

# **Audit Committee Meeting**

**September 2013**



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

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

*(Committee Chair and Members are Subject to Change at the September Board Meeting—Mr. Moss, Chairman; Ms. Charleston; Mr. McDonald; Ms. Palmer; & Ms. Sissney, Committee Members)*

**AGENDA**

**September 13, 2013 – 8:00 a.m.  
TRS East Building, 5<sup>th</sup> Floor, Boardroom**

*The September 12-13, 2013 meetings of the TRS Board of Trustees and Audit Committee will be held by telephone conference call as authorized under Texas Government Code Section 551.130. The Board and Audit Committee intend to have quorums physically present at **1000 Red River Austin, Texas 78701 in the TRS East Building, 5<sup>th</sup> Floor, Boardroom.***

1. Approve minutes of July 26, 2013 Audit Committee meeting  
– Mr. Christopher Moss, Chair
2. Receive State Auditor’s Office report on planned audit of TRS’ Comprehensive Annual Financial Report for Fiscal Year 2013 – Ms. Angelica Ramirez and Mr. Greg Adams, State Auditor’s Office
3. Receive Internal Audit reports
  - A. Fraud Risk Identification and Prevention Controls Audit – Ms. Jan Engler, Ms. Marianne Woods Wiley, Mr. Mike Rehling, Mr. Scot Leith, and Ms. Amanda Gentry
  - B. Semi-Annual Testing of Benefit Payments (Agreed-Upon Procedures)  
– Ms. Amy Barrett
  - C. Investment Compliance Program Self-Assessment – Mr. Hugh Ohn
  - D. Quarterly Investment Testing (Agreed-Upon Procedures) – Mr. Hugh Ohn
4. Receive reports on the status of prior audit and consulting recommendations
  - A. TRS Information Security Follow-Up Audit – Ms. Lih-Jen Lan and Mr. T.A. Miller
  - B. Status of Prior Audit and Consulting Recommendations – Ms. Amy Barrett
5. Consider recommendation to the Board of Trustees regarding the proposed Audit Plan for Fiscal Year 2014 – Ms. Amy Barrett
6. Discuss Section 825.115 of the Texas Government Code regarding closed meetings with the retirement system’s internal or external auditors – Ms. Amy Barrett
7. 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 – 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  
July 26, 2013**

The Audit Committee of the Teacher Retirement System of Texas met on Friday, July 26, 2013 in the 5<sup>th</sup> floor Board room. The following persons were present:

**TRS Board Members**

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

**TRS Staff**

Brian Guthrie, Executive Director  
Ken Welch, Deputy Director  
Amy Barrett, Chief Audit Executive  
Karen Morris, Senior Manager, Internal Audit  
Britt Harris, Chief Investment Officer  
Don Green, Chief Financial Officer  
Janet Bray, Director, Human Resources  
Chris Bailey, Classification and Compensation Specialist, Human Resources  
Carolina de Onís, General Counsel  
Dan Junell, Assistant General Counsel  
Ronnie Bounds, Assistant General Counsel  
Lynn Lau, Assistant Secretary to the Board and Program Specialist, Legal Department  
Howard Goldman, Director, Communications  
Dan Herron, Communications Specialist, Communications  
Michele Bertram, Administrative Assistant, Communications

**Other Attendees**

Steven Huff, Reinhart Boerner Van Deuren s.c.  
Keith Robinson, Focus Group

Audit Committee Chair Christopher Moss called the meeting to order at 3:07 p.m. with a quorum of committee members present.

**1. APPROVE MINUTES OF JUNE 14, 2013 AUDIT COMMITTEE MEETING**

On a motion by Ms. Sissney, seconded by Ms. Charleston, the proposed minutes of the June 14, 2013 Audit Committee meeting were approved as presented.

**2. EVALUATE THE PERFORMANCE OF THE CHIEF AUDIT EXECUTIVE AND CONSIDER A RECOMMENDATION TO THE BOARD OF TRUSTEES REGARDING THE PERFORMANCE APPRAISAL AND COMPENSATION OF THE CHIEF AUDIT EXECUTIVE**

This item was discussed in executive session pursuant to the Texas Open Meetings Act under section 551.074 of the Texas Government Code. At 3:09 p.m., the Audit Committee open session was recessed for the committee to convene in executive session.

The meeting reconvened in open session at 3:52 p.m.

On a motion by Mr. Moss, seconded by Mr. McDonald, the committee voted unanimously to recommend that the Board of Trustees approve the proposed performance appraisal of the Chief Audit Executive for the fiscal year 2013.

The meeting adjourned at 3:53 p.m.

Approved by:

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

**TAB 2**



# Audit Committee Meeting Agenda

## Financial Statement Audit of the Teacher Retirement System

### For the Fiscal Year Ended August 31, 2013

#### INTRODUCTION AND AUDIT TEAM MEMBERS

##### State Auditor's Office Audit Team:

- Angelica M. Ramirez, CPA (Audit Manager)
- Gregory Scott Adams, CPA, MPA, CGFM, Project Manager
- Ishani Baxi, CIDA, Assistant Project Manager
- New and returning team members

#### PURPOSE AND SCOPE OF THE AUDIT

- Issue an opinion on the Teacher Retirement System's fiscal year 2013 financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States.

#### REPORTING TIME LINE

- Independent auditor's report (opinion on the financial statements) – November 12, 2013 (estimated).
- Report on internal controls and on compliance and other matters (required for audits performed in accordance with generally accepted government auditing standards) – November 2013.
- Report to the Legislative Audit Committee – November 2013.

#### ADMINISTRATIVE AND OTHER MATTERS

- Audit work will be conducted in two phases; interim work July 15 – August 23, and substantive work September 30 – November 12.
- Auditors will coordinate their work through the internal audit liaison but will still have direct access to records, employees, and external service providers.
- Internal Audit will provide direct assistance through the performance of selected audit procedures as agreed upon between the State Auditor's Office and Internal Audit.
- The State Auditor's Office is independent to conduct the audit of the System's fiscal year 2013 financial statements. The State Auditor's Office conducts all projects in an environment of full independence; that is, free of any personal, external, or organizational impairment.

TAB 3

**TAB 3A**

**FRAUD RISK IDENTIFICATION AND PREVENTION AUDIT**  
**AUGUST 2013**  
 TRS INTERNAL AUDIT DEPARTMENT

<b>Business Objective</b>	Benefit Accounting (BA) and Benefit Processing (BP) departments: Mitigate significant internal and external fraud risks/opportunities by maintaining key internal controls such as: <ul style="list-style-type: none"> <li>○ Secondary Review/Verification/Approval</li> <li>○ System Edit Checks</li> <li>○ Separation of Duties</li> <li>○ Exception Reports/Reconciliations</li> <li>○ Supporting Documentation</li> <li>○ Restricted System Access</li> </ul>				
<b>Fraud Risks</b>	<b>Disbursements (BA)</b> <ul style="list-style-type: none"> <li>• Falsify address change</li> <li>• Falsify bank information</li> <li>• Falsify payment voucher</li> <li>• Alter account payment status</li> </ul>	<b>Retirement Mail (BP) (Annuity &amp; Disability Payments)</b> <ul style="list-style-type: none"> <li>• Alter member retirement information to inflate benefit</li> <li>• Falsify disability retirement approval</li> </ul>	<b>Refunds (BP)</b> <ul style="list-style-type: none"> <li>• Enter/set up fraudulent member data</li> <li>• Misuse of confidential information</li> <li>• Forgery</li> </ul>	<b>Death Claims (BP)</b> <ul style="list-style-type: none"> <li>• Failure to report annuitant death to collect payments</li> <li>• Forgery</li> <li>• Receive false information</li> <li>• Set up fraudulent beneficiary</li> </ul>	<b>System Access (BA &amp; BP)</b> <ul style="list-style-type: none"> <li>• Create fraudulent annuity payments</li> <li>• Issue payment vouchers to fraudulent payee/address</li> </ul>
<b>Key Controls Tested</b>	<ul style="list-style-type: none"> <li>• Secondary Review / Verification / Approval</li> <li>• System Edit Checks</li> <li>• Separation of Duties</li> </ul>			<ul style="list-style-type: none"> <li>• Exception Reports/ Reconciliations</li> <li>• Supporting Documentation</li> <li>• Restricted access based on job duties</li> </ul>	
<b>Test Results</b>	Key internal controls are in place and are working effectively to mitigate significant fraud risks/opportunities.	<ul style="list-style-type: none"> <li>• Key review process can be circumvented without detected.</li> <li>• Retirement applications finalized by cross-trained staff are not reviewed.</li> </ul>	Key internal controls are in place and are working effectively to mitigate significant fraud risks/ opportunities.	Key internal controls are in place and are working effectively to mitigate significant fraud risks/ opportunities.	Instances of conflicting and excessive system access that could create an opportunity for fraudulent activities were identified.
<b>Recommended Actions</b>	None	<ul style="list-style-type: none"> <li>• Enhance current monitoring of reports.</li> <li>• Quality assurance reviews should be consistent and broadened.</li> </ul>	None	None	Develop a process for regular review of system access based on current job duties.
<b>Management Responses</b>	None	Management agrees with the recommendations and is reviewing changes to processes to enhance monitoring.	None	None	Management agrees with recommendation. Conflicting access has been terminated.

August 27, 2013

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

## EXECUTIVE SUMMARY

We have completed the audit of **Fraud Risk Identification and Prevention**, as included in the *Fiscal Year 2013 Audit Plan*. The business objective related to fraud risk mitigation in the Benefit Accounting (BA) and Benefit Processing (BP) departments is as follows:

Benefit Accounting and Benefit Processing departments mitigate significant internal and external fraud risks/opportunities by maintaining key internal controls such as:

- Secondary Review/Verification/Approval
- System Edit Checks
- Separation of Duties
- Exception Reports/Reconciliations
- Supporting Documentation
- Restricted System Access

Based on our audit results, we determined that management controls are operating effectively to achieve the operational objectives of the business units. However, we did identify significant issues related to system access privileges that could prevent the departments from effectively mitigating internal fraud.

In addition, there is an opportunity within Benefit Processing to increase the likelihood of detecting or deterring possible internal fraud by strengthening secondary review processes in two key areas. First, changing current monitoring practices for four existing reports would greatly improve the likelihood of identifying instances where the TRS186 secondary review process<sup>[1]</sup> had been circumvented. Second, by ensuring that quality assurance reviews are consistently occurring within the Retirement Mail Team, and by broadening the scope of the reviews to include a sample of retirements finalized by cross-trained staff, the likelihood of fraudulent activities being detected or deterred would also increase.

Results of our procedures are presented in more detail in the **Results and Recommendations** section (page 4). The audit objective, scope, methodology and conclusion are described in **Appendix A** (page 11).

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<sup>[1]</sup> The TRS186V secondary review is a process in which finalized retirement applications are verified by a second processor to ensure accuracy. This process was also identified by management as a key control in identifying and preventing fraud.

