

# **Audit Committee Meeting**

**June 2014**



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

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

*(Mr. Moss, Chairman; Ms. Charleston; Mr. Corpus; Ms. Palmer; & Ms. Sissney, Committee Members)*

**AGENDA**

**June 6, 2014 – 8:00 a.m.  
TRS East Building, 5<sup>th</sup> Floor, Boardroom**

1. Approve minutes of March 27, 2014 Audit Committee meeting – Mr. Christopher Moss, Chair
2. Receive report on independent financial auditor requirements to test census data of reporting entities – Ms. Angelica Ramirez and Mr. Michael Clayton, State Auditor's Office
3. Receive report on Health Care Audit Risk Assessment and Model Three-Year Audit Plan Project – Ms. Amy Barrett; Ms. Susan Haseley and Ms. Gail Kincaid, Protiviti Inc.
4. Receive Internal Audit reports
  - A. Audit of Refunds of Inactive and Dormant Accounts – Ms. Jan Engler
  - B. Audit of Contractor Onboarding and System Access – Ms. Lih-Jen Lan
  - C. Third Quarter Test Results of Investment Controls (External Public Markets, Cash Securities Operation, Investment Performance) – Mr. Hugh Ohn
  - D. Quarterly Investment Compliance Testing (Agreed-Upon Procedures) – Mr. Hugh Ohn
5. Receive report on the status of prior audit and consulting recommendations – Ms. Amy Barrett
6. Consider Recommendation to the Board of Trustees Regarding Revisions to the Audit Plan for Fiscal Year 2014 and receive Status Report on Reporting Entity Reviews
  - A. Proposed Revisions to Fiscal Year 2014 Audit Plan – Ms. Amy Barrett
  - B. Status of Reporting Entity Reviews – Ms. Amy Barrett and Ms. Karen Morris
7. Discuss or consider Internal Audit administrative reports and matters related to governance, risk management, internal control, compliance violations, fraud, regulatory reviews or investigations, hotline usage report, fraud risk areas, audits for the annual internal audit plan, or auditors' ability to perform duties – Mr. Christopher Moss and 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 the full Audit Committee constitutes a quorum of the Board, the meeting of the Committee is also being posted as a meeting of the Board out of an abundance of caution.

**TAB 1**



**TEACHER RETIREMENT SYSTEM OF TEXAS  
AUDIT COMMITTEE MEETING  
March 27, 2014**

The Audit Committee of the Teacher Retirement System of Texas met on Thursday, March 27, 2014 in the 5<sup>th</sup> floor Board room. The following persons were present:

**TRS Board Members**

Christopher Moss, Audit Committee Chair  
Nanette Sissney, Board Vice Chair, Audit Committee Member  
Anita Smith Palmer, Audit Committee Member  
T. Karen Charleston, Audit Committee Member  
David Corpus, Audit Committee Member  
R. David Kelly, Board Chair  
Todd Barth, Board Member  
Joe Colonna, Board Member  
Dolores Ramirez, Board Member

**TRS Staff**

Brian Guthrie, Executive Director  
Ken Welch, Deputy Director  
Amy Barrett, Chief Audit Executive  
Hugh Ohn, Director, Investment Audit Services  
Karen Morris, Director, Pension Audit Services  
Jan Engler, Manager, Internal Audit  
Dinah Arce, Senior Auditor, Internal Audit  
Toma Miller, Senior Auditor, Internal Audit  
Dorvin Handrick, Senior Information Technology Auditor, Internal Audit  
Nick Ballard, Senior Investment Auditor, Internal Audit  
Amy Morgan, Chief Information Officer  
Kyle Weigum, Manager, Voice & Data Networking, Information Technology  
Britt Harris, Chief Investment Officer  
Jerry Albright, Deputy Chief Investment Officer  
Dale West, Director, External Public Markets  
Chi Chai, Senior Managing Director, Internal Public Markets  
Jase Auby, Chief Risk Officer, Investment Division  
Mohan Balachandran, Senior Managing Director, Asset Allocation Group, Investment Division  
Thomas Albright, Chief of Staff to the Chief Investment officer, Investment Division  
Mike Pia, Chief of Staff to the Chief Investment Officer, Investment Division  
Janis Hydak, Managing Director, Quantitative Research, Investment Division  
David DeStefano, Managing Director, Portfolio Management, Investment Division  
Shayne McGuire, Managing Director, Fundamental Research, Investment Division  
Sharon Toalson, Executive Assistant to the Chief Investment Officer, Investment Division

### **TRS Staff (cont'd)**

Carolina de Onís, General Counsel  
Angela Vogeli, Assistant General Counsel  
Denise Lopez, Assistant General Counsel  
Lane Arnold, Assistant General Counsel  
Lynn Lau, Assistant Secretary to the Board and Program Specialist, Legal Department  
Jamie Michels, Manager, General Accounting  
Janie Duarte, Assistant Manager, General Accounting and Budgeting  
Marianne Woods Wiley, Chief Benefit Officer  
Tom Guerin, Manager, Benefit Counseling  
Barbie Pearson, Assistant Manager, Benefit Counseling  
Howard Goldman, Director, Communications  
Michelle Pagán, ERM Specialist, Risk Management & Strategic Planning

### **Other Attendees**

Philip Mullins, Texas State Employees Union  
Ann Fickel, Texas Classroom Teachers Association  
Tom Rogers, Texas Retired Teachers Association & Austin Retired Teachers Association  
Josh Sanderson, Association of Texas Professional Educators  
Bill Barnes, Texas Retired Teachers Association,  
Ted Melina Raab, Texas American Federation of Teachers  
Ron Franke, Myers and Stauffer LC

Audit Committee Chair Christopher Moss called the meeting to order at 9:45 a.m. with a quorum of committee members present.

#### **1. APPROVE MINUTES OF DECEMBER 13, 2013 AUDIT COMMITTEE MEETING**

On a motion by Ms. Nanette Sissney, and seconded by Mr. David Corpus, the proposed minutes of the December 13, 2013 Audit Committee meeting were approved as presented.

#### **2. RECEIVE COMPTROLLER OF PUBLIC ACCOUNTS REPORT ON THE POST-PAYMENT AUDIT OF TEACHER RETIREMENT SYSTEM OF TEXAS**

Ms. Janie Duarte gave an overview of the Post-Payment Audit of TRS performed by the Comptroller of Public Accounts. She stated that in order to ensure that agencies comply with state law, the Comptroller's Fiscal Management Division performs post-payment audits of TRS and all state agencies every few years. She reported that the audit revealed one payroll error related to the underpayment of longevity pay for a TRS employee in the amount of \$5,160. Upon the finding, TRS processed the compensation to the employee and is using more diligence in ensuring that prior state service is recorded in the required form. She stated that other insignificant errors related to travel and purchase order transactions totaled less than \$600.

She stated that a corrective action plan was submitted to the Comptroller's office to address the errors.

### **3. RECEIVE REPORT ON FOLLOW-UP AUDIT OF TELEPHONE COUNSELING CENTER PERFORMANCE MEASURES**

Mr. Ron Franke, Myers and Stauffer LC, presented the results of the Follow-up Audit of the Telephone Counseling Center Performance Measures. He stated that the objective of this follow-up audit was to identify what actions were taken by TRS management to implement four recommendations made during the original Telephone Counseling Center Performance Measures Audit completed in January 2013. He stated that the results of the follow-up audit found that management had fully implemented all four recommendations.

### **4. RECEIVE INTERNAL AUDIT REPORTS**

#### **A. Report on Observation of TRS-ActiveCare Vendor Selection Process**

Ms. Jan Engler reported on her observation of the TRS-ActiveCare health plan administrator and pharmacy benefits manager vendor selection process. She stated that she served in an advisory capacity as a non-voting member of the evaluation team. While being included in the entire process, she was able to confirm that established purchasing and procurement processes were followed throughout the selection process. She was also included in the review of proposed wording for the vendor contracts and was able to ensure that the right to audit was included in them because that guarantee may impact future audit projects in the Health and Insurance Benefits Department. Ms. Barrett added that advisory projects also allow Internal Audit staff to comment on best practices during the development of an activity by a business unit rather than after the fact.

#### **B. Second Quarter Test Results of Investment Controls (Internal Public Markets, Trading, Control Environment)**

Mr. Hugh Ohn reported on the results of the second quarter investment controls testing. He stated that the three areas evaluated included internal public markets, trading, and the control environment. Management controls within internal public markets and the trading group were found to be working effectively.

Mr. Ohn stated that an analysis of the control environment includes reviewing the organization's commitment to integrity and ethical values, the Board of Trustees oversight over management activities, management establishment of the organizational structure including delegation of authority and reporting lines within the organization, and management commitment to hire, train, and retain employees. Management controls in this area were found to be operating effectively within TRS. He noted that the procurement process within the Investment Management Division control environment was not reviewed since a separate audit in this area is planned for the fourth quarter.

#### **C. Quarterly Investment Testing (Agreed-Upon Procedures)**

Mr. Hugh Ohn reported that one exception was noted in the quarterly investment testing because two external managers purchased a company on the Iran/Sudan restricted list. This was a timing issue where the purchases occurred just as the restricted list was released in January 2014. The external managers immediately disposed of the securities upon notification.

#### **D. Semi-Annual Testing of Benefit Payments (Agreed-Upon Procedures)**

Ms. Amy Barrett reported that no issues were found during the semi-annual testing of benefit payments.

#### **5. RECEIVE REPORT ON THE STATUS OF PRIOR AUDIT AND CONSULTING RECOMMENDATIONS**

Ms. Amy Barrett informed the Committee that there were no past due outstanding audit recommendations. Some recommendations were fully implemented or awaiting final validation by Internal Audit before being considered fully implemented.

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

Ms. Barrett reviewed several standard administrative reports. She indicated that Internal Audit is making good progress on accomplishing the projects on the annual audit plan. She noted that two proposed changes to the audit plan may be presented at the June Audit Committee meeting. She briefly reviewed the Internal Audit performance measures indicating that the department is either meeting or on task to meet all measures.

