	<ul style="list-style-type: none"> Capacity analysis performed by TRS Access to partner's or evaluator's network (including inquiries about capacity issue)
	(16) Unhappy emerging manager community due to poor outreach efforts by TRS staff	A) TRS' communication efforts with emerging managers B) Annual Emerging Manager Conference C) Program staff's goal to return emerging manager calls within 24 hours D) Clear communication of program goals and principles to partners and evaluators	<ul style="list-style-type: none"> TRS' communication efforts with emerging managers (to be measured through informal survey) Communication of program goals and principles to partners and evaluators
	(17) Hiring and relying on external partner or evaluators with poor quality or reputation	A) TRS staff's due diligence before hiring partners or evaluators B) Board or IIC approval before hiring	<ul style="list-style-type: none"> Due diligence performed on evaluators before hiring (when the Request for Proposal process was not utilized)

Business Objective	Inherent Risks (without considering controls)	Management Controls	Controls Tested
	(18) Prospective emerging manager's contact with TRS or evaluators are lost or not followed through to the next level	A) Intake records maintained at TRS B) TRS' referral to partners or evaluators	<ul style="list-style-type: none"> Follow-up activities done by partners or evaluators on TRS referrals
To establish policies and procedures for monitoring emerging manager investments (including partners, evaluators, and emerging managers) to ensure that the emerging manager portfolio is positioned to capture positive performance going forward (Portfolio Monitoring)	(19) No guidelines exist for staff to follow, especially in case of staff turnover	A) Cross-training of staff B) External resources available, including partners, evaluators, and custodian	<ul style="list-style-type: none"> Various monitoring performed by external parties
	(20) Failure to detect poor performance or changes occurring at a manager concerning personnel, resources, assets, investment strategies, and operation	A) Monitoring by both internal staff and outside partners/evaluators B) Attendance at advisory board meetings C) Periodic reporting by partners and evaluators	<ul style="list-style-type: none"> Periodic reporting by partners and evaluators
	(21) Inadequate monitoring of emerging managers, partners, or evaluators	A) Policies or agreements related to monitoring of managers B) Monitoring by both internal staff and outside evaluators C) Attendance at advisory board meetings D) Periodic reporting by partners and evaluators	<ul style="list-style-type: none"> Consulting assistance for developing TRS monitoring policies and procedures, including survey of peers
	(22) Monitoring results or reports not received at all or not timely received	A) Contract requiring periodic reporting B) Performance reports provided by the custodian C) Investment Accounting's review and corrective action if needed	<ul style="list-style-type: none"> Performance reports provided by the custodian
	(23) Incomplete or inaccurate data monitored or reported (including data provided to State Street)	A) Independent compilation of data/report by the custodian B) TRS staff's review of data/reports submitted	Not selected for testing
	(24) Not taking corrective action in a timely manner or taking improper action	A) Responsible parties for follow-up action clearly identified B) Involvement and review by multiple internal and external parties	Not selected for testing

RESULTS AND RECOMMENDATIONS

OVERALL RESULTS

Based on our audit results, we determined that management controls are operating effectively to achieve business objectives. Investment Management Division (IMD) management has been prudently investing allocated emerging manager funds. In addition, TRS is viewed as a significant participant and market-leading investor in the emerging manager community. No significant issues were identified. The positive results as well as opportunities for management to enhance controls related to the Emerging Manager Program are described below.

POSITIVE RESULTS

Internal Audit and the external specialist engaged by Internal Audit made the following observations:

- The TRS Emerging Manager Program is viewed as a significant market participant and market-leading investor in the Emerging Manager space.
- TRS has exercised prudence in selecting a fund-of-funds manager and evaluators to source, perform due diligence, and in some cases allocate to emerging managers.
- The TRS Board of Trustees has approved \$1.65 billion for emerging manager investments. Substantially all has been committed through direct and indirect programs to date, and projections are on target for net asset value (NAV) investment by 2018. Diversification in portfolios is also in line with targets set by the Investment Policy Statement.
- Clear definition of emerging manager in the Investment Policy Statement is conveyed to fund-of-funds manager and evaluators.
- Due diligence procedures and documentation are adequately performed by fund-of-funds manager and evaluators.
- The TRS Emerging Manager Conference hosted in Austin, Texas is viewed very positively within the emerging manager universe, and for those that have attended, it is a 'must-attend' event.
- The dedicated Emerging Manager team is perceived to be very responsive and helpful among managers that have attempted to access TRS capital. Despite resource constraints and the volume of work necessary to effectively monitor such a sizable Emerging Manager Program, the TRS Emerging Manager staff is continuously developing policies and procedures to adequately monitor emerging manager portfolios, including on-site visits and frequent reviews.
- In addition to ad hoc reporting, the fund-of-funds manager and evaluators provide quarterly emerging manager reports, and State Street provides monthly performance reports.
- The TRS Emerging Manager Program has received several awards, including two in 2012, and has been featured in many publications, including Bloomberg News.