## BACKGROUND

### TRS Fraud, Waste, and Abuse Prevention Program Timeline

- 2004 – Texas Governor issued *Executive Order RP36* and TRS responds with the *Key Components of Fraud Prevention* document that same year
- 2005 – *Business unit risk assessments* initiated
- 2006 – *Fraud, Waste, and Abuse Prevention Policy* developed
- 2007 – *Fraud, Waste, and Abuse Prevention Committee (FWAP)* created
- 2008 – *Enterprise Risk Management (ERM)* program formally established and the *Risk Oversight Committee (ROC)* formed
- 2009 – *Internal Audit Memorandum on TRS Fraud Risk: Prevention & Awareness* issued
- 2010 – *Internal Fraud & Ethics Hotline* implemented
- 2011 –
  - *TEAM* project updating legacy systems begins and includes fraud risk exercises
  - *TRS Fraud, Waste, and Abuse Prevention Policy* is updated
  - *Internal Fraud & Ethics Hotline* awareness materials are updated & distributed

### Benefit Accounting

Benefit Accounting has district reporting responsibilities, as well as Special Service Buyback, Annuity Payroll, and Employment After Retirement. The customer base Benefit Accounting serves includes active members, retirees, beneficiaries, alternate payees, reporting entities, financial institutions, software providers, the Office of the Texas Comptroller, and TRS staff.

The Disbursements team within Benefit Accounting is responsible for ensuring TRS annuitants and beneficiaries receive their monthly payments on time every month. The monthly payroll is in excess of \$600 million dollars per month paid to over 300,000 retirees.

The team works closely with other TRS departments such as Benefit Processing, General Accounting, Information Technology, and Legal Services, as well as the Office of the Texas Comptroller, Employees Retirement System, and the Texas Retired Teachers Association to ensure the accuracy of the monthly annuity payroll.

### Benefit Processing

Benefit Processing is the department where eligibility for benefits - service retirement, disability retirement, in-service death benefits, retiree death benefits, special service purchases, and refunds of member accounts - is determined. Once eligibility is determined, it is their responsibility to calculate those benefits accurately and issue them timely.

Benefit Processing does not stand alone, however. In meeting the challenges of benefit delivery, they work closely with other departments in the Benefits Services Division, such as Benefit Counseling and Member Data Services; as well as, Benefit Accounting, General Accounting, Information Technology, and Legal Services.

*Source: Multiple sources including department intranet and publications (unaudited)*

## BUSINESS OBJECTIVES, RISKS, AND CONTROLS

For the Fraud Risk Identification and Prevention audit, we obtained information about the following fraud-related business objectives, as well as possible fraud risks and the key controls management established to mitigate these risks:

<b>Business Objectives</b>	Benefit Accounting (BA) and Benefit Processing (BP) departments: Mitigate significant internal and external fraud risks/opportunities by maintaining key internal controls such as: <ul style="list-style-type: none"> <li>• Secondary Review / Verification / Approval</li> <li>• System Edit Checks</li> <li>• Separation of Duties</li> <li>• Exception Reports/Reconciliations</li> <li>• Supporting Documentation</li> <li>• Restricted System Access</li> </ul>	
<b>Business Units</b>	Benefit Accounting – Disbursements	Benefit Processing – Death Claims, Refunds, Retirement Mail
<b>Business Risks</b>	<ul style="list-style-type: none"> <li>• Falsify address change</li> <li>• Falsify bank information</li> <li>• Falsify payment voucher</li> <li>• Alter account payment status</li> <li>• Issue payment vouchers to fraudulent payee/address</li> <li>• Forgery</li> </ul>	<ul style="list-style-type: none"> <li>• Alter member retirement information to inflate benefit</li> <li>• Falsify disability retirement approval</li> <li>• Enter/set up fraudulent member data</li> <li>• Misuse of confidential information</li> <li>• Forgery</li> <li>• Create fraudulent annuity payments</li> <li>• Failure to report annuitant death to collect payments</li> <li>• Receive false information</li> <li>• Set up fraudulent beneficiary</li> </ul>
<b>Management Controls</b>	<ul style="list-style-type: none"> <li>• Secondary Review / Verification / Approval</li> <li>• System Edit Checks</li> <li>• Separation of Duties</li> <li>• Exception Reports/Reconciliations</li> <li>• Supporting Documentation</li> <li>• Restricted System Access</li> </ul>	
<b>Controls Tested</b>	<ul style="list-style-type: none"> <li>• Secondary Review / Verification / Approval</li> <li>• System Edit Checks</li> <li>• Separation of Duties</li> <li>• Exception Reports</li> <li>• Supporting Documentation</li> <li>• Restricted system access based on job duties</li> </ul>	

# RESULTS AND RECOMMENDATIONS

## OVERALL RESULTS

Based on our audit results, we determined that management controls are operating effectively to achieve the operational objectives of the business units. However, we did identify significant issues related to system access privileges that could prevent the departments from effectively mitigating internal fraud.

In addition, there is an opportunity within Benefit Processing to increase the likelihood of detecting or deterring possible internal fraud by strengthening secondary review processes in two key areas. First, changing current monitoring practices for four existing reports would greatly improve the likelihood of identifying instances where the TRS186 secondary review process<sup>[1]</sup> had been circumvented. Second, by ensuring that quality assurance reviews are consistently occurring within the Retirement Mail Team, and by broadening the scope of the reviews to include a sample of retirements finalized by cross-trained staff, the likelihood of fraudulent activities being detected or deterred would also increase.

## POSITIVE RESULTS

### A. Benefit Accounting – Disbursements Staff Demonstrate Awareness of Fraud Prevention Controls such as Separation of Duties and Secondary Review

- Team Leader and staff have shown that they are very knowledgeable of the importance of maintaining separation of duties and have established six standard rules to determine appropriate system access restrictions within the team.
- Team Leader and staff have established a well-documented and effective process for reviewing exception reports. They have clear procedures and demonstrate an understanding of both the purpose and importance of the reports they review.

### B. Benefit Processing – Death Claims (Team 3) Staff Demonstrate Awareness of Fraud Prevention Controls such as System Edit Checks and Verification

- At the request of staff, the Death Claims (DCLM) system is capable of calculating and pre-populating the survivor benefit amount of \$10,000 for one beneficiary or multiple beneficiaries.
- Automated survivor benefits payments cannot move to pay status until all benefit set up requirements have been independently verified within the DCLM system.

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<sup>[1]</sup> The TRS 186V secondary review is a process in which finalized retirement applications are verified by a second processor to ensure accuracy. This process was also identified by management as a key control in identifying and preventing fraud.

C. Benefit Processing – Refunds (Team 4) Staff Demonstrate Awareness of Fraud Prevention Controls such as Quality Assurance Reviews and Verification

- Team Leader performs regular quality checks of multiple aspects of processed files for accuracy. Accuracy rates are determined and formal feedback is provided to staff members as part of the ongoing training process.
- Verification of processed refund applications prior to going to pay status is automatically documented within the REFM system. Verification information is also a variable in the quality assurance reviews described above.

D. Benefit Processing – Retirement Mail (Team 5) has an Effective Process for Identifying Unintentional Errors in Benefit Calculations.

- Continuous benefit testing performed by Internal Audit has found very few errors in benefit calculations for recent retirees.

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

**1. 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.**

- A. Testing of system access privileges within Benefit Processing identified twelve employees with conflicting access that provided an opportunity for long-term annuity payment fraud. Upon notification, management immediately restricted accesses as appropriate to close this opportunity for fraud.

In addition, testing found that TRS's *Information Classification Review Worksheet* needs to be updated to include necessary restrictions for key commands to help ensure excessive accesses are not inadvertently granted in the future.

- B. Conflicting access privileges that would allow for fraudulent manual payments were identified. Testing found one exception within the Disbursements Team of Benefit Accounting and multiple exceptions within Benefit Processing.
- C. Testing found widespread issues with excessive or carryover access privileges where staff members were found to have update capabilities that were not needed for their current job duties.
- D. Multiple instances were identified within the Disbursements Team of Benefit Accounting where access privileges conflicted with the separation of duties rules established within the team.

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

- E. Testing found that the TRS enterprise-wide annual review of system access does not include a review of individuals with update capabilities for the Texas Identification Number System (TINS) used to update payee addresses and direct deposit information at the Texas Comptroller's office.

Although these access rights are not maintained by the Security Administration team within the Information Technology department, having these access privileges reviewed at the same time would allow a manager to have a more complete picture of system access privileges for staff members.

## **Recommendation**

We recommend that Benefit Accounting and Benefit Processing improve system access reviews by developing a process for managers and team leaders to routinely review access privileges across all teams. Management should ensure that current accesses are limited to those necessary to carry out current job duties. This process should include a balance between the need for cross-training staff and the importance of restricted access to limit the opportunity for fraud.

## **Management Responses**

**Benefit Accounting** concurs with the finding. Annually, we will review the TRS system access and TINS access for each Benefit Accounting team member. The annual review has been completed for the current fiscal year. The review will take place within the fourth quarter of each fiscal year.

In addition to our annual review of staff access, we will also include a review when a staff member assumes new duties or moves to another position within the department or agency. The expected implementation date is December 31, 2013.

**Benefit Processing** management agrees with the recommendation to develop a process to review access privileges across all teams. We will also include a review when a staff member assumes new duties or moves to another position within the department or agency.

The Benefit Processing workload peaks at different times of the year for different teams; therefore, we rely on cross-training of staff to meet service level agreements and maximize staff utilization. Any changes to system access will have to be balanced between the risk of having the access and the need to process benefit requests in a timely manner. This process should be developed by October 31, 2013.

## **OTHER REPORTABLE RESULTS**

### **2. Enhance current monitoring of reports within Benefit Processing to improve the likelihood of identifying fraudulent activities.**

The 186V secondary review is a process in which finalized retirement applications are verified by a second processor to ensure accuracy. This process was also identified by management as a key control in identifying and preventing fraud.

Testing found that the current 186V secondary review is a manual, paper-based process that relies upon the retirement processor following proper procedures to be effective. Currently, there is not a way to ensure that every retirement application being processed has undergone a secondary review. The review process can be circumvented should a processor choose not to make the finalized application available for verification.

By circumventing secondary review, a processor could fraudulently inflate benefit payments as well as circumvent the Medical Review Board process and fraudulently approve disability retirements without being initially detected.

Additionally, testing identified that changing current monitoring practices for the following four existing reports would greatly improve the likelihood of identifying instances where the TRS186 secondary review process had been circumvented.

a. TRS115 Uncommit Log

This log is maintained in an Excel file and records the time, date, and user ID whenever changes are made to the Retirement Processing Worksheet (TRS115) and an image of the changes is not submitted to the member's file. Routine review of this log could identify possible fraud, especially if an individual shows a pattern of not imaging changes.

Testing found that this report is not currently being reviewed on a regular basis.

b. RT3030 – Comparison of Termination versus Payroll Data (Unequal 7 Report)

This is a monthly report generated for each processor that identifies when the amount of a finalized benefit payment differs from a system calculated benefit using salary information in the ledgers system (LGRS).