Ms. Barrett also discussed new guidance for independent auditors of public pension plan financial statements from the American Institute of Certified Public Accountants (AICPA). The guidance pertains to audits of “census data” reported to actuaries, and it states that public pension plans are responsible for the completeness and accuracy of the census data reported to them by their reporting entities. Financial statement auditors will need to assess controls around this data at pension plans and perform external validations of information reported to the pension plan at a sample of reporting entities.

In closing, Ms. Barrett introduced Nick Ballard to the Committee. She stated that Mr. Ballard is joining Internal Audit as a Senior Investment Auditor and will be located within the Investment Management Division.

The meeting adjourned at 10:35 a.m.

Approved by:

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

**TAB 2**

Audit Considerations Related to  
Implementation of  
Governmental Accounting Standards Board  
(GASB)  
Statement No. 67 and Statement No. 68

June 6, 2014

Michael Clayton, CPA, CFE, CIDA, CISA  
Managing Senior Auditor  
State Auditor's Office



John Keel, CPA



John Keel, CPA

# Background/Overview

- Implementation of GASB 67 and GASB 68 will result in changes to how pension information is audited.



John Keel, CPA

# American Institute of Certified Public Accountants (AICPA) Guidance

- The AICPA has issued audit guidance in the form of white papers (February 2014) and interpretations (April 2014) related to the implementation of GASB 67 and GASB 68.



John Keel, CPA

# Plan Controls Over Member Data

- The AICPA is emphasizing the consideration of plan controls over active member census data.
- Accuracy and completeness of census data provided to the actuary is a consideration.
- Absence of effective management controls by the plan is a deficiency in internal controls over financial reporting.
- Plan management processes for verifying the underlying payroll records of the participating employers to determine accuracy and completeness of data are a consideration.



John Keel, CPA

# Key AICPA Guidance

- Auditors are required to test procedures on the plan census data for active employees to for accuracy and completeness.
- Cost-sharing defined benefit pension plans will be required to issue two new supplemental schedules. Those schedules are required because the audited plan financial statements will not include all of the information necessary for employers to record their share of the net pension liability.



John Keel, CPA

# Census Data Testing

- Guidance suggests that auditors should take a risk-based approach to selecting the employer census data for testing for purposes of issuing an opinion on the financial statements.
- Guidance suggests that auditors should test enough employers to ensure that any employer considered significant to the population would be tested every 10 years.



John Keel, CPA

# New Schedules

- **Schedule of Employer Allocations** - This schedule calculates the pension contribution effort for each employer making contributions to the plan (percentage-based calculation).
- **Schedule of Pension Amounts by Employer** - This schedule shows the total change in pension amounts by change type for each employer contributing to the plan.



John Keel, CPA

# Audit Considerations for New Schedules

- The AICPA suggests that plan management should obtain auditor opinions on the **Schedule of Employer Allocations** and the **Schedule of Pension Amounts by Employer**.
- AICPA guidance requires auditors to audit the new schedules in accordance with AU-C Section 805 *Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*.



John Keel, CPA

# Additional Considerations

- Plan employers will need the opinions on the schedules because they will need to rely on the information issued by the plan.
- If employer auditors cannot rely on work done by plan auditors, that could result in a situation in which employer auditors may want to do their own audit work on the plan.
- Issuance of the opinions increases the overall audit risk for plan auditors.



John Keel, CPA

# Potential Changes to State Auditor's Office Audit Approach

- Testing of employer census data and the timing of that testing.
- Additional testing of controls around the census data reporting process for active and retired members.
- Issuing a separate opinion on the new schedules after the financial statement opinion.
- Timing of completion of actuarial data by Teacher Retirement System actuary.

# Communication with Reporting Entities



John Keel, CPA

- AICPA guidance emphasizes the importance of communication with reporting entities (employers).
- Employer auditors will be relying on work done by plan auditors to issue their audit opinions.
- If employer auditors cannot rely on audit work done at the plan, that could result in employers not receiving unqualified opinions on their financial statements.



John Keel, CPA

# Key Items for Communication

- Communicating census data testing to employers,
- Contacting employers and their auditors for any employers that may not be included as part of the census data testing.
- Communicating the time frame for the audit work for any employers that have a fiscal year that does not end on August 31, 2015.
- Ensuring that employers and their auditors know where to find the Schedule of Employer Allocations and Schedule of Pension Amounts by Employer after the audit opinion is issued on those schedules.



John Keel, CPA

# Questions

## Background and High-Level Summary of SLGEP Efforts

In June 2012, the GASB issued two new standards that will substantially change the accounting and financial reporting of public employee pension plans and the state and local governments that participate in such plans. GASB Statement No. 67, *Financial Reporting for Pension Plans*, revises existing guidance for the financial reports of most governmental pension plans. GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. GASB Statement No. 67 is effective for financial statements for periods beginning after June 15, 2013. GASB Statement No. 68 is effective for financial statements for fiscal years beginning after June 15, 2014.

There are numerous accounting and auditing issues facing governmental plans (both cost-sharing and agent) and participating employers that the SLGEP has been working very diligently to address. During this process, the SLGEP has had many discussions internally with representatives of the Auditing Standards Board, as well as with other key stakeholders including actuaries, plans, governmental employers, and the GASB. The remainder of this *GAQC Alert* discusses the status of the SLGEP efforts, guidance issued to date, and other additional guidance expected.

## Whitepapers Released Relevant to Cost-Sharing Plans, Participating Employers, and Auditors

With the implementation of GASB Statement No. 68, employers will be required to recognize a liability as employees earn their pension benefits (that is, as they provide services to the government). For the first time, employers participating in cost-sharing plans will recognize their proportionate share of the collective pension amounts for all benefits provided through the plan. The SLGEP has released one whitepaper which addresses numerous issues from the employer and employer auditor perspective that will arise from the implementation of GASB Statement No. 68. These issues need to be addressed by employers sooner rather than later and will involve close coordination between employers and cost-sharing plans. In a separate whitepaper, the SLGEP has addressed responsibilities of the plan and its auditor regarding the completeness and accuracy of all census data underlying certain financial statement elements of the plan. Each of these papers is discussed in more detail below:

*Whitepaper on Employer and Related Auditor Issues.* This whitepaper titled, *Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting*, addresses issues related to how employers participating in cost-sharing plans obtain all necessary information to properly recognize and disclose pension amounts in their financial statements and how their auditors obtain sufficient appropriate evidence to support their opinions on employer financial statements. It should be of interest to cost-sharing plans, participating employers, and their auditors. In the whitepaper, the SLGEP recommends that cost-sharing plans calculate and disclose in two schedules each employer's allocation percentage and pension amounts. The SLGEP further recommends the plans engage their auditors to obtain reasonable assurance and report on the schedules in accordance with AU-C section 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. The employer and employer auditor have their own responsibilities with regard to the information provided by the plan, as further discussed in the whitepaper, but the plan auditor's report on the schedules provides evidence that the pension amounts allocated to the employer and included in the employer's financial statements are not materially misstated. Most importantly, the whitepaper concludes that if a cost-sharing plan issues financial statements, but does not prepare the above described schedules or if it does prepare the above described schedules but does not engage its auditor to opine on them as recommended by the SLGEP, it is unlikely that employer auditors will be able to accumulate sufficient appropriate audit evidence necessary to provide unmodified opinions on opinion units of the government financial reporting entity that have material allocated pension amounts. It is important to emphasize that unaudited information provided by the plan to its employers to support allocations or pension amounts would not be sufficient appropriate audit evidence for their auditors to base their opinions. Read the whitepaper for much more detail.

*Whitepaper on Plan Census Data Issues.* The whitepaper titled, *Single-Employer and Cost-Sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements*, addresses the role of census data in single-employer and cost-sharing plan financial statements and the plan auditor's responsibility for such census data. It should be of primary interest to cost-sharing plans and their auditors. However, participating employers may also wish to review the whitepaper as it could have ramifications for them. In the whitepaper, the SLGEP addresses the responsibility of the cost-sharing plan to obtain all necessary information and the plan auditors to obtain sufficient appropriate evidence regarding the completeness and accuracy of all census data underlying certain financial statement elements of the plan. From an audit perspective, the whitepaper describes the plan auditor's responsibility to identify and assess the risks of material misstatement of these elements. For this purpose, the plan auditor should:

1. Obtain an understanding of the processes and controls used by the plan's management to support the completeness and accuracy of census data provided to the actuary.
2. Consider the likelihood of misstatement and whether the potential misstatement is of such a magnitude that it could result in a material misstatement of the total pension liability, contribution revenue, or contributions receivable.

The nature, timing, and extent of substantive procedures to be performed over the census data and the underlying payroll records of employers will depend on the assessed risk of material misstatement of the relevant elements and whether management has effective processes to determine the completeness and accuracy of census data provided to the actuary. Note that in order to obtain sufficient appropriate audit evidence the whitepaper explains that it is necessary to select a representative group of contributing employers each year on a rotating basis for testing underlying payroll records of employees who are potentially eligible for participation in a cost-sharing plan. A risk-based approach for selecting the employers to test each year is also described. [Read the whitepaper for more detail.](#)

## **Expected Issuance of Related Auditing Interpretations**

In addition to the above described whitepapers, the SLGEP, working with the AICPA Audit and Attest Standards Team, is currently developing a series of auditing interpretations that will address specific questions pertaining to both the auditors of the cost-sharing plans and employers. These interpretations will support certain of the conclusions reached in the SLGEP whitepapers and include interpretations of AU-C 500, *Audit Evidence*, AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, and AU-C 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. The clearance process for these interpretations is currently underway and they are expected to be released no later than late March. A future *GAQC Alert* will announce the issuance of these interpretations.

TAB 3



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# Teacher Retirement System of Texas

## Health Care Risk Assessment

### *Overview of Results*

May 2014

**protiviti**®  
Risk & Business Consulting.  
Internal Audit.

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# Project Objective

In order to define a model Three-Year Audit Plan, TRS Internal Audit engaged Protiviti to perform a Health Care Risk Assessment (HCRA). The purpose of the HCRA was to identify and prioritize risks related to the processes used in administering health care benefits provided under TRS-Care and TRS-ActiveCare to employees, retirees, and their dependents.