SIGNIFICANT RESULTS¹

No significant issues and recommendations were identified.

OTHER REPORTABLE RESULTS

1. Closely monitor the fund-of-funds manager's portfolio as well as the firm's situation

One fund-of-funds manager has been serving TRS' indirect emerging manager program since 2005. However, there have been several changes with this manager since inception. We noted the following with this manager and its emerging manager portfolio:

- Senior-level staff turnover
- The firm unit which manages the emerging manager program is for sale
- Investment performance has not met expectations, especially the private equity funds for vintage years 2005 and 2008
- The firm is no longer perceived to have "dry powder" (i.e., cash)

Recommendation

We recommend that IMD management closely monitor the fund-of-funds manager's situation as well as its portfolio and if necessary, take appropriate action.

Management Responses

Management agrees with the recommendation. We will continue to monitor the fund-of-funds manager's situation as well as the portfolio and if necessary, take appropriate action. Expected implementation date is June 2014.

2. Improve fund-of-funds manager and evaluators' responsiveness to prospective emerging managers by clearly communicating TRS' expectations and ensuring timely and satisfactory closure on referrals

When emerging managers contact TRS for business opportunities, TRS refers them to the external fund-of-funds manager or evaluators for due diligence purposes in most cases. As part of managing the emerging manager pipeline, the fund-of-funds manager and evaluators are tracking these TRS referrals. Results of our informal survey of emerging managers (who have either been denied capital or not yet received capital from TRS) indicated very positive experiences with TRS staff (16 out of 16). However, some of them expressed concerns related to a lack of communication and delays in responsiveness by the fund-of-funds manager or evaluators. Since any prospective emerging manager's poor experiences could have a negative impact on TRS' reputation, opportunities to improve the fund-of-funds manager and evaluators' responsiveness to prospective emerging managers exist.

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

Recommendation

We recommend that TRS staff improve the fund-of-funds manager and evaluators' responsiveness to prospective emerging managers by clearly communicating TRS' expectations and ensuring timely and satisfactory closure on the referrals TRS previously made.

Management Responses

Management agrees to meet with the external specialist, the fund-of-funds manager, and evaluators to better understand the nature and magnitude of this issue. Based on our findings, the IMD will implement a change to the current process and/or reporting as is deemed necessary. Expected implementation date is December 2013.

3. Revise the Investment Policy Statement (IPS) to be consistent with the fund commitment plan

According to the IPS, TRS' target allocation to emerging managers is \$1.65 billion. It further states that this target allocation is based on commitments. However, during the Board of Trustees' meeting in February 2013, the Investment Management Committee directed IMD staff to change the target allocation based on the net asset value, instead of the commitment.² Based on this direction, IMD has developed a revised fund commitment plan throughout 2018. Therefore, the current target asset allocation policy is inconsistent with the allocation based on the net asset value.

Recommendation

We recommend that IMD management revise the target asset allocation policy for emerging managers from the current commitment-based to the net asset value based to be consistent with the updated asset allocation plan.

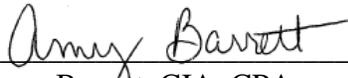
Management Responses

Management agrees with the recommendation. At the next IPS policy review, IMD management will recommend an amendment to the investment policy to state the appropriate emerging managers' policy allocation.

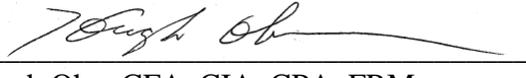
² The amount of asset allocation based on commitments could be quite different from the amount of allocation based on net asset values because funding of committed capital in private equity and real asset investments will occur over an extended period of time. For this reason, it is common to commit private equity and real asset investments by 1.5 to 1.8 times the target allocation to reach the target asset allocation in net asset value.