Currently, this report is regularly reviewed by the originating processor who is responsible for notating the reason for any discrepancies and returning the report to the Team Leader. Changing the current process so that reports are reviewed by random processors rather than the originator would enhance this review by helping to identify any salaries that were fraudulently inflated during retirement processing.

c. BB7100 - Unverified Stat Rehabs Report

This is a weekly report that lists unverified changes made on the rehab screen within the previous 10 days. Information on this screen feeds into the Retirement Setup Form (TRS115S) and is used to create retirement estimates. Changes go into effect immediately; however procedures require that all changes be visually reviewed for accuracy and verified in the system by a second person. Regular review of unverified changes could identify if an individual is purposefully trying to avoid review of changes made to this screen.

Currently, the Special Service Buy Back Team Leader and the Retirement Setup Team Leader review the report each week to ensure any unverified changes made by their teams are verified. The Special Service Buy Back Team Leader also notifies the Refunds Team Leader and Death Claims Team Leader if members of their teams appear on the report.

At present, no one on the Retirement Mail Team reviews this report. Past reports show that members of the Retirement Mail Team have regularly appeared on the report. If no one is verifying changes on this screen, it is possible that fraudulent changes could go undetected.

d. AP2020 – Retirement Batch Processing Add Journal

This report is generated twice a week and lists all recent service and disability retirees added to payroll.

A consultant within Benefit Processing reviews this report for disability retirees. All newly added disability retirees with less than 10 years of service are reviewed to ensure the disability benefit is setup for the correct number of years. For all other disability retirees, information on a specific screen regarding the type of disability and the number of Medical Review Board members that agreed with the approval decision are captured. This information is used to produce statistical reports requested by the Medical Review Board.

The current review process does not confirm that proof of the Medical Review Board opinions listed in the system are evidenced by completed forms in the member's file.

## **Recommendation**

To identify possible fraud that could go undetected by the manual 186V secondary review process, we recommend that management implement the listed changes to the monitoring process for the following reports:

a. TRS115 Uncommit Log

A process to ensure regular review of this log should be established.

b. RT3030 – Comparison of Termination versus Payroll Data “Unequal 7” Report

Enhance the current review process by ensuring the review is performed by non-originating staff.

c. BB7100 – Unverified Stat Rehabs Report

A process should be implemented so that all teams within Benefit Processing are reviewing this report and taking appropriate action to ensure all changes to the rehab screen are verified.

d. AP2020 – Retirement Batch Processing Add Journal

When reviewing recent disability retirees, rather than only using the system to capture information needed for reports, verify that imaged copies of the TRS138 forms are in the member's file.

## **Management Responses**

Benefit Processing management agrees with the recommendation and is working with Information Technology to develop an independent online verification process for the TRS 186 form. To ensure all applications are reviewed prior to annuity payments being made, the system will require a secondary verification. The online verification should be in production by August

31, 2014. In the interim, management will implement the following changes to our current report monitoring process:

- a. A request has been submitted to Information Technology that would enable an auto-image of the TRS115 when an update is made to the RETP system. This change should be in production by October 31, 2013.
- b. The Retirement Mail team leader has already begun distributing these reports to someone other than the originator to add a secondary review.
- c. All team leaders in Benefit Processing have been added to the distribution of the BB7100 report. This change is already in production as of this report.
- d. AP2020 – Management will work with Information Technology to include disability approval information on the 186D form. This change will require the person performing the secondary verification to ensure the proper Medical Board Review process was followed as evidenced by the imaged TRS138 forms in the member file. The expected implementation date is October 31, 2013.

### **3. Ensure that consistent quality assurance reviews occur and broaden the sample of reviewed items within Benefit Processing**

Management identified the quality assurance reviews conducted by the Retirement Mail Team Leader as being a key control in identifying and preventing fraud. Testing found that the reviews are not occurring on a consistent basis. Additionally, the tool used to randomly select items for review is limited to items worked by members of the Retirement Mail Team. Retirement applications finalized by cross-trained staff outside of Retirement Mail are not being reviewed by the Team Leader.

#### **Recommendation**

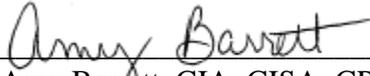
We recommend that a process be established to ensure consistent random review of items worked by the Retirement Mail team as well as retirements finalized by employees outside of Retirement Mail.

#### **Management Responses**

Management agrees with the recommendation and will work with Information Technology to expand the use of the quality assurance monitoring tool to include all department team members that are processing retirements. To ensure consistency throughout the department, management will develop a process where a sample of retirement forms is routinely reviewed by team leaders. Estimated completion of this item is October 31, 2013.

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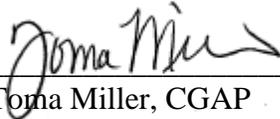
We appreciate Benefit Accounting and Benefit Processing management and staff for their cooperation, courtesy, and professionalism extended to us during this audit. We also appreciate support provided by Information Technology and General Accounting.



Amy Barrett, CIA, CISA, CPA  
Chief Audit Executive



Jan Engler, CIA, CISA, CFE  
Audit Manager



Toma Miller, CGAP  
Internal Auditor

## APPENDIX A

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

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

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

#### AUDIT OBJECTIVE

Determine if Benefit Accounting and Benefit Processing departments mitigate significant internal and external fraud risks/opportunities by maintaining key internal controls such as:

- Secondary Review/Verification/Approval
- System Edit Checks
- Separation of Duties
- Exception Reports/Reconciliations
- Supporting Documentation
- Restricted System Access

#### SCOPE

The scope of the audit included the areas within Benefit Processing Death Claims Team 3, Refunds Team 4, Retirement Mail Team 5, and the Benefit Accounting Disbursements Team. The time period for controls testing was the current fiscal year 2013.

#### METHODOLOGY

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

1. Determined if the activity occurred, what was done with the results, and if the activity was documented.
2. Identified the fraud risk that the activity was designed to mitigate.
3. Concluded whether this activity serves as a key control to mitigate fraud risk/opportunity as management intended.

## CONCLUSION

Based on our audit results, we determined that management controls are operating effectively to achieve the operational objectives of the business units. However, we did identify significant issues related to system access privileges that could prevent the departments from effectively mitigating internal fraud.

In addition, there is an opportunity within Benefit Processing to increase the likelihood of detecting or deterring possible internal fraud by strengthening secondary review processes in two key areas. First, changing current monitoring practices for four existing reports would greatly improve the likelihood of identifying instances where the TRS186 secondary review process<sup>[1]</sup> had been circumvented. Second, by ensuring that quality assurance reviews are consistently occurring within the Retirement Mail Team, and by broadening the scope of the reviews to include a sample of retirements finalized by cross-trained staff, the likelihood of fraudulent activities being detected or deterred would also increase.

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<sup>[1]</sup> The TRS 186V secondary review is a process in which finalized retirement applications are verified by a second processor to ensure accuracy. This process was also identified by management as a key control in identifying and preventing fraud.

**TAB 3B**

# SEMI-ANNUAL TESTING OF BENEFIT PAYMENTS

JANUARY 2013 – JUNE 2013

TRS Internal Audit Department

<b>Business Objectives</b>	To deliver retirement and related benefits authorized by law for members and their beneficiaries.		
<b>Business Risks</b>	<b>Fraud / Errors</b> Benefit payments could be incorrect or fraudulent in these areas: <ul style="list-style-type: none"> <li>• Payments to recent retirees</li> <li>• Benefit payments with an expiration date</li> </ul>	<b>Eligibility</b> TRS members could retire with full benefits without meeting Rule of 80 or minimum requirements	<b>Manual Voucher Payments</b> Manual voucher payments could be processed incorrectly or without proper authorization
<b>Management Assertions</b>	All benefit payments are valid	All retirees who received annuity benefit payments are eligible	All manually processed voucher payments are valid
<b>Agreed-upon Procedures</b>	Matched benefit payments to supporting documents in two areas: 1. Recent retiree benefit recalculations 2. Benefit payment expiration dates	3. Recalculated Rule of 80 or minimum requirements for all new normal-age service retirements during the testing period	4. Matched 60 randomly selected manually processed voucher payments to supporting documentation
<b>Test Results</b>	No Exceptions	No Exceptions	No Exceptions
<b>Management Responses</b>	N/A	N/A	N/A

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

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

August 20, 2013

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

We have completed the second testing period for the **Semi-Annual Testing of Benefit Payments** as included in the *Fiscal Year 2013 Audit Plan*.

We performed the procedures listed below that were agreed to by management of Benefit Services, Health and Insurance Benefits, and the Financial Division. These procedures included four data-mining tests designed to identify anomalies in benefit payments during the current testing period and possible deviations from management's benefit processing controls.

For this testing period, the tests performed included testing gross payment amounts made to recent retirees, manual benefit payments, normal age retirement criteria, and expiry date testing for five or ten year guaranteed period payments, disability retirement payment calculations for retirees with less than 10 years of service, and expiry dates greater than 50 years. There were no exceptions noted as a result of the test procedures performed. The detailed procedures and results of our testing are explained in **Appendix A**.

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

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

### **Internal Control Structure**

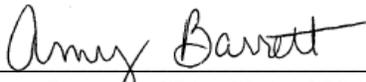
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas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

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

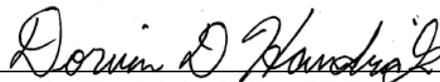
This report is intended solely for information and use by TRS management, the Board of Trustees, and oversight agencies, and is not intended to be and should not be used by anyone other than those specified parties. However, this report is a matter of public record and its distribution is not limited.

\* \* \* \* \*

We express our appreciation to management and key personnel of Information Technology, Benefit Services, Health and Insurance Benefits, and the Financial Division for their cooperation and professionalism shown to us during the testing.



Amy Barrett, CIA, CPA, CISA  
Chief Audit Executive



Dorvin Handrick, CISA, CDP  
Senior IT Auditor



Jan Engler, CIA, CISA, CFE  
Internal Audit Manager

## APPENDIX A

### AGREED UPON PROCEDURES AND RESULTS

1. Test Purpose: Test that gross annuity payments from January to June 2013 to recent retirees (December 2012 or later retirements) are calculated accurately.

Test Description: Query the *January to June 2013 Benefit Payments Data File* for all gross annuity payments that were related to recent member retirements and randomly select five sample items from each month for a total of 30 sample items. Recalculate the gross payment amount as follows: The annuitant's standard annuity payment is first recalculated based on the member's number of years of service and the average salary amount at the time of retirement and agreed to the supporting documentation in the *TRS Imaging System*. If applicable, recalculate the gross annuity payment amount using the annuity payment option adjustment factor(s) selected by the member per the supporting documentation in the *TRS Imaging System*.

Test Result: All 30 gross annuity payments to recent retirees from January to June 2013 were recalculated and traced to supporting documentation. No exceptions were noted.

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

Test Description: Test the expiration date accuracy for a sample of annuity payments from January to June 2013 for the three groups described below. Agree the recorded expiration date to the auditor's calculation based on the imaged documents maintained in the *TRS Imaging System*. Each test is described as follows:

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

b. Expiration date of disability retirement with less than 10 years service

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

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

c. Expiration date is longer than 50 years from the date of current payment record.

Obtain items from all payment records with an expiration date that is more than 50 years from each data file from January to June 2013 that have not been previously tested. Recalculate and agree the recorded expiration date to the supporting documentation.