# Project Approach

The approach used to perform the Health Care Risk Assessment included:

1

Review existing documents, interview or survey TRS Board of Trustees, Executive Management, Health & Insurance Benefits (HIB) personnel and Key Vendors

2

Review key business processes to identify top potential risks

3

Create TRS-Care and TRS-ActiveCare Risk Models

4

Identify top potential risks based on impact and likelihood of occurrence and document risk definitions; evaluate consistency with HIB Enterprise Risk Assessment

5

Link top potential risks to potential auditable areas

6

Create model Three-Year Audit Plan

# Areas of Strengths

It is important to recognize that many areas of strength were identified during our assessment. Several key areas noted include:

Tone at the top - TRS Board of Trustees and Executive Management demonstrate commitment to meet the expectations set forth in the Texas Statutory Provisions for TRS-Care and TRS-ActiveCare

Leadership demonstrates commitment to meet the needs of plan participants

HIB management and their primary vendors maintain a close working relationship

HIB departmental teams are focused on continuous improvement and exhibit a problem-solving culture and creative approaches to improving operations

# Key Potential Risks (Not Findings)

Based on our discussions with key TRS users knowledgeable of current business processes, walkthroughs of processes in the business operations, our knowledge and expertise in health care, and our assessment results, we identified the following top six potential risk areas with associated potential control weakness or deficiency risk drivers to be considered for future audit work.

## Risk of Insufficient Funding and Decreased Affordability

- TRS-Care revenues may be insufficient to cover the actual cost of claims and expenses
- TRS-ActiveCare revenues may be insufficient to cover the actual cost of claims and expenses
- TRS-Care and TRS-ActiveCare plan costs may cause coverage to be unaffordable and out of reach of participants

## Risk of Insufficient Working Capital, Premium Collection and Forecasting

- Benefits utilized may exceed the projected claim costs
- Catastrophic claims may not be accounted for sufficiently in the model understating projected claim cost
- TRS-ActiveCare and TRS-Care premium contributions are not fully collected
- Validation of dependent eligibility of TRS-ActiveCare and TRS-Care participants not provided to TRS
- TRS-ActiveCare prospective forecasting of member premium needs, participating entity contributions and claim expenditures not consistently performed
- TRS-Care participant premium contributions may be insufficient to cover the cost of claims projected for the benefit plan
- Model may not account for industry changes and new treatment options

## Risk of Inadequate Vendor Oversight

- HIB vendor contracts may not fully define delegated functions and responsibilities
- Performance, compliance and fraud for both self-insured and fully-insured plans may not be monitored exposing participants and TRS to higher risk
- Vendors may not provide reports to communicate performance, compliance or fraud
- Vendor performance may not be consistent with industry standards/benchmarks
- Oversight best practices, i.e. COSO framework may not be achieved

# Key Potential Risks (Not Findings) - Continued

## Risk of Insufficient Governance and Significant Dependence on External Expertise

- Internal health care subject matter expertise may not be fully developed or attained in HIB
- TRS may not be able to provide the three lines of defense necessary for effective risk management: 1) performance monitoring, 2) monitoring by subject matter expert, and 3) independent (internal or external) audits
- Compliance risk across all vendors and products may not be assessed

## Risk of Ineligible Services Being Authorized and/or Claims are Paid

- Verification of member/dependent eligibility not performed upon enrollment or when changes occur in TRS-Care or TRS-ActiveCare

## Risk of Non-Compliance with Laws and Regulations

- CMS regulations and standards required for Medicare Advantage and Part D Prescription Drug Plans for TRS-Care participants
- State of Texas health care regulations regarding HMO fully-insured benefit plans within TRS-ActiveCare *Chapter 843, Texas Insurance Code and Title 28, Part 1, Chapter 11, Texas Administrative Code*
- Affordable Care Act Regulations
- HIPAA regulations
- Fraud, Waste and Abuse Prevention for TRS-ActiveCare and TRS-Care *per Executive Order RP 36* and for TRS-Care *per CMS Manual, Chapters 9 and 21*
- Texas Statutes 1575 and 1579 defining TRS health care benefit administration of TRS-Care and TRS-ActiveCare

# Potential Audits

Title	Risk(s) Addressed	Priority*	Preliminary Scope
<b>Vendor Oversight</b>	<ul style="list-style-type: none"> <li>• Insufficient funding and forecasting</li> <li>• Insufficient working capital and premium collection</li> <li>• Non-compliance with laws and regulations</li> <li>• Insufficient governance and significant dependence on external expertise</li> <li>• Inadequate vendor oversight</li> </ul>	High	A. Assess whether the HIB vendor oversight process addresses performance, compliance and risk for each contracted vendor.
<b>External Vendor Claim Processes</b>	<ul style="list-style-type: none"> <li>• Ineligible services authorized and/or claims paid</li> <li>• Non-compliance with laws and regulations</li> <li>• Insufficient working capital and premium collection</li> </ul>	High	<p>A. Assess whether the current external claim audit assesses timeliness, completeness and accuracy for all vendors processing TRS-Care and TRS-ActiveCare claims.</p> <p>B. Assess whether the current HIB vendor contracts are complete and contain the specificity required to define the functions being delegated.</p> <p>C. Assess whether current contract requirements are met.</p>
<b>Governance</b>	<ul style="list-style-type: none"> <li>• Insufficient governance and significant dependence on external expertise</li> <li>• Non-compliance with laws and regulations</li> </ul>	High	A. Assess the combination of processes and structures in place to inform, direct, manage, and monitor the activities of the health care plans toward the achievement of their objectives.
<b>Member Premium Billing</b>	<ul style="list-style-type: none"> <li>• Ineligible services authorized and/or claims paid</li> <li>• Insufficient funding and forecasting</li> <li>• Insufficient working capital and premium collection</li> </ul>	Medium	A. Assess TRS-Care and TRS-ActiveCare member premium billing process and delinquency process.
<b>Dependent Audit</b>	<ul style="list-style-type: none"> <li>• Ineligible services authorized and/or claims paid</li> <li>• Insufficient working capital and premium collection</li> </ul>	Medium	<p>A. Assess the process and frequency that the participating entities use to verify the eligibility of dependents added to TRS- ActiveCare</p> <p>B. Assess the process and frequency that TRS uses to verify eligibility of dependents added to TRS-Care.</p>
<b>Compliance with Medical Regulations</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> <li>• Inadequate vendor oversight</li> </ul>	Medium	<p>A. Assess TRS-ActiveCare Enrollment process.</p> <p>B. Assess TRS-Care Medicare Advantage Enrollment process.</p> <p>C. Assess TRS-ActiveCare Appeals and Complaints process.</p> <p>D. Assess TRS-Care Medicare Advantage Appeals and Grievance process.</p>

\*Priority was defined by number of risks or financial impact of the audit to TRS

This report provides Management with information about the condition of risks and internal controls at one point in time. Future changes in environmental factors and actions by personnel will impact these risks and internal controls in ways this report cannot anticipate.

# Potential Audits

Title	Risk(s) Addressed	Priority*	Preliminary Scope
<b>Compliance with Pharmacy Regulations</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> <li>• Inadequate vendor oversight</li> </ul>	Medium	A. Assess TRS-Care pharmacy Appeals and Grievances process. B. Assess TRS-Active Care pharmacy quantity limit denials. C. Assess TRS-Care pharmacy transition fills.
<b>OIG Sanction Check</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> <li>• Inadequate vendor oversight</li> </ul>	Medium	A. Assess whether TRS Human Resources Department and HIB vendors who administer TRS-Care Medicare Advantage or Part D benefits are performing OIG sanction checks for all new hires and monthly thereafter.
<b>Vendor Compliance Plan Review</b>	<ul style="list-style-type: none"> <li>• Insufficient governance and significant dependence on external expertise</li> <li>• Inadequate vendor oversight</li> </ul>	Medium	A. Assess whether all HIB vendors who have a compliance plan in place address all seven elements of compliance and plans are actively administered.
<b>HIB Vendor Bid and Selection Process</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> <li>• Insufficient funding and forecasting</li> </ul>	Medium	A. Assess the TRS Purchasing Department and HIB vendor bid development and selection process.

\*Priority was defined by number of risks or financial impact of the audit to TRS

This report provides Management with information about the condition of risks and internal controls at one point in time. Future changes in environmental factors and actions by personnel will impact these risks and internal controls in ways this report cannot anticipate.