* * * * *

We appreciate the IMD's Emerging Manager Program management and staff for their cooperation, courtesy, and professionalism extended to us during this audit. We also appreciate accommodation and timely support provided by the external fund-of-funds manager and evaluators for the TRS Emerging Manager Program.



Amy Barrett, CIA, CPA
Chief Audit Executive



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



Brian Gomolski, CIA, CPA
Senior Investment Auditor

APPENDIX A

AUDIT OBJECTIVE, SCOPE, METHODOLOGY, AND CONCLUSION

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

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

AUDIT OBJECTIVE

The audit objective was to determine whether internal controls are in place and are working effectively to achieve the business objectives stated below and mitigate significant risks to meeting those objectives.

- To prudently invest allocated funds in emerging managers to generate positive risk-adjusted returns for TRS, utilizing a rigorous due diligence process
- To develop a deep pipeline of high quality emerging managers by maintaining a strong relationship with partners, evaluators, and key industry contacts
- To establish policies and procedures for monitoring emerging manager investments (including partners, evaluators, and emerging managers) to ensure that the emerging manager portfolio is positioned to capture positive performance going forward

SCOPE

The scope of the audit included both the private and public emerging manager investments made since 2005 through March 31, 2013. It also covered the investments made by the fund-of-funds manager (Indirect Program) as well as the investments in emerging managers by TRS Investment staff with assistance from four evaluators (Direct Program).

METHODOLOGY

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

- Obtained Emerging Manager Program report provided to 82nd legislature
- Reviewed IPS for completeness of policy elements
- Performed on-site visit to the fund-of-funds manager
- Performed on-site visits to evaluators
- Examined due diligence performed by partner/evaluators

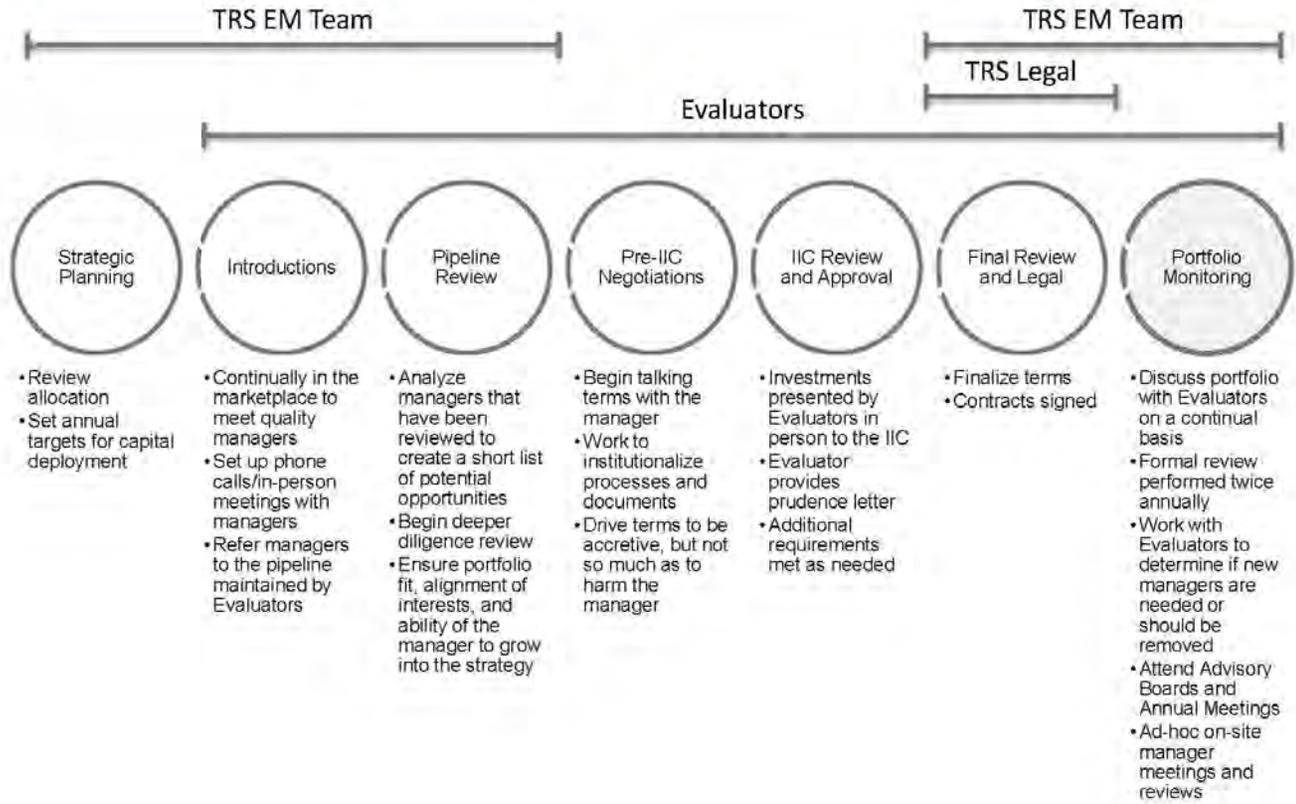
- Compared actual to target asset allocation
- Obtained management's fund commitment plan
- Obtained evidence of TRS' monitoring of fund performance
- Surveyed peers for data including size, performance, etc.
- Obtained cost analysis of Emerging Manager Program
- Obtained evidence of TRS' tracking of manager referrals to partner/evaluators
- Obtained evidence of partner/evaluators' tracking of manager referrals by TRS
- Verified emerging manager definition included in partner/evaluators' contracts
- Obtained evidence of IIC approval of Emerging Manager Direct Program
- Obtained partner/evaluators' due diligence policies
- Obtained TRS due diligence policies
- Obtained evidence of program promotion efforts
- Attended annual emerging manager conference
- Obtained capacity analysis on the population of emerging managers
- Informally surveyed select emerging managers
- Obtained evidence of due diligence performed on evaluators
- Obtained evidence of partner/evaluators' reporting to TRS
- Provided guidance to TRS Emerging Manager team to develop monitoring procedures
- Obtained evidence of custodian performance reporting to TRS