Test Results:

a. Expiration date of guaranteed-period annuity options retirement

- i.) No exceptions were noted where the expiration date was greater than the retirement date plus the guaranteed period.
- ii.) All 45 unique sample items of records, with an active payment status but no expiration date, were traced to the supporting documentation. No exceptions were noted.

b. Expiration date of disability retirement with less than 10 years service

No exceptions were noted.

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

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

3. Test Purpose: Test for normal-age service retirement benefits from January to June 2013 that do not meet the Rule of 80 with at least five years of service or the minimum retirement age of 65 with at least five years of service.

Test Description: Query the *January to June 2013 Benefit Payments Data File* for all payments that were related to normal-age service retirement benefits since December 2012. All proportionate retirements, early age retirements, and disability retirements are excluded. The annuitant's retirement age is calculated based on the year and month of the member's retirement date and birth date in the annuity system records. All records were recalculated by the auditor according to the stated criteria using the automated audit software.

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

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

Test Description: Select a random sample of 10 manual voucher payments per month from the *January to June 2013 Benefit Payments Data File*. Trace and agree these manual voucher payments to the supporting documents maintained in the TRS *Imaging System*.

Test Results: We randomly selected 60 manual voucher payments to test. These test samples included 18 premium refunds, eight annuity pop-ups, 11 qualified domestic relations order (QDRO) related payments, two payments re-issued due to returned payments, 10 retiree requests to re-issue payment, seven payments re-issued due to retiree/beneficiary death, and four other related manual payments. All payments were traced and agreed to the supporting documents. No exceptions were noted.

**TAB 3C**

## 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 and Compliance

SUBJECT: Self-assessment of Investment Compliance Function

DATE: August 23, 2013

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### Executive Summary

We have completed the self-assessment<sup>1</sup> of the **Investment Compliance** function, as included in the revised *Fiscal Year 2013 Audit Plan*. The project objectives were to:

- Determine whether compliance monitoring activities performed by the Investment Compliance team are consistent with relevant regulatory and industry guidelines
- Identify options for organizational placement of Investment Compliance function to ensure independence as well as optimal utilization of existing resources and expertise

Based on our self-assessment, we concluded as follows:

- Overall, investment compliance monitoring and reporting activities are consistent with relevant regulatory and industry guidelines.
- We identified and presented options for organizational placement of Investment Compliance function to executive management. Based on this information as well as other considerations, executive management decided to move the Investment Compliance function to Legal Services, effective September 2013. This change is expected to strengthen the Investment Compliance function since it would add legal expertise to the compliance program and enable the independence of Internal Audit to evaluate the effectiveness of the compliance function in the future.

### Background Information

This project was initiated to address the recommendation from the fiscal year 2013 Internal Audit External Quality Assurance Review which stated that “*The CAE should dialogue with the Board of Trustees and the Executive Director to determine the best course of action regarding Internal Audit’s compliance monitoring for the Investment Division.*” This recommendation was based on the Institute of Internal Auditors (IIA) position paper, entitled “*The Three Lines of Defense in Effective Risk Management and Control,*” which states that “*a compliance function is a management function. Since Internal Audit performs investment compliance monitoring, Internal Audit is not able to provide independent assurance on the effectiveness of the investment compliance program under the current structure.*”

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<sup>1</sup> TRS Internal Audit manages Investment Compliance and therefore, we are unable to provide independent assurance regarding this function.

The Investment Compliance function at TRS is currently located within Internal Audit. This function moved from the Investment Management Division (IMD) to Internal Audit in October 2008 when one Full Time Equivalent (FTE) staff was transferred to Internal Audit. This move was intended to strengthen the independence and breadth of the function. At that time, Enterprise Risk Management (ERM) was part of Internal Audit and Investment Accounting was part of the IMD.

Since the Investment Compliance function's transfer to Internal Audit, the Employee Trading Policy was issued, pre-clearance software for employee personal trading was implemented, State Street began analyzing and monitoring compliance, and quarterly compliance reports to the Executive Director and Audit Committee were issued.

#### Primary Responsibilities of Investment Compliance

Per its Investment Compliance Charter, Investment Compliance is responsible for the following duties:

1. Investment Policy Statement (IPS) Compliance Monitoring and Reporting
  - a. Monitor and report on compliance with investment-related policies to the Board of Trustees
  - b. Coordinate with State Street for daily policy and investment management agreement (IMA) compliance analysis
  - c. Provide support to ensure compliance with statutes on Sudan and Iran investment restrictions
  - d. Obtain quarterly certifications from staff regarding compliance matters
2. Employee Trading Policy Compliance Monitoring and Reporting
  - a. Monitor personal and TRS trades to identify abusive trades
  - b. Maintain and monitor a Watch List to protect Material Non-Public Information (MNPI)
  - c. Administer an automated system to process pre-clearance requests for personal trades
  - d. Report Employee Trading Policy violations to the Executive Director
  - e. Train new Covered Persons on compliance requirements of the Employee Trading Policy

#### Consistency with Regulatory and Industry Guidelines

Based on the self-assessment, we conclude that overall, our investment compliance monitoring and reporting activities are consistent with relevant regulatory and industry guidelines as well as internal policies and procedures.

During our assessment, we noted that little guidance exists for an investment compliance program similar to the TRS program. We reviewed several other sources such as Securities Exchange Commission rules applicable to private funds or asset managers, other pension plans, internal policy, and the TRS Investment Compliance Charter to assist us in the self-assessment.

The following table summarizes our assessment areas, regulatory or policy sources, and assessment elements:

(1) Compliance with Investment-related Policies:

Assessment Area	Source	Assessment Elements
Adoption of written compliance policies and procedures	SEC Compliance Rule 38a-1 under the Investment Company Act of 1940	<ul style="list-style-type: none"> <li>• Compliance requirements under the Investment Policy Statement (IPS)</li> <li>• Governing body's approval of the policy</li> <li>• Protection of confidential information</li> <li>• Business continuity plans</li> </ul>
Annual review of compliance policies and procedures	SEC Compliance Rule 38a-1 under the Investment Company Act of 1940	<ul style="list-style-type: none"> <li>• Consideration of compliance matters occurred during the previous year and changes in the business activities</li> <li>• Tracking of changes in applicable laws and regulations</li> </ul>
Designation of a chief compliance officer (CCO)	SEC Compliance Rule 38a-1 under the Investment Company Act of 1940	<ul style="list-style-type: none"> <li>• Roles and responsibilities of the Chief Compliance Officer (CCO)</li> <li>• CCO competence and experience</li> <li>• Position of seniority and authority</li> <li>• Independence from fund management</li> </ul>
Compliance monitoring activities, including compliance tests	Investment Compliance Charter	<ul style="list-style-type: none"> <li>• Types and frequency of compliance tests</li> <li>• Adequacy of compliance tests (including gap analysis and quarterly testing plans)</li> </ul>
Follow-up activities for resolution of compliance exceptions identified	Investment Compliance Charter	<ul style="list-style-type: none"> <li>• Resolution of compliance exceptions</li> <li>• Documentation of the follow-up activities</li> </ul>
Reporting of compliance test results	Investment Compliance Charter	<ul style="list-style-type: none"> <li>• Information content for compliance reports</li> <li>• Reporting structure and frequency</li> </ul>

(2) Compliance with Personal Trading Policy:

Assessment Area	Source	Assessment Elements
Prevention and detection of Front-Running	SEC Antifraud rules	<ul style="list-style-type: none"> <li>• Identification of Covered Persons</li> <li>• Preclearance prior to personal trades, including information systems used</li> <li>• Reconciliation of personal trades with TRS trades</li> <li>• Elevation of suspicious personal trades for potential investigation</li> </ul>
Protection of Material Non-Public Information (MNPI)	SEC Antifraud rules	<ul style="list-style-type: none"> <li>• Process to maintain a Watch List</li> <li>• Information barriers established</li> </ul>
Education on Personal Trading Policy	TRS Trading Policy	<ul style="list-style-type: none"> <li>• Training provided to new and/or existing TRS employees or contractors</li> </ul>

(3) Other Compliance Areas:

Assessment Area	Source	Assessment Elements
Oversight of external compliance monitoring service provider (i.e. State Street)	Investment Compliance Charter	<ul style="list-style-type: none"> <li>Approval of compliance rules</li> <li>Review of compliance reports, including exceptions (“alerts”)</li> <li>Audit or due diligence of compliance monitoring services</li> </ul>
Organizational Independence	Institute of Internal Auditors Publications; Industry guidelines and practices	<ul style="list-style-type: none"> <li>Reporting structure</li> <li>Independence from fund management</li> <li>Independence maintained to provide assurance</li> </ul>
Collaboration with other departments (including IMD, Legal, ERM, etc.)	Industry guidelines	<ul style="list-style-type: none"> <li>Collaboration and coordination efforts</li> <li>Meetings and committee participation</li> </ul>

Organizational Placement Options, including Pros, Cons, and Peer Practices

The following table summarizes options available for organizational location of investment compliance function, including pros, cons, and peer practices:

Option	Pros	Cons	Peer Practices
#1: Stay within <b>Internal Audit</b> – Maintaining Status Quo	<ul style="list-style-type: none"> <li>Working well</li> <li>Internal Audit benefits from compliance staff location within IMD and technical expertise of this staff</li> <li>No organizational or FTE changes needed</li> </ul>	<ul style="list-style-type: none"> <li>Misalignment - Internal Audit reports to the Audit Committee when the Risk Committee is tasked with resolving compliance findings per bylaws</li> <li>Internal Audit cannot provide assurance on this function</li> </ul>	<ul style="list-style-type: none"> <li>Employees Retirement System (ERS) of Texas</li> <li>Kentucky Retirement System</li> </ul>
#2: Transfer to <b>Legal Services</b>	<ul style="list-style-type: none"> <li>Already tracks and monitors regulatory changes</li> <li>Staff knowledgeable in IPS and personal trading policy</li> </ul>	<ul style="list-style-type: none"> <li>Requires an FTE transfer</li> <li>May not have resources to perform personal trading reconciliations; may require support from Internal Audit or Investment Accounting</li> </ul>	<ul style="list-style-type: none"> <li>San Diego County Employees’ Retirement Association</li> <li>New Hampshire Retirement System</li> <li>Caisse de depot Quebec</li> </ul>
#3: Transfer to <b>Investment Accounting</b>	<ul style="list-style-type: none"> <li>Facilitates Investment Accounting knowledge of IMD operations and interaction with State Street Bank</li> <li>Reconciliation of personal trades is consistent with accounting function</li> </ul>	<ul style="list-style-type: none"> <li>Requires an FTE transfer</li> <li>Additional responsibility for Investment Accounting staff when director has assumed additional responsibilities in another area</li> </ul>	<ul style="list-style-type: none"> <li>New York State Teachers’ Retirement System</li> <li>Ontario Teachers’ Pension Plan</li> <li>Oregon State Treasurer</li> </ul>

Option	Pros	Cons	Peer Practices
<b>#4: Transfer to Enterprise Risk Management (ERM)</b>	<ul style="list-style-type: none"> <li>• Aligns risk reporting with risk management committee responsibilities</li> <li>• Most common among peers, especially in large funds with mature risk management function</li> <li>• Enhances ERM team knowledge of investments</li> </ul>	<ul style="list-style-type: none"> <li>• Requires an FTE transfer</li> <li>• ERM program staff are fully tasked and may not have time to take on another function</li> </ul>	<ul style="list-style-type: none"> <li>• State of Washington Investment Board</li> <li>• Florida Board of Administration</li> <li>• Ohio Public Employees' Retirement System (PERS)</li> <li>• State of Wisconsin Investment Board</li> </ul>

The Chief Audit Executive presented the pros, cons, and peer practices related to the above organizational placement options for TRS executive management’s consideration on August 8, 2013. Based on this information as well as other considerations, executive management decided to move the Investment Compliance function (including one Full Time Equivalent) to Legal Services, effective September 2013.