# Model Three-Year Audit Plan

Project	Risk(s)	Audit Year	Preliminary Scope
<b>Vendor Oversight</b>	<ul style="list-style-type: none"> <li>• Insufficient funding and forecasting</li> <li>• Insufficient working capital and premium collection</li> <li>• Non-compliance with laws and regulations</li> <li>• Insufficient governance and significant dependence on external expertise</li> <li>• Inadequate vendor oversight</li> <li>• Vendor contract violation</li> </ul>	1	<ul style="list-style-type: none"> <li>A. Assess whether the HIB vendor oversight process addresses performance, compliance and risk for each contracted vendor.</li> <li>B. Perform actuarial vendor review.</li> <li>C. Assess whether the current HIB vendor contracts are complete and contain the specificity required to define the functions being delegated.</li> <li>D. Assess whether current contract requirements are met.</li> </ul>
<b>External Vendor Claim Processes</b>	<ul style="list-style-type: none"> <li>• Ineligible services authorized and/or claims paid</li> <li>• Non-compliance with laws and regulations</li> <li>• Vendor contract violation</li> <li>• Insufficient working capital and premium collection</li> </ul>	2	<ul style="list-style-type: none"> <li>A. Assess whether the current external claim audit assesses timeliness, completeness and accuracy for all vendors processing TRS-Care and TRS-ActiveCare claims.</li> </ul>
<b>Member and Dependent Eligibility and Premium Billing/Collection</b>	<ul style="list-style-type: none"> <li>• Insufficient funding and forecasting</li> <li>• Insufficient working capital and premium collection</li> <li>• Ineligible services authorized and/or claims paid</li> </ul>	2	<ul style="list-style-type: none"> <li>A. Assess TRS-Care and TRS-ActiveCare participant premium billing process and delinquency process .</li> <li>B. Assess the process and frequency that the participating entities use to verify the eligibility of dependents added to TRS-ActiveCare.</li> <li>C. Assess the process and frequency that TRS uses to verify eligibility of dependents added to TRS-Care.</li> </ul>
<b>Compliance with Medical Regulations</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> <li>• Ineligible services authorized and/or claims paid</li> <li>• Insufficient working capital and premium collection</li> </ul>	3	<ul style="list-style-type: none"> <li>A. Perform an audit of TRS-ActiveCare and TRS-Care Standard Plan Enrollment processes.</li> <li>B. Perform an audit of TRS-Care Medicare Advantage Enrollment process.</li> <li>C. Perform an audit of TRS-ActiveCare complaints and appeals process.</li> <li>D. Perform an audit of TRS-Care complaints, grievances and appeals process.</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>• Non-compliance with laws and regulations</li> </ul>	3	<ul style="list-style-type: none"> <li>A. Assess the combination of processes and structures in place to inform, direct, manage, and monitor the activities of the health care plans toward the achievement of their objectives .</li> </ul>

# Acknowledgement

The risk assessment team would like to thank all the TRS personnel and their vendors who assisted us in our work during this project. We received input and recommendations from:

- Board of Trustees
- Executive Team, Executive and Deputy Directors and Chief Health Care Officer
- HIB Management: Health and Insurance Benefits Operations Director and Assistant Directors of Operations and Finance
- HIB Primary Vendors including Fiduciary Counsel
- TRS Support Departments including Legal, Procurement, Human Resources and Information Technology
- All employees within the Health & Insurance Benefits Department

# Health Care Risk Model – TRS-Care

## Health Care, Pharmacy

### ENVIRONMENT

- Capital Availability
- Political
- Legal
- Catastrophic Loss
- Health Care Advancements
- Health Care Reform
- Privacy Violations
- Outsourcing

### PARTICIPANT MANAGEMENT

- Demographic Shifts
- Concentration
- Preferences
- Discretionary Spending
- Awareness
- Disease Burden

### REGULATORY AND COMPLIANCE

- Government Programs
- Medicare/Medicaid
- Federal Department of Labor
- State Mandates
- HIPAA
- Privacy
- Accreditation
- NCQA, URAC, JCAHO

### TRS

- Product Needs Assessment
- Product Benefit Review - Standard/Non-standard
- Carrier(s) Selection
- Contracting/Pricing/Guarantee
- Retiree/Dependent Communications - carrier coordination
- Enrollment/Disenrollment
- Eligibility Management - Retiree, Dependent
- Eligibility Transactions with Carriers - Retrospective Adjustments
- Benefit Exceptions
- Direct Premium Billing and Collection – Annuity Contribution
- Direct Premium Billing and Collection - Member Contribution
- Internal Phone Counselors
- Procurement
- Vendor Contracting
- Vendor Management/Delegation Oversight
- Medical Loss Ratio Monitoring – Plan Participant Rebates
- Internal Audits
- Fraud Waste and Abuse Management / Employee
- Corrective Action Plans
- Performance Guarantee Management
- Human Resources

#### Actuarial Vendor

- Product Needs Assessment
- Product Benefit Review - Standard/Non-standard
- Underwriting
- Reporting (Performance/Productivity/Regulatory)
- Regulatory Change Management

### OPERATIONS

#### Medical Health Plan Vendor

- Provider Network Adequacy
- Case Installation/Testing
- Retiree/Dependent Communications
- Enrollment/Disenrollment
- Eligibility Management - Retiree, Dependent
- Claims Processing
- Benefit Exceptions
- Direct Premium Billing and Collection - Member Contribution
- Appeals – Fiduciary
- Grievance Management
- Reporting(Performance/Productivity/Regulatory)
- Reporting (Utilization Management, Clinical Claims Review, Case Management, Disease Management)
- Department of Labor Regulatory (audit) Management
- State Regulatory (Market Conduct Exam) Management
- CMS Regulatory (Medicare) Management
- Medical Loss Ratio Monitoring – Plan Participant Rebates
- Account Management
- Compliance/Legal Monitoring
- Operational Compliance Management
- Regulatory Review/Monitoring
- Fraud Waste and Abuse Management/Employee
- Claims Litigation
- Regulatory Change Management
- Corrective Action Plans
- Human Resources
- Silver + FIT

#### Claim Audit Vendor

- Vendor Delegation Oversight - Claims

#### Pharmacy Vendor

- Provider Network Adequacy
- Case Installation/Testing
- Retiree/Dependent Communications
- Enrollment/Disenrollment
- Eligibility Management - Retiree, Dependent
- Claims Processing
- Direct Premium Billing and Collection - Member Contribution
- Appeals – Fiduciary
- Grievance Management
- Reporting(Performance/Productivity/Customer/Regulatory)
- Reporting (Utilization Management, Clinical Claims Review, Case Management, Disease Management, Medication Therapy Management)
- State Regulatory (Market Conduct Exam) Management
- CMS Regulatory (Medicare) Management
- Account Management
- Compliance/Legal Monitoring
- Operational Compliance Management
- Regulatory Review/Monitoring
- Fraud Waste and Abuse Management/Employee
- Claims Litigation
- Regulatory Change Management
- Corrective Action Plans

### GOVERNANCE

- Strategy
- Leadership
- Organizational Culture
- Budget
- Goals and Objectives
- Staffing
- Quality Improvement Committee
- Health Care Risk Assessment
- Project Management
- Planning
- Key Performance Indicators
- Organizational Change Management
- Change Readiness
- Board Effectiveness
- Succession Planning

### REPUTATION

- Branding
- Product Integrity & Safety
- Social Media Communications
- Negative Media Coverage
- Regulatory Sanctions
- Ethical Behavior/Code of Conduct
- Stakeholder Relations

### FINANCIAL

- Bid Development
- Product Pricing
- Cash Management
- Financial Reporting
- Regulatory Reporting
- Actuarial Reserve
- Claims Payment Reconciliation
- SSAFE16

### INFORMATION TECHNOLOGY

- Data Integrity
- Data Security/Access
- Availability of Information
- IT Infrastructure
- Program Change Control
- Testing
- System Implementations Team
- Disaster Recovery/Redundancy
- Delegated Vendor Data Management

# Health Care Risk Model – TRS-ActiveCare

## Health Care, Pharmacy

### ENVIRONMENT

- Capital Availability
- Political
- Legal
- Catastrophic Loss
- Health Care Advancements
- Health Care Reform
- Privacy Violations
- Outsourcing

### PARTICIPANT MANAGEMENT

- Demographic Shifts
- Concentration
- Preferences
- Discretionary Spending
- Awareness
- Disease Burden

### REGULATORY AND COMPLIANCE

- Government Programs
- Medicare/Medicaid
- Federal Department of Labor
- State Mandates
- HIPAA
- Privacy
- Accreditation
- NCQA, URAC, JCAHO

### TRS

- Product Needs Assessment
- Product Benefit Review - Standard/Non-standard
- Carrier(s) Selection
- Contracting/Pricing/Guarantee
- Employee/Dependent Communications - carrier coordination
- Benefit Exceptions
- Internal Phone Counselors
- Procurement
- Vendor Contracting
- Vendor Management/Delegation Oversight
- Medical Loss Ratio Monitoring – Plan Participant Rebates
- Internal Audits
- Fraud Waste and Abuse Management / Employee
- Corrective Action Plans
- Performance Guarantee Management
- Human Resources

### Participating Entities

- Enrollment/Disenrollment
- Eligibility Management – Employee/Dependent
- Eligibility Transaction with Carriers Retrospective Adjustments
- Premium Billing and Collection Employer Contributions
- Premium Billing and Collection Member Contributions

### Actuarial Vendor

- Product Needs Assessment
- Product Benefit Review - Standard/Non-standard
- Underwriting
- Reporting (Performance/Productivity/Customer/Regulatory)
- Regulatory Change Management

### Claim Audit Vendor

- Delegation Oversight – Claim

### OPERATIONS

#### Medical Health Plan Vendor

- Product Needs Assessment
- Provider Network Adequacy
- Case Installation/Testing
- Employee/Dependent Communications
- Enrollment/Disenrollment
- Eligibility Management - Employee, Dependent
- Claims Processing
- Benefit Exceptions
- Direct Premium Billing and Collection - Member Contribution
- Appeals – Fiduciary
- Grievance Management
- Reporting (Performance/Productivity/Customer/Regulatory)
- Reporting (Utilization Management, Clinical Claims Review, Case Management, Disease Management, Medication Therapy Management)
- Department of Labor Regulatory (audit) Management
- State Regulatory (Market Conduct Exam ) Management
- Medical Loss Ratio Monitoring – Plan Participant Rebates
- Account Management
- Compliance/Legal Monitoring
- Operational Compliance Management
- Regulatory Review/Monitoring
- Fraud Waste and Abuse Management / Employee
- Claims Litigation
- Regulatory Change Management
- Corrective Action Plans
- Human Resources

#### Pharmacy Vendor

- Provider Network Adequacy
- Case Installation/Testing
- Employee/Dependent Communications
- Enrollment/Disenrollment
- Eligibility Management - Employee, Dependent
- Claims Processing
- Direct Premium Billing and Collection - Member Contribution
- Appeals – Fiduciary
- Grievance Management
- Reporting (Performance/Productivity/Regulatory)
- Reporting (Utilization Management, Clinical Claims Review, Case Management, Disease Management, Medication Therapy Management)
- Department of Labor Regulatory (audit) Management
- State Regulatory (Market Conduct Exam ) Management
- Account Management
- Compliance/Legal Monitoring
- Operational Compliance Management
- Regulatory Review/Monitoring
- Fraud Waste and Abuse Management
- Claims Litigation
- Regulatory Change Management
- Corrective Action Plans