CONCLUSION

Based on our audit results, we determined that management controls are operating effectively to achieve business objectives. Investment Management Division (IMD) management has been prudently investing allocated emerging manager funds. In addition, TRS is viewed as a significant participant and market-leading investor in the emerging manager community. During our audit, no significant issues were identified. However, we identified opportunities to enhance controls related to: (a) close monitoring of the fund-of-funds manager's situation and its portfolio, (b) responsiveness of the fund-of-funds manager and evaluators to prospective emerging managers, and (c) revising the policy of emerging manager fund allocation based on the net asset value rather than the commitment amount.

APPENDIX B

Direct Investing



TAB 5C

QUARTERLY INVESTMENT TESTING
INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), WIRE TRANSFER PROCEDURES
 CALENDAR QUARTER ENDED MARCH 31, 2013, 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 two months ended April 30, 2013)
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 Documentation provides support for reports tested 	<ul style="list-style-type: none"> All supporting documentation exists All newly approved investments were within authorized limits 	<ul style="list-style-type: none"> All other requirements of the IPS, SLP, wire transfer procedures, etc. are met 	No exceptions
Management Responses	None	None	None	None

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

May 20, 2013

Britt Harris, Chief Investment Officer
Don Green, Chief Financial Officer

We have completed the **Quarterly Investment 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 the 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 and procedural requirements have been met.

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 and Investment Accounting 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