This organizational change is expected to strengthen the investment compliance function by including the responsibilities for identifying regulatory requirements by tracking changes in relevant laws and regulations. In addition, this practice is common among private sector companies which maintain separate corporate compliance offices.

Currently, Investment Compliance team’s responsibilities are limited to monitoring and reporting on compliance matters related to investment-related policies and personal trading policies while the responsibilities for identifying regulatory compliance requirements are currently being performed by the collaboration between IMD staff and Legal Services staff. This separation of duties was intentional to maintain Internal Audit’s independence in accordance with professional auditing standards which prohibit internal audit from performing management’s responsibilities, such as developing policies or designing compliance rules.

Project Scope and Methodology

We conducted this self-assessment utilizing Standard 1311 (Internal Assessments) of the *International Standards for the Professional Practices of Internal Auditing* issued by the Institute of Internal Auditors, Inc. (IIA). Our assessment criteria included regulatory guidelines such as the Securities Exchange Commission (SEC) Compliance Rule 38a-1 as well as Internal Audit’s Investment Compliance Charter.

The scope of our self-assessment included the investment compliance function performed by Internal Audit staff. Investment compliance function includes providing guidance for complying with laws and regulations, monitoring compliance with rules, and reporting compliance violations. The scope did not include non-investment compliance function, such as compliance with employee benefits and healthcare laws and regulations.

Our methodology included the following procedures:

- Interviews with customers and stakeholders, including executive management, IMD staff, Legal Services staff, ERM staff, and Investment Accounting staff
- Review of Investment Policy Statement, TRS Trading Policy, and Investment Compliance Manual
- Review of compliance-related reports prepared by Internal Audit, IMD, Legal Services, and State Street Compliance Services
- Review of industry guidelines and publications to identify assessment criteria, including SEC rules, IIA publications, industry practices, and TRS Investment Compliance Charter
- Survey of the members of the Council of Compliance Officers (CCO) regarding common evaluation criteria for investment compliance activities
- Survey of the members of the Association of Public Pension Fund Auditors (APPFA) regarding the organizational location of the investment compliance function

**TAB 3D**

**QUARTERLY INVESTMENT TESTING**  
**INVESTMENT POLICY STATEMENT (IPS), SECURITIES LENDING POLICY (SLP), WIRE TRANSFER PROCEDURES**  
 CALENDAR QUARTER ENDED JUNE 30, 2013, EXCEPT AS NOTED

<b>Business Objectives</b>	1. <u>Board Reports</u> All required information is reported to the TRS Board of Trustees	2. <u>Investment Selection and Approval</u> Investments made are within delegated limits and established selection criteria	3. <u>Other (IPS, SLP, wire transfers, other reporting)</u> Risk limits are followed for other investment programs and activities	4. <u>Monitoring by Investment Compliance Specialist</u> Investment activities comply with IPS (for the three months ended July 31, 2013)
<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 (proxy, securities lending, IPS)
<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>	<ul style="list-style-type: none"> <li>Perform various compliance checks and monitor State Street's daily compliance reports</li> </ul>
<b>Test Results</b>	<ul style="list-style-type: none"> <li>All reporting requirements met, except the projected closing date for one investment</li> <li>Documentation provides support for reports 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>The Absolute Return asset allocation was -0.06%, which was below the 0% minimum range</li> </ul>
<b>Management Responses</b>	Management agrees. Checklist has been updated to prevent this exception from happening again.	None	None	Management agrees. We will adjust our process to require a systematic comparison of trust positioning prior to trading.

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

August 15, 2013

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

We have completed the **Quarterly Investment Testing** of compliance with the requirements of the Investment Policy Statement (IPS), Securities Lending Policy (SLP), and procedures for wire transfers as included in the *Fiscal Year 2013 Audit Plan*.

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

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

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

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

### **Internal Control Structure**

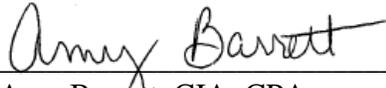
We were not engaged to and did not perform an examination of the internal controls nor the operating effectiveness pertaining to the subject areas tested. Accordingly, we do not express an opinion on the suitability of the design of internal controls nor the operating effectiveness of the subject areas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

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

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

\* \* \* \* \*

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



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Amy Barrett, CIA, CPA  
Chief Audit Executive



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Brian T. Gomolski, CIA, CPA  
Senior Investment Auditor



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

## APPENDIX A

### AGREED-UPON PROCEDURES AND RESULTS

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
1	3	IPS Article 1.5 – Obtain evidence that Sudan/Iran restricted lists have been updated and reports have been filed	<ul style="list-style-type: none"> <li>• In June of each year, ensure responsible staff have updated Sudan/Iran restricted lists</li> <li>• Determine whether TRS complied with the following requirements of Gov. Code 806.102:               <ul style="list-style-type: none"> <li>a) Notification to Comptroller's Office regarding holdings of Sudan-Restricted Companies within 14 days after receiving the List</li> <li>b) 50% Divestment within 270 days</li> <li>c) 100% Divestment within 450 days</li> <li>d) Filed annual report of Sudan investment activity by December 31 of each year</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Staff updated lists as required</li> <li>• List was obtained and appropriate updates made. No other actions necessary at this time.</li> </ul>	No response required
2	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)	Information about the projected closing date for one hedge fund investment (Theleme Fund) was mislabeled as “Not Applicable” when it should have been the expected funding date of July 31, 2013.	Management agrees with the recommendation. The exception was a result of an oversight during our quality control process. Our checklist has been updated in order to prevent this exception from happening again.
3	2	IPS Article 3.3f – Obtain evidence of IMD’s prudent underwriting objectives for advisor’s due diligence	Select sample of Private Market investments approved during testing period, obtain evidence of existence of advisor's report stating investment opportunity meets prudent underwriting standards and merits inclusion within respective portfolios	For selected Private Markets approved investments for the quarter, verified that the prudence letter from the advisor was included in the IIC materials	No response required
4	2	IPS Article 6 – Obtain evidence that new	Test sample of approved investments and verify each is independent private	Investments tested are independent private investment management firms	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
		investments in emerging managers meet requirements	investment management firm with less than \$2 billion, has a performance track record as a firm of less than 5 years, or both	with less than \$2 billion or have a performance track record as a firm that is no more than 5 years or both	
5	3	IPS Article 9.3d – Obtain evidence of IMD’s examination of requirements of its securities lending agent	Confirm securities lending agent is an organization rated A- or better by a Nationally Recognized Statistical Rating Organization (NRSRO)	Reviewed the Daily Derivatives Report as of June 30, 2013 and noted that the rating for State Street was A- or better per Moody’s, Fitch, and Standard and Poor’s	No response required
6	2	IPS Article 11 - Verify existence of placement agent questionnaire for each new investment selected for testing and test for inclusion in summary report to Board	<ul style="list-style-type: none"> <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</li> </ul> </li> </ul>	For the sample selected for testing, no manager or partner organization exceeded the authorized limits and documentation existed for IMD staff calculations of authorized limits. There were no Special Investment Opportunities.	No response required

STEP #	OBJ. #	TEST PURPOSE	TEST DESCRIPTION	TEST RESULT	MANAGEMENT RESPONSE
			<p>CIO notified the Executive Director (ED) 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 Report of Senior Investment Compliance Specialist (SICS) – Verify with SICS that all other policy requirements were met	Obtain the investment compliance report from the Sr. ICS of other non-compliance issues as a result of the custodian's monitoring procedures	Obtained the investment compliance report. Refer to <b>Appendix B</b>	Refer to <b>Appendix B</b>
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 ending June 30, 2013.**

## APPENDIX B

### COMPLIANCE WITH INVESTMENT AND RELATED POLICIES As of and for the three months ended July 31, 2013

Policy	Compliance Exceptions	Reportable Exceptions	Management Responses
Investment Policy Statement (IPS)	Yes	The Absolute Return asset allocation was -0.06%, which was below the 0% minimum range	Management agrees. We will adjust our process to require a systematic comparison of trust positioning prior to trading.
Securities Lending Policy (SLP)	No	None	N/A
Proxy Voting Policy	No	None	N/A

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

**TAB 4**

**TAB 4A**

**TAB 4A – TRS Information Security Follow-Up Audit**

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**

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

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>11-306 Investments Performance Calculations and Reporting</b>					
	Include the performance calculation methodology used by State Street in TRS written operating policies and State Street Service Agreement	In Progress	Other Reportable	8/2011	9/2013
<b>12-303 Audit of External Private Market Investments</b>					
	Reconcile the partner capital statement with audited financial statements	Implemented	Other Reportable	10/2012	8/2013
<b>12-401 Building Security</b>					
	Procedure manual should include all tasks and a process to periodically review and update the procedure manual	Implemented	Other Reportable	10/2012	8/2013
<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

**Significant to Business Objectives**

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

**Other Reportable**

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

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

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>13-102</b>	<b>Telephone Counseling Center Performance Measures Audit (Outsourced Audit conducted by Myers and Stauffer LC)</b>				
	Address Average Speed to Answer (ASA) reliability issues	Implemented	Significant	5/2013	8/2013
	Evaluate service level as a more suitable measure	In Progress	Other Reportable	12/2013*	
<b>13-201</b>	<b>Health Care Administration Audit</b>				
	Ensure staff members complete all mandatory training	Implemented	Other Reportable	7/2013	7/2013
	Enhance management assessment of system access for transitioning employees	Implemented	Other Reportable	7/2013	7/2013
	Formalize procedures for non-financial contract monitoring – staff guidance	In Progress	Other Reportable	3/2014	
	Formalize procedures for non-financial contract monitoring – minor contract requirement modifications	In Progress	Other Reportable	9/2014	
	Strengthen internal processes and procedures related to plan enrollment and coverage changes	In Progress	Other Reportable	3/2014	
<b>13-305</b>	<b>Emerging Manager Program Audit</b>				
	Improve fund-of-funds manager and evaluator’s responsiveness to prospective emerging managers by clearly communicating TRS’ expectations and ensuring timely and satisfactory closure on referrals	In Progress	Other Reportable	12/2013	
	Closely monitor the fund-of-funds manager’s portfolio as well as the firm’s situation	In Progress	Other Reportable	6/2014	
	Revise the Investment Policy Statement to be consistent with the fund commitment plan	In Progress	Other Reportable	10/2014	

\*Date changed from September 2016 reported in June 2013 quarterly report to reflect date evaluation will be completed and provided to executive management rather than the implementation date.