### HMO Vendors

- Employee/Dependent Communications - carrier coordination
- Eligibility Management - Employee, Dependent
- Product Needs Assessment Provider Network Adequacy
- Case Installation/Testing
- Employee/Dependent Communications
- Enrollment/Disenrollment
- Eligibility Management - Employee, Dependent
- Claims Processing
- Benefit Exceptions
- Direct Premium Billing and Collection - Member Contribution

### GOVERNANCE

- Strategy
- Leadership
- Organizational Culture
- Budget
- Goals and Objectives
- Staffing
- Quality Improvement Committee
- Health Care Risk Assessment
- Project Management
- Planning
- Key Performance Indicators
- Organizational Change Management
- Change Readiness
- Board Effectiveness
- Succession Planning

### REPUTATION

- Image & Branding
- Product Integrity & Safety
- Social Media Communications
- Negative Media Coverage
- Regulatory Sanctions
- Ethical Behavior/Code of Conduct
- Stakeholder Relations

### FINANCIAL

- Bid Development
- Product Pricing
- Cash Management
- Financial Reporting
- Regulatory Reporting
- Actuarial Reserve
- Claims Payment Reconciliation
- SSAE16

### INFORMATION TECHNOLOGY

- Data Integrity
- Data Security/Access
- Availability of Information
- IT Infrastructure
- Program Change Control
- Testing
- System Implementations Team
- Disaster Recovery/Redundancy
- Delegated Vendor Data Management

# Glossary of Acronyms

Acronym	Definition
<b>CMS</b>	Centers for Medicare and Medicaid Services
<b>COSO</b>	Committee of Sponsoring Organizations of the Treadway Commission Control Framework
<b>HMO</b>	Health Maintenance Organization
<b>HIPAA</b>	Health Insurance Portability and Accountability Act
<b>JCAHO</b>	Joint Commission on Accreditation of Healthcare Organizations
<b>NCQA</b>	National Committee for Quality Assurance
<b>OIG</b>	Office of Inspector General
<b>Part D</b>	Medicare Pharmacy Benefits
<b>URAC</b>	Utilization Review Accreditation Committee
<b>SSAE 16</b>	Statement on Standards for Attestation Engagements No. 16

*\*Priority was defined by number of risks or financial impact of the audit to TRS*

This report provides Management with information about the condition of risks and internal controls at one point in time. Future changes in environmental factors and actions by personnel will impact these risks and internal controls in ways this report cannot anticipate.



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**TAB 4**

# TAB 4A

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

# TAB 4B

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

**TAB 4C**

# THIRD QUARTER TEST RESULTS OF INVESTMENT CONTROLS

May 16, 2014

## TRS Internal Audit Department

<b>Business Objectives</b>	<b>External Public Markets:</b> Identify and invest in top tier external managers to provide superior risk adjusted return	<b>Cash Securities Operation:</b> Settle trades and move related cash to prevent asset losses or delays	<b>Investment Performance:</b> Ensure that investment returns are accurately calculated and reported
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>Failure to add value</li> <li>Hiring unqualified managers</li> <li>Investing strategy changes or style drift by managers</li> <li>Incorrect fee amount paid</li> <li>Non-compliance with laws, regulations, or Investment Management Agreement (IMA) requirements</li> </ul>	<ul style="list-style-type: none"> <li>Failed trade</li> <li>Incorrect amount of cash or securities paid or received</li> <li>Settlement risk (related to foreign currency trades)</li> <li>Financial losses (e.g., opportunity cost, fees, penalties, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>Miscalculated investment returns due to errors, mistakes, or fraud</li> <li>Incomplete or inconsistent calculation methods used</li> <li>Incorrect asset allocation decisions</li> <li>Awarding inaccurate incentive compensation</li> </ul>
<b>Management Controls</b>	<ul style="list-style-type: none"> <li>Investment performance monitoring</li> <li>Due diligence and approval</li> <li>CUSUM* and Trend Deviation signals</li> <li>Monitoring by consultants</li> <li>TRS staff's review and approval of fees charged</li> <li>Hedge fund classification criteria used</li> <li>Compliance monitoring</li> </ul>	<ul style="list-style-type: none"> <li>Pre-settlement review</li> <li>Trade Status Report (Fails, Unmatched, Matched)</li> <li>Trade reconciliation</li> <li>Supervisory review of trade reconciliation</li> <li>Service level agreement with the custodian</li> <li>Failed trade report</li> <li>Dedicated custodian staff</li> </ul>	<ul style="list-style-type: none"> <li>Investment Operation staff's return calculations</li> <li>Reconciliation of performance with the custodian</li> <li>Service level agreement on calculation methods</li> <li>Custodian's quality control checks</li> <li>Use of third-party pricing and data sources</li> </ul>
<b>Controls Tested</b>	<ul style="list-style-type: none"> <li>Investment performance monitoring</li> <li>Due diligence and approval</li> <li>CUSUM signals</li> <li>Monitoring by consultants</li> <li>Hedge fund classification criteria used</li> </ul>	<ul style="list-style-type: none"> <li>Pre-settlement review</li> <li>Trade reconciliation</li> <li>Supervisory review of trade reconciliation</li> <li>Service level agreement with the custodian</li> </ul>	<ul style="list-style-type: none"> <li>Investment Operation staff's return calculations</li> <li>Reconciliation of performance with the custodian</li> <li>Service level agreement on calculation methods</li> </ul>
<b>Results</b>	Management controls are operating effectively to achieve business objective.	Management controls are operating effectively to achieve business objective.	Management controls are operating effectively to achieve business objective.
<b>Recommended Actions</b>	None	None	None
<b>Management Responses</b>	N/A	N/A	N/A

\* CUSUM is a shortened term for Cumulative Sum which is a monitoring tool used to detect a change in investment performance.

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

## MEMORANDUM

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

FROM: Amy Barrett, Chief Audit Executive  
Hugh Ohn, Director of Investment Audit Services

SUBJECT: **Third Quarter Test Results of Investment Controls**

DATE: May 16, 2014

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The purpose of this memo is to report the interim results of Internal Audit's tests of Investment Management Division (IMD) controls for the third quarter of fiscal year 2014. The results of these tests are considered interim since they will be used to express the overall opinion on IMD controls at the end of the fiscal year 2014. For the third quarter of fiscal year 2014, we tested controls related to the following three areas: (a) External Public Markets; (b) Cash Securities; and (c) Investment Performance. As part of this project, Internal Audit engaged an external service provider (Lenox Park LLC) to obtain additional expertise in the areas of external manager due diligence.

### OVERVIEW

#### External Public Markets (EPU)

The External Public Markets (EPU) program at TRS started in 2008 shortly after the 80<sup>th</sup> Texas Legislature authorized the TRS Board of Trustees to delegate investment authority to contract with private professional managers for investment and management of Trust assets. The EPU's mission is to identify and invest in top tier external managers to provide superior risk adjusted return for the teachers of Texas. The role of the External Public Markets Managers at TRS:

- Long Oriented Investment Managers
  - Higher tracking error strategies: alpha focus
  - Complements internally managed equity portfolios
- Hedge Fund Managers
  - Stable value, functions as fixed income substitute
  - Directional, functions as an equity substitute
- Other Absolute Return/Fixed Income Managers
  - Tactical Exposure during valuation extremes
  - Partnership with top-tier, premier investors worldwide

The EPU team at TRS, which consists of portfolio managers, investment managers and analytics members, is responsible for identifying prospective managers, recommending them to the Internal Investment Committee (IIC) for hiring, monitoring investment performance and risk of managers and portfolios, and firing underperforming managers. The EPU team's monitoring of

external managers and hedge funds is supplemented by the services provided by external consultants.

As of March 31, 2014, the market value of the portfolios managed by the EPU team was \$40.6 billion. The breakdown of these portfolios is as follows:

<b>Portfolio</b>	<b>Market Value (in billion)</b>	<b>Percentage</b>	<b>Number of Managers or Funds</b>
Long-Oriented	\$29.0	71.4%	37
Directional Hedge Funds	6.2	15.3%	23
Stable Value Hedge Fund	5.1	12.6%	25
Other Absolute Return	0.3	0.7%	1
<b>Total External Public =</b>	<b>\$40.6</b>	<b>100.0%</b>	<b>86</b>

According to State Street’s PureView report, one-year and three-year returns of the Total External Public Market’s portfolio were 13.38% and 7.56%, outperforming its benchmark by 158 basis points and 76 basis points, respectively.

#### Cash Securities

The Cash Securities team, which is part of the Investment Operations, is responsible for reconciling executed trades (for both equities and foreign currency) before and after settlement. The business objective of Cash Securities is to settle trades and move related cash to prevent asset losses or settlement delays. The Cash Securities team works closely with the custodian to prevent executed trades from failing. The team is also responsible for ensuring that TRS receives entitled shares resulting from corporate action, such as stock splits, stock dividend, mergers, acquisitions, and spinoffs.

#### Investment Performance

The Performance team, which is part of the Investment Operations, is responsible for preparing daily, weekly, and monthly investment performance reports for internal public portfolios, external public portfolios, private markets portfolios, and total funds. The Performance team is also responsible for reconciling its own investment performance reports with State Street’s performance reports.

### **FINDINGS AND RECOMMENDED ACTIONS**

No significant or reportable issues and recommendations were identified.