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 	<ul style="list-style-type: none"> • Reports contained the required reporting information • Supporting documentation existed for the reports selected for testing 	No response required
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. Each 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 appropriate) per investment on a 	No rebalancing occurred in selected investments.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<p>monthly basis</p> <ul style="list-style-type: none"> Obtain documentation from IMD staff supporting rebalancing analytics. Report on exceptions. 		
4	2	Article 9.9 – Verify leverage used meets requirements	<ul style="list-style-type: none"> Verify leverage was used only as authorized Inquire whether any risk parameters were exceeded and if so, was the limit caused by leverage 	Leverage was used only as authorized and no risk parameters were exceeded.	No response required
5	2	IPS Article 11 - Verify existence of placement agent questionnaire for each new investment selected for testing and test for inclusion in summary report to Board	<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 at least semi-annually 	No placement agents were used in selected investments.	No response required
6	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 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 c) Obtain documentation that CIO 	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 were no investments in Special Investment Opportunities.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			and ED requested comments from chairman of appropriate board committee and TRS consultants and advisers d) Verify Special Investment Opportunity did not exceed \$1 billion. 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		
7	4	Compliance Report of Senior Investment Compliance Specialist (SICS) – Verify with SICS that all other policy requirements were 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
8	3	Quarterly Disclosures – Verify all known compliance violations have been reported	Send request for disclosure to IMD management, Legal Investment staff, and CIO requesting disclosure of any known compliance violations during testing period	Obtained all disclosures from IMD management, Legal Investment staff, and CIO of any known compliance violations during testing period	No response required
9	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, verify that supporting documentation exists for each	All wire transfers tested were properly authorized and correct amounts were wired.	No response required
10	3	SLP Section 5 - Obtain evidence of IMD review of securities lending program and performance of lender	Obtain evidence that staff reviewed the progress of the securities lending program, including an overall evaluation of the performance of the lender, with the Risk Committee	A review of the securities lending program was presented by State Street at the April 2013 Risk Management Committee meeting.	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 March 31, 2013.

APPENDIX B

COMPLIANCE WITH INVESTMENT AND RELATED POLICIES As of and for the two months ended April 30, 2013

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 6

**TRS Internal Audit
Summary of Audit Recommendations Status
June 2013**

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	8/2013
12-303 Audit of External Private Market Investments					
	Reconcile the partner capital statement with audited financial statements	In Progress	Other Reportable	10/2012	8/2013
12-401 Building Security					
	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
12-403 Audit of Compensation, Payroll and Position Control					
	Develop and implement a written procedures manual for payroll	In Progress	Other Reportable	4/2013	10/2014
13-102 Telephone Counseling Center Performance Measures Audit (Outsourced Audit conducted by Myers and Stauffer LC)					
	Address Average Speed to Answer (ASA) reliability issues	In Progress	Significant	5/2013	
	Evaluate service level as a more suitable measure	In Progress	Other Reportable	9/2016	

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
June 2013**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
13-303 Audit of Derivatives					
	Further restrict network folder level access to Derivative model files	Implemented	Other Reportable	4/2013	4/2013
	Establish a formal checklist procedure to help ensure consistent usage of the TAA model	implemented	Other Reportable	6/2013	4/2013
	Derivative model files should be password protected	Implemented	Other Reportable	8/2013	4/2013

Independent Audit Report on TRS-ActiveCare Service Providers (Reported at April 2013 Audit Committee meeting)

Health and Insurance Benefits (HIB) management agrees with the recommendations and issues noted by Sagebrush Solutions and has determined that while none are significant to the plan's operations or finances, the steps taken by the vendors to prevent reoccurrences are adequate. Therefore, no further management action is required beyond ongoing vendor monitoring and coordination with HIB staff.

TAB 7

Teacher Retirement System of Texas
June 2013 Audit Committee Agenda Items Mapped to TRS Enterprise Risk Inventory

403(b)	Accounting & Reporting	Budget	Business Continuity	Communications & External Relations
Credit	Customer Service	<i>Employer Reporting</i> Agenda Item 4A	Ethics & Fraud Prevention	Facilities
Governmental/ Association Relations & Legislation	<i>Health Care Administration</i> Agenda Item 5A	Information Security & Confidentiality	<i>Investment Accounting</i> Agenda Item 2	Investment Operations
<i>Investment Reporting</i> Agenda Item 5C	Legacy Information Systems	Liquidity/Leverage	<i>Market</i> Agenda Item 5B	<i>Open Government</i> Agenda Items 3, 4B, 6 & 7
Pension Benefit Administration	Pension Funding	Purchasing & Contracts	Records Management	Regulatory, Compliance, & Litigation
Retiree Health Care Funding	TEAM Program	Workforce Continuity		