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

**State Auditor's Office (SAO) Outstanding Recommendations**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>SAO Audit Report, April 2013, Incentive Compensation at the Teacher Retirement System, the Permanent School Fund, and the Employees Retirement System (reported at the June 2013 Audit Committee)</b>					
	Obtain board confirmation of Incentive Compensation Plan	In Progress	Other Reportable	9/2013	

**External Quality Assurance Review – Fiscal Year 2013**

Project	Recommendation	Status	Issue Type	Estimated Date	Revised / Actual Date
<b>Report on The External Quality Assurance Review of the Teacher Retirement System's Internal Audit Department, June 2013 (reported at the June 2013 Audit Committee)</b>					
	Enhance existing department written procedures to include how the CAE should address potential impairments to auditor independence or objectivity when disclosed by audit staff	Implemented	Other Reportable	8/2013	
	Dialogue with the Board of Trustees and the Executive Director to determine the best course of action regarding compliance activities for the Investment Division	Implemented	Other Reportable	9/2013	
	Include the requirement to discuss the results of the annual internal assessment with senior management and the Board of Trustees as activities in the QAIP	Implemented	Other Reportable	8/2013	
	Train Internal Audit staff and include them in the conduct of the annual risk assessment	Implemented	Other Reportable	8/2013	

**TAB 5**

# Fiscal Year 2014 Audit Plan

## *September 13, 2013*

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Amy Barrett, CIA, CISA, CPA  
Chief Audit Executive

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Christopher S. Moss  
Chair, Audit Committee, Board of  
Trustees

---

Brian Guthrie  
Executive Director

---

R. David Kelly  
Chair, Board of Trustees



# Executive Summary

## Professional and Statutory Requirements

This document provides the *Fiscal Year 2014 Audit Plan* (Audit Plan) as required by professional auditing standards, the *Texas Internal Auditing Act* (Act), and the *Texas Government Code 2102.008* for the Teacher Retirement System of Texas (TRS). The Act requires state agencies to conduct a program of internal auditing that includes an annual audit plan that is prepared using risk assessment techniques and identifies individual audit projects to be conducted during the year. The Audit Plan is required to be evaluated and updated annually for recommendation of approval by the TRS Audit Committee of the Board of Trustees (Audit Committee) to the TRS Board of Trustees (Board). Internal Audit is independent of management and provides objective assurance and consulting services designed to add value and improve TRS' operations.

## Audit Plan Development and Scope

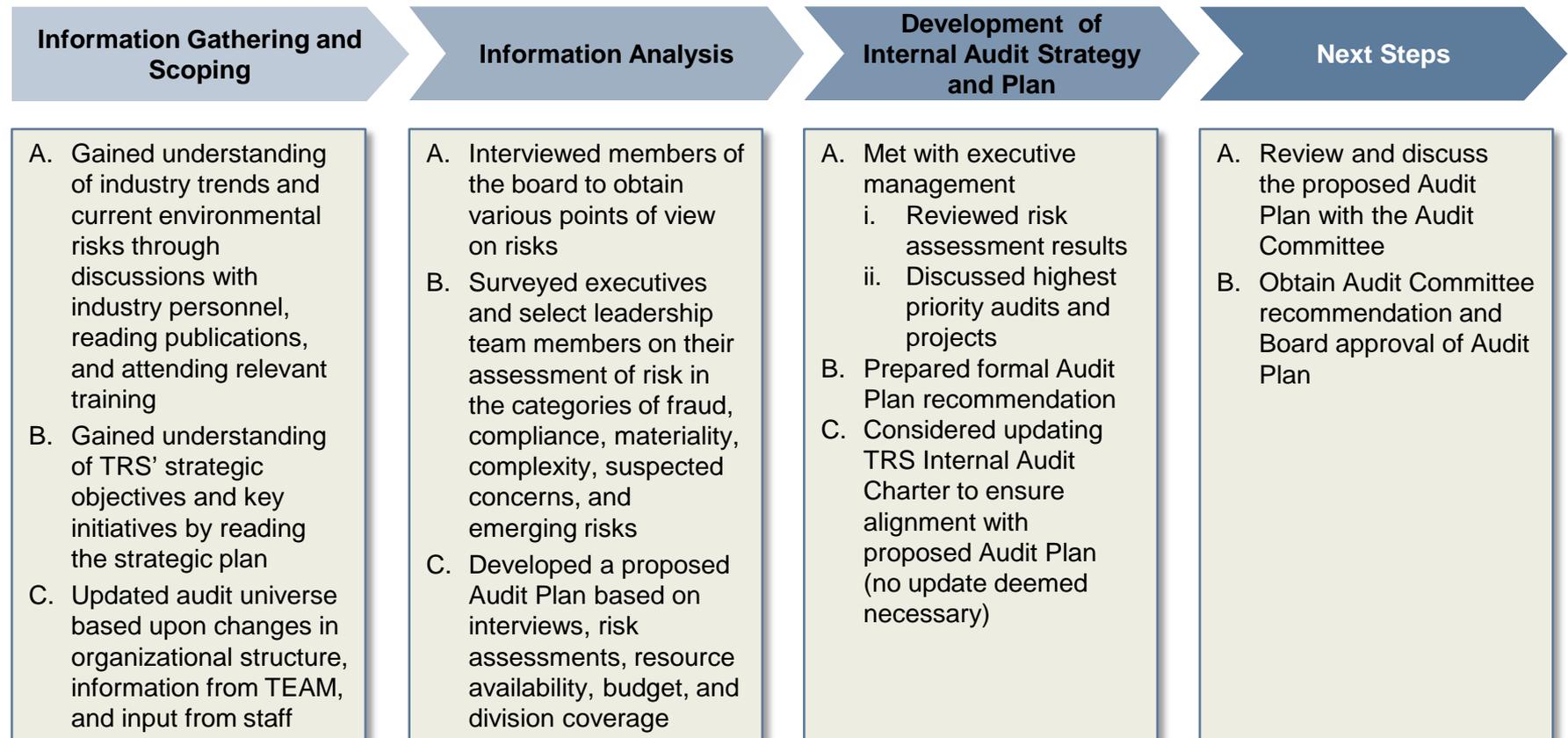
Our Audit Plan is designed to provide coverage of key risks, given the existing staff and approved budget. See the **Appendices** for information regarding the internal audit budget, performance measures, and audit universe.

## Changes Subsequent to Approval

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

# Risk Assessment & Audit Planning Approach

*Interviews with trustees and risk assessment surveys of management were used to identify perceived areas of risk and potential internal audit projects. This information was combined into an overall audit plan designed to address critical risks to achieving TRS objectives while being sensitive to operational requirements. The Audit Plan also includes hours for ad hoc projects and special requests. The following approach was taken in creating the Audit Plan:*



# Trustee and Management Interviews, Meetings, and Surveys

*The table below lists the number of interviews held, meetings attended to discuss the process and its results, and surveys obtained related to developing the Audit Plan.*

TRS trustees interviewed:	7
Executive Council meetings:	2
Executive/Finance:	
Survey responses	8
Management meetings	2
Pension and Health Benefits:	
Survey responses	12
Management meeting	1
Information Technology (IT):	
Survey responses	8
Management meetings	2
Investments:	
Survey responses	14
Interviews	13
Management meetings	2

# Risks Surveyed

*In developing the risk assessment, Internal Audit surveyed management about risks in each area of the Audit Universe in Appendix C. We then combined the scores based on the weightings below to determine the highest risk areas at TRS. The following table describes risk areas surveyed.*

Risk Area (Weight)	Description
<b>Materiality/Impact to TRS (25%)</b>	Financial statement materiality, relative importance to TRS mission and business objectives, and/or sensitivity to negative public exposure of a process or system
<b>Fraud and Ethics Exposure (20%)</b>	Risk inherent in a process that fraud or ethical violations could occur resulting in TRS financial or reputational loss or unauthorized use of TRS data and resources for personal gain
<b>Legal and Regulatory Compliance (20%)</b>	Risk of fines, fees and/or negative public perception from non-compliance with laws, regulations, and fiduciary obligations
<b>Operational Complexity (15%)</b>	Risks arising from tasks and processes that are numerous, intricate, interrelated, and/or complicated
<b>Known Issues (10%)</b>	Knowledge or suspicion of problems/issues within the processes from prior audit, general observations, and other interactions; could include inefficiencies, errors, rework, low service levels, vendor difficulties, and/or special requests from management
<b>Emerging Risks (10%)</b>	New risks or ones that are not fully understood but could have an impact to meeting business objective(s), if realized

# Types of Projects to Cover Risk Areas

**Internal Audit considered risk assessment scores when identifying and prioritizing various projects. An important part of the Audit Plan is that the identified processes, systems, and initiatives should receive differing types and levels of review based on their importance, perceived risk, and most efficient approach. Our suggested levels of review activities are as follows:**

## Audit

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

## Agreed-Upon Procedures

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

## Formal Consulting

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

## Informal Consulting (Advisory)

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

# Audit Plan: Executive and Finance

*The tables on this and the following pages summarize the name of each project, type of project, and preliminary scope of work to be performed. Scope of work will be finalized as part of each project's formal planning phase.*

Title	Type	Preliminary Scope
Electronic Records	Audit	Assess whether electronic records are maintained to enable business functionality and are in accordance with TRS requirements
Purchasing and Contract Administration	Audit	Assess whether TRS contract manual is complete and current, approvals are defined, and contracts administered and monitored in accordance with requirements; assess efficiency of operations
GASB 67 and 68 Implementation Status	Consulting	Compare the status of GASB implementation with pronouncements and industry guidance; participate in internal committees addressing implementation efforts
Fraud Investigation Procedures Development	Advisory	Update and document comprehensive procedures for fraud investigations
Internal Ethics and Fraud Hotline Administration	Advisory	Follow-up on hotline calls (both internal and external)
Meetings Participation	Advisory	Participate (non-voting) in various TRS-wide meetings such as Executive Council, Leadership Team, Risk Oversight Committee, Social Media Advisory Committee, and Fraud, Waste and Abuse Prevention Committee
Special Requests and Surprise Inspections	Various	Complete projects as requested by management; complete surprise inspections (such as cashier's function) to gain an understanding of controls in an area and provide "perception of detection"

## Audit Plan: Benefits (Pension and Health)

Title	Type	Preliminary Scope
Cost of Living Adjustment (COLA) Calculation	Audit	Assess completeness and accuracy of COLA calculation
Refunds, Inactive and Escheated Accounts	Audit	Identify and assess key controls for refunds, inactive accounts, and escheated accounts
Special Service Buy Back Process	Audit	Identify and assess key controls for Special Service Buy Back process; recalculate a sample of transactions before and after the legislative change
Telephone Counseling Center Follow-Up	Audit	Determine whether counseling center hold times have been resolved and report on implementation status of prior audit recommendations
Benefits Testing for State Auditor's Office (SAO) for CAFR and Financial Audit Coordination	Audit	Conduct benefit testing on behalf of the SAO to be used in completion of CAFR audit; coordinate activities of the SAO to ensure deadlines are met; coordinate quarterly update meetings with executive management and the SAO
Semi-Annual Benefits Testing	Agreed-Upon Procedures	Recalculate a sample of benefit payments annually and determine whether documentation on file supports the calculation