**TAB 4D**

**QUARTERLY INVESTMENT TESTING**  
**INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), WIRE TRANSFER PROCEDURES**  
**CALENDAR QUARTER ENDED MARCH 31, 2014, EXCEPT AS NOTED**

<b>Business Objectives</b>	<p>1. <u>Board Reports</u> All required information is reported to the TRS Board of Trustees</p>	<p>2. <u>Investment Selection and Approval</u> Investments made are within delegated limits and established selection criteria</p>	<p>3. <u>Other (IPS, SLP, wire transfers, other reporting)</u> Risk limits are followed for other investment programs and activities</p>	<p>4. <u>Monitoring by Investment Compliance Officer</u> Investment activities comply with IPS (for the three months ended April 30, 2014)</p>
<b>Business Risks</b>	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
<b>Management Assertions</b>	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 (IPS, securities lending)
<b>Agreed-Upon Procedures</b>	<ul style="list-style-type: none"> <li>Compare Board reports to IPS requirements</li> </ul>	<ul style="list-style-type: none"> <li>Vouch Internal Investment Committee (IIC) approved investments to supporting documentation</li> <li>Verify approval limits of new investments</li> </ul>	<ul style="list-style-type: none"> <li>Validate IMD obtained reporting requirements of new managers/funds and summarized results</li> <li>Obtain senior management disclosures about known compliance violations</li> <li>Test supporting documentation for wire transfers</li> </ul>	Monitor investment activities for compliance, including State Street's daily compliance monitoring services and reports
<b>Test Results</b>	<ul style="list-style-type: none"> <li>All reporting requirements are met</li> <li>Documentation provides support for information tested</li> </ul>	<ul style="list-style-type: none"> <li>All supporting documentation exists</li> <li>All newly approved investments were within authorized limits</li> </ul>	<ul style="list-style-type: none"> <li>All other requirements of the IPS, SLP, wire transfer procedures, etc. are met</li> </ul>	<ul style="list-style-type: none"> <li>All investment policy requirements are met</li> </ul>
<b>Management Responses</b>	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, 2014

Carolina de Onis, TRS General Counsel

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 2014 Audit Plan*.

We performed the procedures listed below that were agreed to by the TRS Legal Services division. These procedures include tests that supplement the current compliance monitoring procedures performed by State Street and the Investment Compliance Officer.

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.

Our testing procedures and results, including the monitoring results of the Investment Compliance Officer, are included in **Appendix A**.

### **Internal Control Structure**

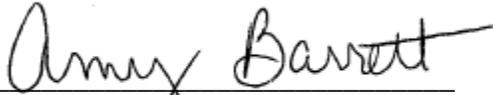
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas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



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Hugh Ohn, CFA, CPA, CIA, FRM  
Director of Investment Audit Services

## 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	Obtain copies of all reports required to be reported to Board of Trustees and compare to reporting requirements per Investment Policy Statement (IPS)	Reports required to be reported to Board of Trustees complied with IPS.	No response required
2	2	Article 2.6 – Verify that Investment Management Division (IMD) evaluated hedge fund classification	<ul style="list-style-type: none"> <li>• Select sample of approved investments in hedge funds and external managers</li> <li>• Obtain analysis indicating whether each investment is hedge fund or not. If analysis is unavailable, inconclusive, or erroneous, report that result</li> <li>• For any analysis requiring Board approval of classification, obtain Board minutes to verify whether approval was obtained</li> </ul>	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"> <li>• Determine if Chief Investment Officer (CIO), Deputy CIO, or Director of External Public Markets adjusted portfolios for the purposes of rebalancing or adjusting risks</li> <li>• 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 monthly basis</li> <li>• Obtain documentation from IMD staff supporting rebalancing analytics. Report on exceptions.</li> </ul>	Each month's rebalancing trades did not exceed the 2% limit of the External Public Markets portfolio.	No response required
4	3	IPS Article 10.3d – Obtain evidence of IMD's examination of	Confirm securities lending agent is an organization rated A- or better by a Nationally Recognized Statistical Rating	Reviewed the Daily Derivatives Report as of February 28, 2014 and noted that the rating for State Street was A- or	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
		requirements of its securities lending agent	Organization (NRSRO)	better per Moody's, Fitch, and Standard and Poor's	
5	2	Article 10.9 – Verify leverage used meets requirements	<ul style="list-style-type: none"> <li>• Verify leverage was used only as authorized</li> <li>• Inquire whether any risk parameters were exceeded and if so, was the limit caused by leverage</li> </ul>	Leverage was used only as authorized and no risk parameters were exceeded.	No response required
6	2	IPS Article 12 - 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"> <li>• For each investment selected for testing, verify that IMD obtained responses to the questionnaire</li> <li>• Determine that IMD compiled responses to the questionnaires and reported all results to Board at least semi-annually</li> </ul>	Each investment tested had a completed questionnaire and was included in the summary report to the Board.	No response required
7	2	IPS Appendix B – Verify investments approved are within policy limits	<ul style="list-style-type: none"> <li>• Select sample of approved investments and obtain tear sheet for each, observe the approved amounts are within authorized limits <ul style="list-style-type: none"> <li>a) Initial allocation – .50%</li> <li>b) Additional or follow-on – 1%</li> <li>c) Total Manager Limits – 3%</li> <li>d) Total limit each manager organization – 6%</li> </ul> </li> <li>• Obtain documentation from IMD staff that supports the calculations of the authorized limits</li> <li>• Inquire if any “Special Investment Opportunities” were made for the quarter, and if so: <ul style="list-style-type: none"> <li>a) Obtain documentation that the Special Investment Opportunity was either a distressed situation or market dislocation</li> <li>b) Obtain documentation that the CIO notified the Executive Director (ED)</li> </ul> </li> </ul>	For the sample selected for testing, no manager or partner organization exceeded the authorized limit. There were no Special Investment Opportunities.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<p>of each Special Investment Opportunity</p> <p>c) Obtain documentation that CIO and ED requested comments from chairman of appropriate board committee and TRS consultants and advisers</p> <p>d) Verify Special Investment Opportunity did not exceed \$1 billion.</p> <p>e) Verify that no further investment in a special Investment Opportunity was made until Board reauthorized CIO's authority to designate a Special Investment Opportunity</p>		
8	4	Compliance certification by the Investment Compliance Officer (ICO) – Verify with ICO that all other policy requirements were not violated	Obtain information about any investment compliance violations from the ICO of other non-compliance issues, including the result of the custodian's monitoring services	Obtained information from the ICO.	No response required
9	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
10	3	Test authorizations of wire transfers – Verify wire transfers are authorized and properly supported	Obtain wire transfer reports for testing period, select sample of wire transfers, verify that supporting documentation exists for each	All wire transfers tested were properly authorized and correct amounts were wired.	No response required

**Note: Testing procedures for the Investment Policy Statement (IPS), Securities Lending Policy (SLP), and wire transfers are for the activity for the quarter ended March 31, 2014.**

**TAB 5**

**TRS Internal Audit  
Summary of Audit Recommendations Status  
June 2014**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>12-403 Audit of Compensation, Payroll and Position Control</b>					
	Develop and implement a written procedures manual for payroll	In Progress	Other Reportable	4/2013	10/2014
<b>13-201 Health Care Administration Audit</b>					
	Formalize procedures for non-financial contract monitoring – staff guidance	Implemented	Other Reportable	3/2014	3/2014
	Formalize procedures for non-financial contract monitoring – minor contract requirement modifications	Implemented	Other Reportable	9/2014	3/2014
	Strengthen internal processes and procedures related to plan enrollment and coverage changes	Implemented	Other Reportable	3/2014	3/2014
<b>13-602 Fraud Risk Identification and Prevention Audit</b>					
	Benefit Accounting - Improve system access reviews to ensure access privileges remain current with job duties	Implemented	Significant	12/2013	12/2013
	Benefit Processing - Improve system access reviews to ensure access privileges remain current with job duties and are appropriately balanced between the need for cross-training staff and the need for restricted access to limit opportunity for fraud	Implemented	Significant	12/2013	9/2013

**Significant to Business Objectives**

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

**Other Reportable**

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

**TRS Internal Audit  
Summary of Audit Recommendations Status  
June 2014**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>14-301</b>	<b>Investment Management Division Controls (Broken down by each quarter tests)</b>				
1 <sup>st</sup> QTR	Consider other funding options to address long-term CSA revenue shortfall projections	Implemented	Other Reportable	7/2014	5/2014
<b>14-404</b>	<b>Audit Of Cost of Living Adjustment (COLA)</b>				
	Verify the COLA eligibility for each of the 804.005 payees	In Progress	Other Reportable	6/2014	

**TAB 6**

**TAB 6A**

## 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 2014 Audit Plan

DATE: June 6, 2014

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Per the approved *Fiscal Year 2014 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 2014 Audit Plan<sup>1</sup>

Project	Proposed Change	Reason	Substitution
Electronic Records	Deferred to Fiscal Year 2015	<ul style="list-style-type: none"> <li>• Management has activity underway with electronic records</li> <li>• Allocate additional resources to TEAM</li> </ul>	Resources allocated to TEAM Internal Controls Project and other TEAM related activities
Health Care Governance, Risk Management and Reporting	Deferred - Timing TBD	<ul style="list-style-type: none"> <li>• Potential significant changes with healthcare plans may occur</li> </ul>	Resources allocated to Purchasing and Contract Administration Audit
TEAM Internal Controls Project	Added	Planning and activities need to begin this fiscal year	N/A

<sup>1</sup> 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 6B

CONFIDENTIAL – GOVERNMENT CODE 552.116 – The information in this document is part of the audit working papers of the Teacher Retirement System of Texas Internal Audit department. These working papers are protected from disclosure under section 552.116 of the Texas Government Code and may not be shared, released, forwarded or otherwise disclosed.