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

Title	Type	Status
Executive		
Ethics and Communications Policies Compliance Audit	Audit	Cancel (Tab 4B)
Investment Compliance Self-Assessment	Advisory	Add (Tab 4B)
Fraud Risk Identification and Prevention Audit	Audit	In Progress
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	Complete
Benefit Payment Testing (financial audit)	Audit	Complete
Benefit Payment Testing (semi-annual)	Agreed-Upon Procedures	1 of 2 Complete
Benefit Processing Surprise Inspection	Advisory	Complete
Health Care Division		
Health Care Administration Audit	Audit	Complete
Health Care Vendor Update Meetings	Advisory	Ongoing
Vendor and Auditor Selection Observation Fraud	Advisory	
Information Technology Division		
Backup and Recovery Audit	Audit	Complete
Health Insurance Portability and Accountability Act (HIPAA) IT Security Rule Recommendations Implementation and Validation	Audit	In Progress
Internal Network Vulnerabilities Scan	Agreed-Upon Procedures	Complete
Network Penetration Test; Security Risk Assessment Review	Advisory	
Technology Committee Meetings Attendance	Advisory	Ongoing

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

Title	Type	Status
Finance Division		
Employer Reporting Audit	Audit	Revise (Tab 4B)
Procurement and Contracting Audit	Audit	Cancel (Tab 4B)
1099 Reporting and Payment Processing	Advisory	Complete
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	Complete
Derivatives Audit	Audit	Complete
Investment Policy Compliance Testing (quarterly)	Agreed-Upon Procedures	Current QTR Complete
Contractual Allowance Identification	Consulting	Complete
Incentive Compensation Review	Advisory	Complete
Employee Trading Policy Compliance Monitoring	Advisory	Ongoing
Emerging Risks Monitoring	Advisory	Ongoing
Investment Committees Attendance	Advisory	Ongoing
Travel Inspection	Advisory	
Coordination of SAO Audit of Incentive Compensation	Advisory (Added to Plan)	Complete
Coordination of SAO Ethics Policies Follow-Up Audit	Advisory (Added to Plan)	Complete
Internal Audit Department		
External Quality Assurance Review	Audit	Complete
Annual Internal Audit Report	Audit	Complete
Audit Recommendation Follow-up	Audit	Ongoing
Audit Plan	Advisory	In Progress
Audit Committee Meetings Preparation	Advisory	Ongoing
Internal Audit Strategic Plan	Advisory	In Progress

Fiscal Year 2013 Internal Audit Advisory Services¹

March – May 2013

BENEFIT SERVICES
TEAM PROJECT <ul style="list-style-type: none"> • Executive Steering Committee Participation • Business Rules Committee Participation • Organizational Change Management Advisory Group Participation • Monthly meetings with TEAM Project Manager • Core Management Team: Standing Prioritization Review Meeting • Independent Program Assessment Vendor Coordination and Support • Assistance to TRS Project Management Office with identification of internal controls in the Line of Business commitments and Financial System Replacement requirements
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 • Participation in Discussions to Establish Automated Derivatives Monitoring in Bloomberg • Collaboration to Develop a Process Map for Principal Investing of Private Markets Deals • Coordination of State Auditor’s Office Audit of Incentive Compensation • Quarterly Update Meeting with IMD Managing Director of Risk • Quarterly Meeting with State Street Compliance group • Participation in several walkthroughs of new LiveCycle process for private markets funding; feedback provided to Information Technology and Investment Accounting staff
FINANCIAL SERVICES
<ul style="list-style-type: none"> • Flowcharting Benefit Accounting’s Disbursement Process
EXECUTIVE
<ul style="list-style-type: none"> • State Auditor’s Office Quarterly Update Meetings Coordination and Support • Hot Line Call Facilitation • Triage Procedures Update (develop framework for fraud and ethics investigations) • Executive Requests • Social Media Advisory Committee Participation • Fraud, Waste and Abuse Prevention Committee Participation • Website Advisory Committee Participation
INFORMATION TECHNOLOGY
<ul style="list-style-type: none"> • Enterprise Security Project Team Participation

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
3rd Quarter Ending May 31, 2013**