## Audit Plan: Benefits (Pension and Health)

Title	Type	Preliminary Scope
TRS Employer Reporting Controls	Advisory	Follow-up on internal control improvements recommended during a special project; provide assistance for their implementation
Employer Self-Audit Program	Advisory	Pilot and complete employer self-audits in the areas of Pension and TRS-Care Surcharges and Employment After Retirement
Employer Investigations/Special Projects	Various	Work with internal team to follow up on employer-related matters
Health Care Governance, Risk Management, and Reporting	Audit and Consulting	Assess sufficiency of board activities relating to health care (e.g., meet statutory requirements, address risks identified, apply processes consistent with similar organizations); inquire of industry thought leadership about leading practices
Health Care Vendor Update Meetings	Advisory	Attend quarterly meetings with health care vendors to understand results and issues
Health Care Vendor and Auditor Selection Observation	Advisory	Observe selection process of large vendor and service providers
TEAM Independent Program Assessment (IPA) Vendor Support	Advisory	Coordinate and monitor activities of the IPA vendor and ensure direct access to executive management and the board
TEAM Committees Participation	Advisory	Participate in TEAM Executive Steering Committee (ESC) and other committees in a non-voting capacity

# Audit Plan: Information Technology

Title	Type	Preliminary Scope
Identity and Access Management, and Contractor Onboarding Process	Audit	Assess whether access for TRS employees and contract workers is adequately controlled; assess whether contract workers are trained on TRS policy, receive background checks, are provided appropriate access, and are properly supervised
Information Technology (IT) Security Program Follow-Up	Audit	Follow-up on implementation status of outstanding FY 2011 IT Security Audit recommendations relating to the Information Security Program
Emerging IT Risks: Cloud Computing and Mobile Device Security	Consulting	Identify risks associated with emerging technologies such as cloud computing and mobile devices based on TRS' strategy and recommend ways to mitigate those risks
Co-Location/Disaster Recovery Planning	Consulting	Identify risks associated with TRS' plan for co-locating its disaster recovery back-up location and recommend ways to mitigate those risks
Network Penetration Test; Security Risk Assessment Review	Advisory	Obtain, read, and follow-up on any issues identified during the network penetration tests and security risk assessment conducted by the TRS Information Security Officer
Technology Committees Meeting Participation	Advisory	Participate (non-voting) in meetings to stay apprised of initiatives relating to enterprise security and information technology operations

# Audit Plan: Investment Management

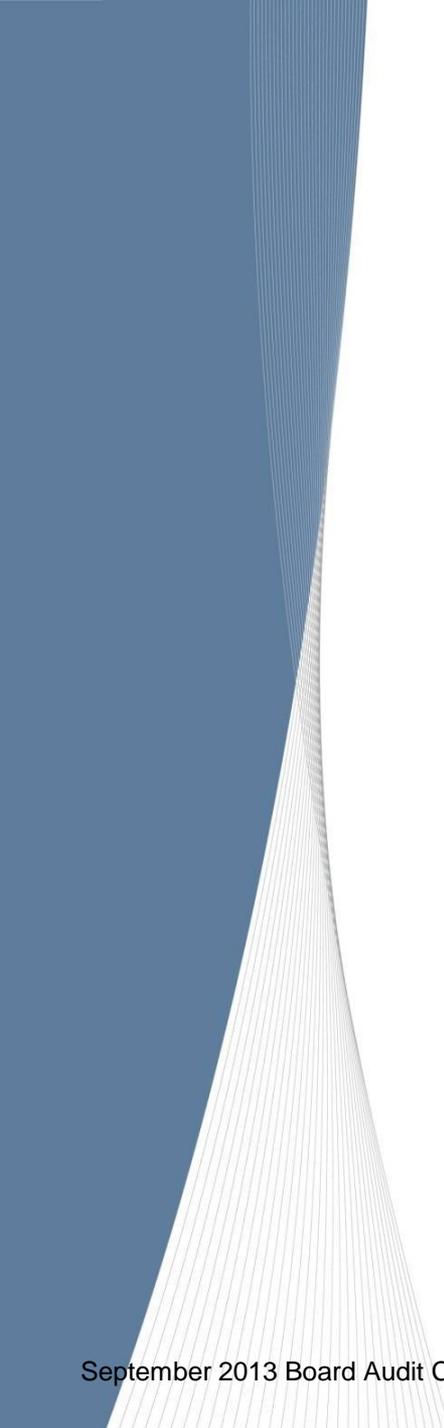
Title	Type	Preliminary Scope
Overall Internal Control Opinion on Investment Activities (includes periodic status reports)	Audit	Assess key operating, compliance, and reporting controls within the Investment Division and its service providers using the newly-revised COSO internal controls framework; emphasize areas managed by outside parties and new strategies; include controls of soft dollars, service provider contractual arrangements, and fees; report periodically on the status of the work
Quarterly Investment Compliance Testing	Agreed-Upon Procedures	Assess compliance with Investment Policy Statement (IPS) requirements including placement agent disclosures and Internal Investment Committee (IIC) processes; test board report accuracy; test wire transfer compliance with internal procedures; provide input into IPS and other investment policy changes
Private Strategic Partner Network (SPN) Fee Calculations	Advisory	Participate in IIC to determine how best to implement controls for ensuring the completeness, transparency, and accuracy of private market SPN fees; work will be used as the basis for future audits
Incentive Compensation Plan Review	Advisory	Prior to payment, recalculate the incentive compensation award amounts to determine if they are calculated in accordance with plan provisions; reconcile performance to the service provider
Investment Committees Attendance	Advisory	Stay current on Investment Management Division initiatives by attending IIC, Derivatives Operations, Monthly Staff, and other meetings including Annual Town Hall

## Audit Plan: Internal Audit Activities

Title	Project Description
Internal Quality Assurance Review	Conduct a self-assessment of Internal Audit's compliance with professional auditing standards
External Quality Assurance Reviews	Lead three quality assurance reviews of state agencies and public pension plans in order to gain points towards future TRS reviews and learn best practices at other similar organizations
Annual Internal Audit Report	Prepare annual report of audit activities in accordance with SAO instructions
Quarterly Audit Recommendations Follow-Up	Follow-up and report on the status of outstanding audit recommendations
Fiscal Year 2015 Audit Plan	Prepare annual audit plan based on a documented risk assessment in accordance with professional auditing standards and the Texas Internal Auditing Act
Health Care Audit Universe	Update health care audit universe to ensure assessment and mitigation of key risks
Audit Committee Meetings Preparation	Prepare communications and attend Audit Committee and Board meetings
Internal Audit Strategic Plan	Update, implement, and measure results of internal audit strategic plan initiatives

## Audit Plan: High Risk Areas or Areas Discussed But Excluded From Plan

Area	Reason for Exclusion
Open Meetings Compliance	Software is being implemented and new staff hired to address open meetings requirements.
1099R Process	Audit resources are fully utilized for FY 2014 projects; consider for FY 2015 Audit Plan.
Employee Ethics Policies	SAO completed a follow-up audit during FY 2014. There were no outstanding recommendations.

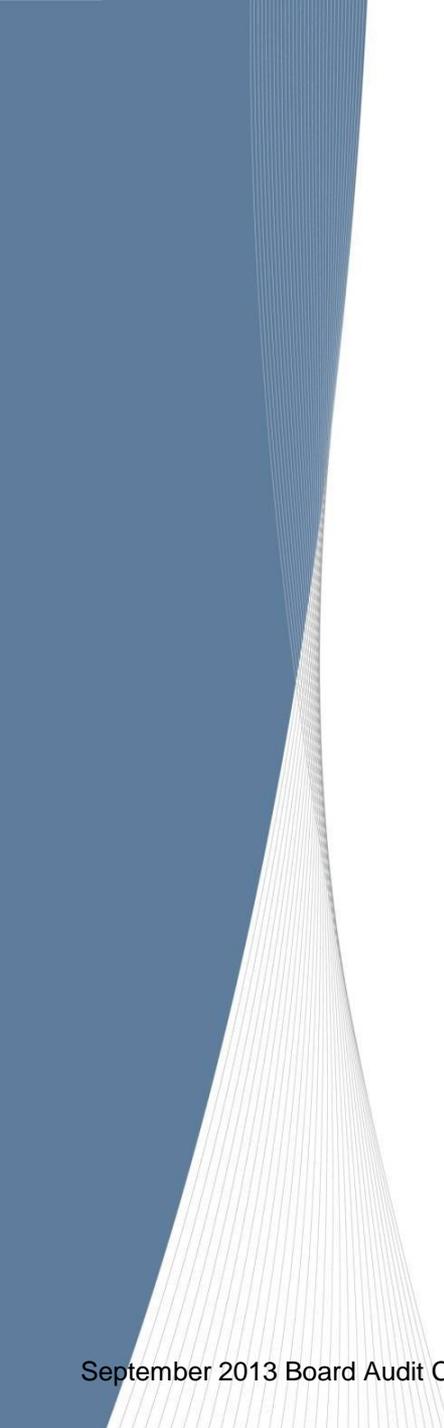


# **Appendix A**

## **Internal Audit Operating Budget**

# Internal Audit Operating Budget

Line Item	Budget FY 2014	Budget FY 2013
000 – Salaries	\$949,133	\$921,440
000 – Benefits	236,053	215,680
200 – Professional Fees	528,500	628,500
505 – Travel-In-State	9,500	7,000
510 – Travel-Out-of-State	18,000	13,500
705 – Dues, Fees, and Staff Development	22,500	25,000
710 – Subscriptions and Reference Materials	4,500	4,500
Total Operating Budget (excluding indirect costs such as computers, office space, and utilities)	\$1,768,186	\$1,815,620
Full Time Equivalent (FTE) Positions (prior to Investment Compliance FTE Transfer)	10.0	10.0



# **Appendix B Internal Audit Performance Measures**

# Internal Audit Goals and Performance Measures

*For the internal audit function, the FY 2014 goals and performance measures are as follows:*

## **Goal 1: Enhance Effectiveness of Internal Audit Organization**

### *Performance Measures*

- a. Update the Internal Audit Strategic Plan, 2012-2016, and align with TRS mission and core values
- b. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services
- c. Develop and implement transition plan for the transfer of the investment compliance function from Internal Audit to Legal Services

## **Goal 2: Develop and Implement Internal Audit Annual Audit Plan based on Formal Risk Assessment**

### *Performance Measures*

- a. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests)
- b. Complete internal self-assessment and report annually on Quality Assurance and Improvement Program

## **Goal 3: Enhance Internal Audit Staff Skills and Knowledge in Emerging Risks and Controls with Emphasis on Information Technology, Investment and Health Care**

### *Performance Measures*

- a. 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
- b. Enhance staff knowledge of investment due diligence key processes by visiting one TRS asset manager