**TAB 7**

**Teacher Retirement System of Texas**  
**June 2014 Audit Committee Agenda Items Mapped to TRS Stoplight Report**

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

## Status of Fiscal Year 2014 Planned Assurance, Consulting, and Advisory Services as of May 2014

Title	Type	Status
<b>Executive</b>		
Electronic Records	Audit	Deferred – see Tab 6A
Fraud Investigation Procedures Development	Advisory	Complete
Internal Ethics and Fraud Hotline Administration	Advisory	Ongoing
University of Texas Students’ Project – Best Practices for Social Media	Consulting (Added)	Complete
Meetings Participation	Advisory	Ongoing
Special Requests	Advisory	Ongoing
<b>Finance</b>		
Purchasing and Contract Administration	Audit	
GASB 67 and 68 Implementation Status	Advisory	In Progress
State Auditor’s Office (SAO) Financial Audit Coordination	Advisory	Complete
Meetings Participation	Advisory	Ongoing
Special Requests and Surprise Inspections	Advisory	In Progress
<b>TEAM Program</b>		
TEAM Independent Program Assessment (IPA) Vendor Support	Advisory	Ongoing
TEAM Committees Participation	Advisory	Ongoing
<b>Pension Benefits</b>		
Cost of Living Adjustment (COLA) Calculation	Audit	Complete
Refunds, Inactive and Escheated Accounts	Audit	Complete
Special Service Buy Back Process	Audit	Complete
Telephone Counseling Center Follow-up (outsourced)	Audit	Complete
Benefits Payment Testing for SAO Financial Audit	Audit	Complete
Semi-annual Benefits Testing	Agreed-Upon Procedures	1 of 2 Complete
<b>Employer Reporting</b>		
TRS Employer Reporting Controls	Advisory	In Progress
Employer Self-Audit Program	Advisory	In Progress
Employer Reviews/Special Projects	Various	In Progress

## Status of Fiscal Year 2014 Planned Assurance, Consulting, and Advisory Services as of May 2014

Title	Type	Status
<b>Health Care Benefits</b>		
Health Care Governance, Risk Management, and Reporting	Consulting	Deferred – see Tab 6A
Health Care Vendor Update Meetings	Advisory	Ongoing
Health Care Vendor and Auditor Selection Observation	Advisory	Complete
<b>Information Technology</b>		
Identity and Access Management, and Contractor Onboarding Process	Audit	Complete
Information Technology (IT) Security Program Follow-up (outsourced)	Audit	In Progress
Emerging IT Risks (outsourced): (1) Cloud Computing (2) Mobile Device Security	Consulting	In Progress –(1)
University of Texas Students' Project – Best Practices and Policies for Cloud Computing and Mobile Devices	Consulting (Added)	Complete
Co-Location/Disaster Recovery Planning	Consulting	Complete
Network Penetration Test; Security Risk Assessment Review	Advisory	In Progress
Technology Committee Meetings Attendance	Advisory	Ongoing
<b>Investment Management</b>		
Overall Internal Control Opinion on Investment Activities (includes periodic status reports)	Audit	In Progress
Quarterly Investment Testing	Agreed-Upon Procedures	1 <sup>st</sup> , 2 <sup>nd</sup> , 3 <sup>rd</sup> QTRS Complete
Private Strategic Partner Network (SPN) Fee Calculations	Consulting	
Incentive Compensation Plan Review	Advisory	Complete
Investment Committees Attendance	Advisory	Ongoing
<b>Internal Audit Department</b>		
Internal Quality Assurance Review	Advisory	In Progress
External Quality Assurance Reviews	Advisory	In Progress
Annual Internal Audit Report	Audit	Complete
Quarterly Audit Recommendations Follow-up	Audit	Ongoing
Fiscal Year 2015 Audit Plan	Advisory	
Health Care Audit Risk Assessment, Model 3Year Audit Plan Project	Consulting	Complete
Audit Committee Meetings Preparation	Advisory	Ongoing
Internal Audit Strategic Plan	Advisory	In Progress

## Fiscal Year 2014 Internal Audit Advisory Services<sup>1</sup> March 2014 – May 2014

<b>BENEFIT SERVICES</b>
<b>TEAM PROJECT PARTICIPATION</b> <ul style="list-style-type: none"> <li>• Executive Steering Committee</li> <li>• Budget Committee</li> <li>• Data Management Project</li> <li>• Decommissioning Project</li> <li>• Reporting Entity Outreach Core Team Meeting</li> <li>• Organizational Change Management Advisory Group</li> <li>• Audit High Level Requirements Gathering and Functional Organizational Document</li> <li>• Internal Control Project Development</li> <li>• Monthly meetings with TEAM Project Manager</li> <li>• Core Management Team: Standing Prioritization Review Meeting</li> </ul>
<b>HEALTH BENEFITS</b>
<ul style="list-style-type: none"> <li>• Health Plan Administrator (HPA) and Pharmacy Benefit Manager (PBM) Vendor Quarterly Update Meeting Participation</li> <li>• Health Maintenance Organization Fully Insured Services Request for Proposal (RFP) Meeting Participation (Non-voting)</li> <li>• Health Care Risk Assessment Consulting Project Coordination</li> </ul>
<b>INVESTMENTS</b>
<ul style="list-style-type: none"> <li>• Internal Investment Committee (IIC) Attendance</li> <li>• Monthly Meetings with Deputy CIO and Director of Operations</li> <li>• Master Custodian and Securities Lending Procurement Activities Observation</li> <li>• New Investment Portfolio Process Discussion</li> <li>• SAO Audit of Incentive Pay Plan Coordination</li> </ul>
<b>FINANCIAL SERVICES</b>
<ul style="list-style-type: none"> <li>• Coordination of State Auditor’s Office on the Audit of TRS’ Fiscal Year 2014 Comprehensive Annual Financial Report and plan for GASB 67 and 68 including AICPA guidance</li> <li>• Surprise Inspections of General Accounting, Security and Receiving areas</li> <li>• Financial System Replacement (FSR) Weekly Meetings Participation</li> </ul>
<b>EXECUTIVE</b>
<ul style="list-style-type: none"> <li>• State Auditor’s Office Quarterly Update Meetings Coordination and Support</li> <li>• Hot Line Call Facilitation</li> <li>• Executive Requests</li> <li>• Travel Surprise Inspection</li> </ul>
<b>INFORMATION TECHNOLOGY (IT)</b>
<ul style="list-style-type: none"> <li>• Enterprise Security Project Team Participation</li> <li>• Co-Location/Disaster Recovery Consulting Project Coordination</li> <li>• IT Security Program Follow-up Audit Project Coordination</li> <li>• Cloud Computing Consulting Project Coordination</li> </ul>

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

**Internal Audit Goals and Performance Measures - Fiscal Year 2014  
3rd Quarter Ending May 31, 2014**

Target Performance	Activity	Status
<b>Goal 1: Enhance Effectiveness of Internal Audit Organization</b>		
1. Update the Internal Audit Strategic Plan, 2012-2016, and align with TRS mission and core values.	Internal Audit Strategic Plan for 2015-2019 will be finalized this fiscal year and presented at the September 2014 Audit Committee meeting.	On Task
2. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services.	Achieved approximately 78% fiscal year-to-date by end of third quarter	On Task
3. Develop and implement transition plan for the transfer of the investment compliance function from Internal Audit to Legal Services.	The investment compliance function transferred to Legal Services effective September 1, 2013. Internal Audit management provided assistance as needed during the first quarter.	Achieved
<b>Goal 2: Develop and Implement Internal Audit Annual Audit Plan based on Formal Risk Assessment</b>		
4. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests).	Planned assurance and agreed-upon procedures projects are on schedule and assigned to staff; see <b>Tab 6A</b> for proposed changes to the audit plan	On Task
5. Complete internal self-assessment and report annually on Quality Assurance and Improvement Program.	The internal self-assessment is in progress.	On Task
<b>Goal 3: Enhance Internal Audit Staff Skills and Knowledge in Emerging Risks and Controls with Emphasis on Information Technology, Investment and Health Care</b>		
6. Obtain internal audit staff training and implement COSO Internal Control 2013 Integrated Framework in the Investment Management Division overall internal control opinion audit during fiscal year 2014.	The CAE and two internal audit directors received training on the COSO Internal Control 2013 Integrated Framework. This framework is being implemented in the IMD overall internal control opinion that is currently in progress.	On Task
7. Enhance staff knowledge of investment due diligence key processes by visiting one TRS asset manager.	The Director of Investment Audit Services and the Senior Investment Auditor are scheduled to accompany IMD staff to visit two asset managers in June 2014.	On Task

**Internal Audit Goals and Performance Measures - Fiscal Year 2014  
3rd Quarter Ending May 31, 2014**

<b>Goal 4: Deliver Value-Added Consulting and Advisory Activities</b>		
8. Facilitate coordination of TEAM Independent Program Assessment (IPA) Vendor by coordinating meetings with Executive Director, Executive Steering Committee (ESC) and Core Management Team (CMT), quarterly presentations to the TRS Board of Trustees, and other contractual activities.	Coordination and support of IPA vendor is ongoing	On Task
9. Facilitate timely completion and success of State Auditor's Office (SAO) audits in fiscal year 2014 by effectively providing audit support, coordinating meetings, reserving facilities and gathering schedule and documentation requests.	State Auditor's Office Report on the Audit of Fiscal Year 2013 Comprehensive Annual Report (CAFR) was reported to the Audit Committee in December 2013	Achieved
10. Coordinate with Legal Services and executive management on the development of framework for ethics and fraud investigations and implement in fiscal year 2014.	Internal Audit has provided feedback and suggested best practices to Legal Services regarding the draft internal investigations procedures.	Achieved
11. Coordinate with Benefit Accounting and executive management on the development of employer self-audit program and implement in fiscal year 2014.	Continuation of fiscal year 2013 project; Benefit Accounting staff is heavily involved in TEAM projects but meetings are scheduled in June 2014 to finalize the deliverables	Delayed
<b>Goal 5: Enhance Participation in Professional and Peer Organizations</b>		
12. Participate in at least two quality assurance reviews of internal audit departments in state agencies and public pension funds.	The CAE led a quality assurance review (QAR) of the ERS of Texas and Washington State Investment Board internal audit function. An audit manager is leading a QAR at the Office of the Attorney General internal audit function.	Achieved
13. Participate in professional organizations (APPFA, IIA, ISACA, ACFE, SIAIAF, CFA Institute) through monthly chapter meetings and engage in leadership roles in at least two of the professional organizations.	Participation in professional organizations is ongoing. The CAE is secretary for APPFA, and one audit manager is on the Board of Governors for the Austin Chapter of the IIA.	On Task

**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 Investigations  
Incident Report Activity Summary  
1/1/2010 (inception) through 3/31/2014**

<b>Time Period</b>	<b>Number of Calls Per Ethics and Fraud Hotline</b>	<b>Status</b>
1/01/2010 – 8/31/2010	1	Resolved
9/01/2010 – 8/31/2011	2	Resolved
9/01/2011 – 11/30/2011	0	N/A
12/01/2011 – 3/31/2012	1	Resolved
4/01/2012 – 5/31/2012	0	N/A
6/01/2012 – 8/31/2012	0	N/A
9/01/2012 – 11/30/2012	1	Resolved
12/01/2012 – 3/31/2013	0	N/A
4/01/2013 – 5/31/2013	0	N/A
6/01/2013 – 8/31/2013	0	N/A
9/01/2013 – 11/30/2013	0	N/A
12/01/2013 – 2/28/2014	0	N/A
3/01/2014 – 5/31/2014	1	Resolved

<b>Time Period</b>	<b>Internal Investigations that Internal Audit Provided Assistance</b>	<b>Status</b>
6/01/2013 – 8/31/2013	1	Resolved

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

Per the TRS Fraud and Ethics Hotline Procedures:

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

## MANAGING THIRD-PARTY RISKS

When your organization relies on third-party suppliers or service providers, your exposure to risk multiplies. And while the term “third-party” is often used in reference to big jobs — such as outsourced labor, data processing, or manufacturing — the associated risks can apply to every contractual relationship, no matter how small. They may even extend to include your vendors’ relationships with their service providers or suppliers.