Target Performance	Activity	Status
1. Plan and execute employer audit activities with significant direction and input from TRS subject matter experts	Ongoing coordination with management on the development of employer self-audit tools (See Tab 4A)	On Task
2. Facilitate and monitor timely hiring and coordination of TEAM Independent Program Assessment (IPA) vendor	Ongoing coordination and support of IPA vendor for identifying, communicating, and reporting risks	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)	See Tab 7 for Audit Plan Status; proposed revisions to audit plan (Tab 4B) will not impact the ability to meet this measure	On Task
4. Complete external quality assurance review with no significant compliance exceptions	See Tab 3 : Overall opinion is that Internal Audit is in compliance with professional standards and the Texas Internal Auditing Act	Achieved
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	<ul style="list-style-type: none"> • CAE conducts recurring meetings with Executive Director, attends all Executive Council meetings, and meets with chief officers as needed • CAE meets with Audit Committee Chair quarterly • CAE gathers input annually from trustees and executive management for the annual audit plan development 	On Task
6. Enhance value through allocating time for special requests throughout the year	<ul style="list-style-type: none"> • Allocated 970 hours for unscheduled projects • For listing of scheduled and unscheduled advisory projects, see page 4 under Tab 7 	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	<ul style="list-style-type: none"> • Internal Audit (IA) staff is working with Benefit Accounting and Legal Services staff to gain knowledge on employer reporting and related TRS Laws and Rules. • IA staff has worked with external service providers on outsourced audit projects and advisory projects in Information Technology. 	On Task

**Internal Audit Performance Measures - Fiscal Year 2013
3rd Quarter Ending May 31, 2013**

Target Performance	Activity	Status
8. Systematically monitor emerging investment issues and impact to TRS via the investment compliance program	<ul style="list-style-type: none"> • IA staff attend regular meetings with Deputy CIO and Managing Director of Risk to maintain current on investment issues. • IA investment compliance staff monitors investment related issues through daily news services and discuss at weekly meetings. 	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	Year-to-date calculation is 77% of total available department hours (excluding uncontrollable leave) spent 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	State Auditor's Office Report on the Audit of Fiscal Year 2012 Comprehensive Annual Report (CAFR) was reported to the Audit Committee in December 2012.	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 5/31/2013

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 – 3/31/2012	1	Resolved
4/1/2012 – 05/31/2012	0	N/A
06/01/2012 – 08/31/2012	0	N/A
09/01/2012-11/30/2012	1	Resolved
12/01/2012 – 03/31/2013	0	N/A
4/01/2013 – 5/31/2013	0	N/A

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

Per the TRS Fraud and Ethics Hotline Procedures:

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



For Immediate Release
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COSO Issues Updated *Internal Control-Integrated Framework* and Related Illustrative Documents

ALTAMONTE SPRINGS, Fla., May 14, 2013 – The [Committee of Sponsoring Organizations of the Treadway Commission](#) (COSO) – an organization providing thought leadership and guidance on internal control, enterprise risk management, and fraud deterrence – issued today its updated *Internal Control-Integrated Framework (Framework)* and related illustrative documents. COSO’s original Framework published in 1992 is recognized as the leading guidance for designing, implementing and conducting internal control and assessing its effectiveness.

Authored by PwC under the direction of the COSO Board, the updated *Framework* is expected to help organizations design and implement internal control in light of many changes in business and operating environments since the issuance of the original Framework, broaden the application of internal control in addressing operations and reporting objectives, and clarify the requirements for determining what constitutes effective internal control.

COSO also issued, today, the *Illustrative Tools for Assessing Effectiveness of a System of Internal Control* and the *Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches and Examples*. The *Illustrative Tools* are expected to assist users when assessing whether a system of internal control meets the requirements set forth in the updated *Framework*. The *ICEFR Compendium* is particularly relevant to those who prepare financial statements for external purposes based upon requirements set forth in the updated *Framework*.

“COSO and PwC are very appreciative of the extensive and thoughtful input received from stakeholders through participation in an initial survey of potential updates, the public exposures of draft documents during 2011 and 2012, and other forums during the 2 ½ year development process,” said David Landsittel, Chairman of COSO. “While our original Framework remains fundamentally sound and broadly accepted in the market place, we are confident that the 2013 *Framework* will bring added benefits to users.”

COSO believes that users should transition their applications and related documentation to the updated *Framework* as soon as is feasible under their particular circumstances. As previously announced, COSO will continue to make available its original Framework during the transition period extending to December 15, 2014, after which time COSO will consider it as superseded by the 2013 *Framework*.

The COSO Board believes that the continued use of the original Framework during the transition period (May 14, 2013 to December 15, 2014) is appropriate. During this period, the COSO Board believes that organizations reporting externally should clearly disclose whether the original Framework or the 2013 *Framework* was utilized. COSO will also continue to make available its publication, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* until December 15, 2014, after which time it will no longer be available.