More than 65 percent of organizations rely “heavily” on third parties, according to a recent survey conducted jointly by The Institute of Internal Auditors Research Foundation and Crowe Horwath LLP. Yet, despite the prevailing belief that third-party relationships pose a significant risk to the organization, a large majority (80 percent) of organizations devote only a sliver of their internal audit resources to assessing third-party

risks. Moreover, researchers discovered a lack of consensus about who in the organization actually “owns” each third-party relationship and uncertainty regarding what specific steps should be taken to reduce risk exposures.

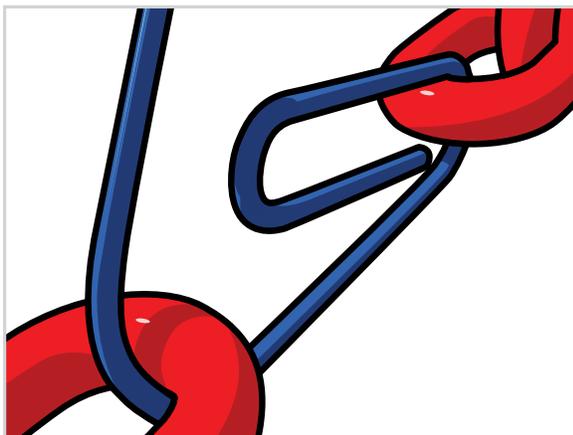
This issue of *Tone at the Top* explores the subject of third-party risks, tapping the insights of three risk management experts who offer several tips to help company leaders grapple with this growing concern.

### Moving Target

“Third-party risk is one of the greatest risks to our organization,” says William Vinson, vice president and chief audit executive at Seagate Technologies, a global leader in computer hard disk drives and data storage solutions. “Whether it’s manufacturing or some other service, we’re handing over a lot of the typical controls we would expect to see internally to someone else.”

Seagate relies heavily on third-party manufacturers and suppliers in China, Malaysia, South Korea, Thailand, Singapore, Brazil, and other countries with a wide range of cultural practices, political systems, regulations, labor laws, and quality-control expectations. Navigating this complex and shifting landscape can be a daunting challenge.

“It’s important for boards and audit committees to recognize that, when you’re talking about third-party risk management, you’re dealing with a constantly



evolving environment,” Vinson says. “Economies change. Politics and regulations change. There has to be a robust and continuing review and evaluation process.”

Establishing comprehensive contract agreements is a step in the right direction. But third-party risk management programs must also include provisions for monitoring compliance and enforcing those contracts.

## Fight for Rights

Although reputational risks — such as poor working conditions, corrupt practices, and product liability — tend to garner more public attention, much of third-party risk management actually involves less provocative matters such as making sure that vendor contracts are clearly written, costs are accurately identified and understood, suppliers and consultants are not padding their bills, and all parties are compliant.

One example of a common third-party risk involves channel distribution arrangements, in which a branded product passes through several checkpoints, taking on the bells and whistles of “value-added” resellers. For example, a computer manufacturer allows a channel partner to add a component, such as memory. But the part is defective or substandard, leading to problems. In such a case, the manufacturer essentially vouches for the work of an invisible third party, whose subpar work may ultimately damage sales and the brand’s reputation.

Software licensing and music royalty agreements are two other common areas where failing to audit or enforce contractual provisions may lead to significant monetary losses. “It’s easy for an IT shop to deploy more software than it pays for,” says Robert Pink, a partner with KPMG who specializes in contract compliance services. “In channel distribution, a third party might understate sales to reduce royalties owed under a reseller agreement.” Fortunately, Pink says he’s seeing an upswing in the exercising of contractual audit rights and the enforcement of single-use provisions.

Historically, that hasn’t been the case. Matthew Behan, principal for KPMG Contract Compliance, says that, in the more than 20 years he has been conducting contract compliance audits, he is often surprised by the hiring company’s lack of follow-up after a contractual agreement is established. Once the contract is signed, it seems no one ever looks at it again, he says.

Still, more often than not, breakdowns in third-party risk management result from a failure to keep close tabs on vendors and to verify that contract terms are

## Third-party Risk Roster

Third-party risks can be found in every corner of an organization. Patrick Warren, principal with the risk consulting unit of Crowe Horwath, groups these risks into the following six categories:

1. **Financial** – Foreign exchange, currency risk, tariffs, taxes, product price, markup, and rebates.
2. **Information** – Accuracy, timeliness, relevance, and security of data shared by multiple parties.
3. **Integrity** – Fraud, regulatory compliance, conflicts of interest, brand, and reputation.
4. **Operational** – Cost, efficiency, contract concerns, business disruption, and supply chain concerns.
5. **Strategic** – Big-picture issues, including social responsibility, environmental conscience, and economic impact of third parties.
6. **Technology** – Computers, data-storage devices, networks, and emerging technologies.

\*Adapted from Warren’s article, “Closing the Gaps in Third-party Risk Management,” *Internal Auditor* magazine, February 2014.

## Qualified Professionals

Internal auditors and risk managers, particularly those who hold The IIA's Certification in Risk Management Assurance, are uniquely qualified to identify potential third-party risk exposures and to make recommendations on policies and procedures to manage those risks.

being met. "We know that third parties make errors," Behan says. "They take advantage of situations. And yet, very often we hear, 'That's just how business is done.' Well, okay — but if that's the way you're going to conduct business, why even have a contract?"

## Reining In Risk

The rapid and accelerating pace of technological advancement and the digitization and monetization of information makes keeping a tight rein on third parties increasingly difficult. Still, with so much at stake, it is critical that organizations document and adequately monitor third-party risks.

Seagate's Vinson offers the following tips for managing the effort:

- 1 Conduct a complete inventory of third-party activities ranked by risk factors, including contract value, corruption potential, financial risk, and regulation.
- 2 Assign an appropriate and proportionate process to manage each identified third-party risk/relationship.
- 3 Establish clear and unequivocal rules to hold vendors accountable and measure performance.
- 4 Ensure that controls and risk-assessment tools adapt to changes in the risk profile.

In many organizations, the responsibility for performing these tasks falls to risk managers and internal audit professionals, who work in tandem to ensure the

organization's many risk exposures are identified and addressed appropriately. Risk managers establish controls and procedures to minimize risks, while internal auditors provide an objective assessment of the controls, recommend improvements, and offer assurance to executive management and the board that risks are addressed appropriately.

Ultimately, it is incumbent upon executives and board audit committees to ensure that third-party risk management is on their radar. Company leaders must understand and be able to quantify these risks to determine whether sufficient resources are allocated to provide assurance that third-party relationships are properly managed.

## Quick Poll Question

How confident are you that your organization's third-party risks are being addressed adequately?

Visit [www.theiia.org/goto/quickpoll](http://www.theiia.org/goto/quickpoll) to answer the question and see how others are responding.

## Questions Boards Should Ask

- Are third-party risks considered in the organization's overall approach to enterprise risk management?
- Has an inventory and ranking of third-party risks been performed?
- Are third-party risk management roles and responsibilities clearly defined within the organization?
- Are appropriate resources allocated to address third-party risks?
- Do risk managers and internal auditors consider third-party risk in their risk assessments and audit plans?

## About The IIA

The Institute of Internal Auditors Inc. (IIA) is a global professional association with 180,000 members in 190 countries. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator. [www.globaliia.org](http://www.globaliia.org)

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Send questions/comments to [tone@theiia.org](mailto:tone@theiia.org).

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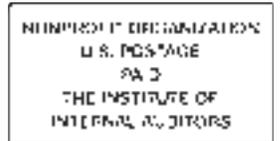
With decades of senior management and corporate board experience, the following esteemed professionals provide direction on this publication's content:

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Michele J. Hooper

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## Internal Audit Staff Quarterly Accomplishments

- Internal Audit hosted three students from the University of Texas at Austin who worked on a consulting project for their graduate audit class project. Dinah Arce was the project lead and assisted the students in their research of best practices and policies on Social Media. The students presented the results of their research to the Communications and Internal Audit staff in April 2014.
- Art Mata transferred to Internal Audit from Benefit Accounting effective May 1, 2014. He was a consultant in Benefit Accounting and brings a wealth of experience and knowledge about TRS to Internal Audit. He will be working on employer reporting audits and internal investigations along with Dinah Arce.
- Hugh Ohn, Dinah Arce, and Amy Barrett attended the May 2014 Association of Public Pension Fund Auditors (APPFA) conference. Dinah Arce was a panel member on the presentation “Best Practices Committee: Risks and Controls for Missing Retirees.”
- Valerie Robateau joined Internal Audit in April as a part-time Administrative Assistant. She earned her associate certifications in Communication Design and Administrative Assistant from Austin Community College and a certification in Business Skills from Grace Institute in Manhattan, New York.