COSO publications are available for purchase at www.coso.org. The *Framework*, *Illustrative Tools*, and *ICEFR Compendium* are available for purchase in both hard copy and electronic formats. An *Executive Summary* can be downloaded by the public free of charge from www.coso.org. In addition, the public exposure drafts of these publications, the related public comment letters, and other background information about the project will remain available on COSO's website through December 31, 2013.

Finally, COSO wishes to thank PwC for its outstanding contributions in developing the updated *Framework* and related illustrative documents, and the Advisory Council for its very thoughtful insights. PwC's consideration of input provided by many stakeholders was instrumental in preserving, clarifying and strengthening, as appropriate, COSO's original Framework.

About COSO

Originally formed in 1985, COSO is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management (ERM) internal control and fraud deterrence. COSO's sponsoring organizations are the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). www.coso.org.

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SEC Charges Institutional Shareholder Services in Breach of Clients' Confidential Proxy Voting Information

FOR IMMEDIATE RELEASE
2013-92

Washington, D.C., May 23, 2013 — The Securities and Exchange Commission today charged Rockville, Md.-based proxy adviser Institutional Shareholder Services (ISS) for failing to safeguard the confidential proxy voting information of clients participating in a number of significant proxy contests.

Additional Materials

➤ [SEC Order](#)

An SEC investigation found that an employee at ISS provided a proxy solicitor with material, nonpublic information revealing how more than 100 ISS institutional shareholder advisory clients were voting their proxy ballots. In exchange for voting information, the proxy solicitor provided the ISS employee with meals, expensive tickets to concerts and sporting events, and an airline ticket. The breach was made possible in part because ISS lacked sufficient controls over employee access to confidential client vote information, as this employee gathered the data by logging into the ISS voting website from home or work and using his personal e-mail account to communicate details to the proxy solicitor. The employee no longer works at ISS.

ISS, which is registered with the SEC as an investment adviser, agreed to settle the charges by paying \$300,000 and retaining an independent compliance consultant.

"Proxy advisers must tailor their controls based on the risks of their particular business in order to protect the integrity of the proxy voting process," said Julie M. Riewe, Deputy Chief of the SEC Enforcement Division's Asset Management Unit. "The internal controls at ISS did not adequately address the potential misuse of confidential proxy voting information by firm employees."

According to the SEC's order instituting settled administrative proceedings, the breach occurred from approximately 2007 to 2012. ISS failed to establish or enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by ISS employees. Specifically, ISS lacked sufficient controls over employee access to databases of confidential client vote information.

The SEC's order finds that ISS willfully violated Section 204A of the Investment Advisers Act of 1940. The order censures the firm and requires ISS to pay a \$300,000 penalty and engage an independent compliance consultant to review its supervisory and compliance policies and procedures. The consultant will evaluate whether ISS's procedures are reasonably designed to ensure that its proxy voting services business complies with the Advisers Act in its treatment of confidential information, communications with proxy solicitors, and gifts and entertainment. Without admitting or

denying the SEC's findings, ISS agreed to cease and desist from committing or causing any future violations of Section 204A.

The SEC's investigation was conducted in the Boston Regional Office by Robert Baker and Kevin Kelcourse of the Asset Management Unit along with Britt Collins and Rachel Hershfang. They were assisted by members of the Boston Regional Office's examination staff, including Daniel Wong, Paul Prata, and Dan Mazzaferro.

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<http://www.sec.gov/news/press/2013/2013-92.htm>

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Internal Audit Staff Quarterly Accomplishments

- Amy Barrett and Toma Miller attended the Association of Public Pension Fund Auditors (APPFA) conference in Philadelphia. Angela Vogeli, Assistant General Counsel and Tess Weil, Partner, Purrington Moody Weil LLP, presented to APPFA on *Trading Derivatives in a Post Dodd-Frank World*.
- Jan Engler, Dorvin Handrick, and Toma Miller attended the State Auditor's Office Learning Center training *Communication and Interpersonal Issues for Auditors: Mastering the Six Critical Skills*.
- Amy Barrett, Jan Engler, and Toma Miller attended one day of the *State and Local Government Benefits Association (SALGBA)* conference in San Antonio.