# Internal Audit Goals and Performance Measures, continued

## **Goal 4: Deliver Value-Added Consulting and Advisory Activities**

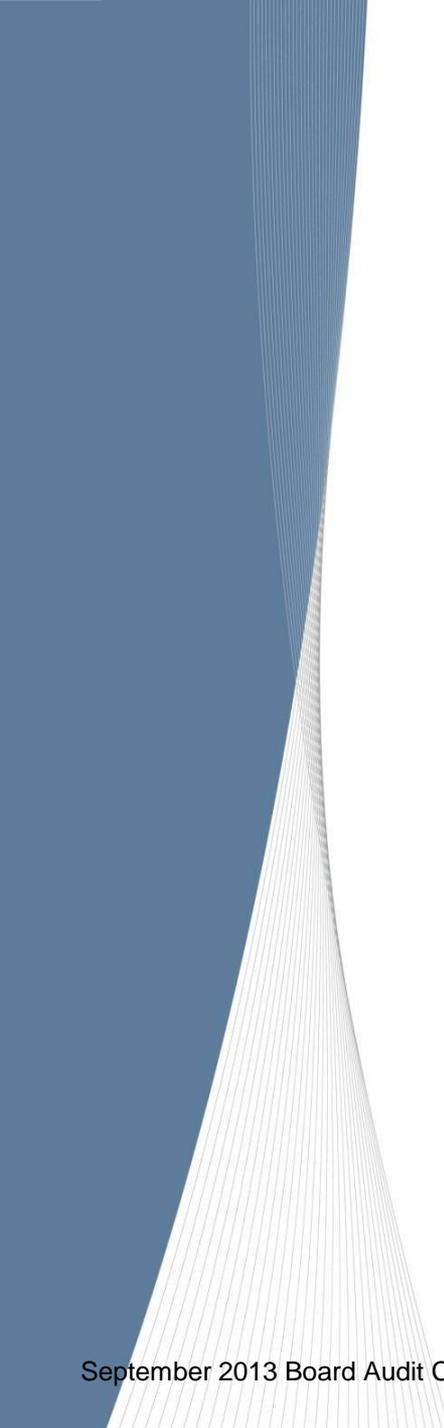
### *Performance Measures*

- a. 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
- b. 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
- c. Coordinate with Legal Services and executive management on the development of framework for ethics and fraud investigations and implement in fiscal year 2014
- d. Coordinate with Benefit Accounting and executive management on the development of employer self-audit program and implement in fiscal year 2014

## **Goal 5: Enhance Participation in Professional and Peer Organizations**

### *Performance Measures*

- a. Participate in at least two quality assurance reviews of internal audit departments in state agencies and public pension funds
- b. Participate in professional organizations (APPFA, IIA, ISACA, ACFE, SAIAP, CFA Institute) through monthly chapter meetings and engage in leadership roles in at least two of the professional organizations



# Appendix C Audit Universe

# Audit Universe

Executive and Finance Divisions; Records Management		
<b>Governance, strategy, and risk management</b>		<b>Workforce Continuity</b>
Board governance (FY13)		Employee recruiting and hiring practices (FY10)
Strategic planning and performance measures (FY13)		Employee training compliance (FY11)
Enterprise Risk Management		Internal policy setting and monitoring
Information technology governance (FY10)		<b>Communications and External Relations</b>
<b>Open Government</b>		Social media
Open meetings compliance		Information and communication
Open records request compliance		<b>403(b)</b>
<b>Ethics and Fraud Prevention</b>		403(b) certification process
Employee ethics policies (FY13)		<b>Records Management</b>
Fraud risk detection and prevention controls (FY13)		Records retention - paper (FY11)
<b>Regulatory, Compliance, &amp; Litigation</b>		Records retention - electronic
Compliance: Pension Trust (FY13)		<b>Accounting &amp; Reporting</b>
Compliance: Health Care Trusts (FY13)		Financial/CAFR reporting including, new accounting pronouncements, reconciliations, general ledger, closing process (FY13)
Litigation risk management		Other reporting (non-financial / CAFR)
<b>Business Continuity</b>		Employee leave, timekeeping, and payroll (FY12)
Business continuity plan (FY09)		Cashier (FY10)
Risk management (health and safety, insurance) (FY12)		
		<b>Accounting &amp; Reporting</b>
		Accounts receivable (FY13)
		Accounts payable (FY13)
		Travel (FY09)
		Federal withholdings/tax compliance
		Inventory
		<b>Budget</b>
		Budget process and reporting (FY10)
		<b>Purchasing and Contracts</b>
		Vendor file, encumbrance, purchasing (FY09)
		Contract administration and monitoring (FY09)
		Contract worker onboarding, monitoring and compliance (FY10)
		HUB program compliance and reporting
		<b>Facilities</b>
		Facility planning and maintenance
		Mail room operations (FY10)
		Security (FY12)

(FY#) - indicates last year audited

IMD Processes	
<b>Governance - IMD</b>	
	Investment Governance and Management (FY13)
<b>IMD Processes</b>	
	Internal Public Markets (FY11)
	External Public Markets (FY11)
	Private Equity (FY12)
	Real Assets (FY12)
	Trade Management (FY11)
	Emerging Manager Program (FY13)
	Energy/Natural Resources (ENR)
	Strategic Partners (FY09)
	Strategic Asset Allocation/Stable Value
	Tactical Asset Allocation (FY13)
	Risk Management (FY12)
	Performance Analytics and Operations (FY11)
	Information Systems (FY10)
	Business Center, Reporting, and HR (FY12)
	Investment Accounting (FY12)

# Audit Universe

Benefits	
Pension Benefit Administration	
1099R	
Annuity payroll (FY13)	
Benefit adjustments (FY13)	
Benefit calculations (FY13)	
Benefit estimates	
Cash receipts (FY10)	
Check payments (FY13)	
Contact management	
Death benefits (FY13)	
Disability benefits (FY13)	
Legal orders (FY13)	
Member account maintenance (FY09)	
Member statements	
Optional Retirement Plan	
Refunds	
Retirement application process	
Retirement system transfer	
Service credit calculation and purchase	
Pension Benefit Administration	
	Statistical reporting (actuarial) (FY10)
	Web self service
	Work flow (Imaging)
	TRS employee benefit administration (administered separately from non-TRS employees)
Employer Reporting	
	Employer setup
	Enrollment
	Employer reporting
Health Care Administration	
	TRS-Care vendor selection and contract monitoring (FY13)
	TRS-Care TRS Administration (FY13)
	TRS-Care Finance (FY10)
	TRS-ActiveCare vendor selection and contract monitoring
	TRS-ActiveCare TRS Administration
	TRS-ActiveCare Finance (FY10)

Information Technology (IT) Processes	
Governance - IT	
	Project prioritization (FY10)
	IT risk management
IT Strategy & Planning	
	Asset management
	Human resources
IT Security	
	Identity and access management (FY13)
	Threat and vulnerability management (FY13)
	Security awareness and training (FY11)
	Security configuration management
	Virtualization
	Cloud based computing
	Mobile device security
Disaster Recovery Plan	
	Co-location
	Disaster Recovery Management (FY09)
IT Processes	
Change & Configuration Management	
	Applications (FY12)
	Databases
	Infrastructure
Data Center Operations	
	Archive management (FY13)
	Facilities management (TAC202) (FY12)
Technology Management	
	Standards
	Technology upgrades
User and Vendor Support	
	Problem management
	Incident response

(FY#) - indicates last year audited

**TEACHER RETIREMENT SYSTEM OF TEXAS  
BOARD OF TRUSTEES  
AUDIT COMMITTEE  
September 13, 2013**

**SUGGESTED MOTION LANGUAGE REGARDING  
RECOMMENDATION FOR APPROVAL OF PROPOSED AUDIT  
PLAN FOR FISCAL YEAR 2014**

**AGENDA ITEM 5**

**Audit Committee Chair:**

“I move that the Committee recommend that the Board of Trustees approve the proposed Audit Plan for Fiscal Year 2014.”

**TAB 6**

## MEMORANDUM

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

FROM: Amy Barrett, Chief Audit Executive

SUBJECT: Closed Meetings with Internal and External Auditors

DATE: September 13, 2013

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### **Purpose and Background**

The purpose of this memo is to outline an amendment in the Texas Government Code related to the audit function and provide examples of how the change may be implemented by the board or audit committee.

Section 825.115 of the Texas Government Code was amended in the most recent legislative session to allow TRS internal and external auditors to meet with the TRS Board of Trustees or the Audit Committee in closed session to discuss the following:

- Governance, risk management or internal control weaknesses, known or suspected compliance violations or fraud, status of regulatory reviews or investigations, or identification of potential fraud risk areas and audits for the annual internal audit plan; or
- The auditors' ability to perform duties in accordance with the Internal Audit Charter, relevant auditing standards, and Chapter 2102 (Texas Internal Auditing Act).

### **Best Practices: Audit Committee Private Sessions in the Corporate World**

Audit committee closed sessions with auditors is not a new concept in the corporate world. A number of publications site them as a best practice for enhancing audit committee effectiveness:

- The Ivey Business Journal 2007 article, *Ten Ways to Enhance the Effectiveness of the Audit Committee*, states: “Separate sessions contribute to the Audit Committee’s effectiveness .... Private sessions with the head of internal audit and the external auditor are particularly important. For the private meeting with the head of internal audit, all major issues should be discussed in a thorough manner. There should be candid, quality and complete dialogue, where tough, necessary internal audit views on areas of high risk, judgment and sensitivity, potentially aggressive accounting treatments, IT integration, automation of control testing, compliance vulnerabilities, suspected fraud or irregularity, and any independence, budget, resource or staffing concerns. Private sessions should also be held with the external auditor to discuss all major issues in a thorough manner.”

- Ernst and Young's 2012 publication, *Audit Committee: Leading Practices and Trends*, states "Audit committees are increasingly holding private sessions, often with internal audit, the external auditor and management. Audit committee members may use this time to reflect on issues, evaluate what is working and what opportunities exist for improvement, and identify follow-up actions."
- The American Institute of Certified Public Accountants Audit Committee Brief from the *Audit Committee Effectiveness Center, Audit Committee Best Practices: Questions for Executive Sessions*, states that these sessions "give participants the opportunity to offer candid views on sensitive issues that may not be appropriate for an open forum."
- PwC's publication, May 2012, *10 Minutes on Effective Audit Committees* states "Separate private audit committee sessions with management and with the auditors enhance the quality of communications and broaden the audit committee's perspectives. Further, when warranted, respecting the confidentiality of these private conversation's increase the effectiveness of the audit committee's oversight."

### **Transparency**

Given that TRS administers three public trusts, it bears additional responsibility to be transparent to all TRS stakeholders. We believe that closed sessions may be best used to serve the board and audit committee to discuss subjects such as:

- Apprise and discuss next steps with the audit committee on allegations or suspicions of fraud
- Apprise the audit committee on circumstances where the auditor is unable to carry out duties or scope limitations occur due to auditor's restricted access to personnel and information
- Discuss audit findings where the information would put the organization at risk of future harm if discussed publicly (e.g. Information Technology vulnerability issues that have not been fully remediated)
- Discuss development of the annual audit plan

### **Audit Committee Agenda**

The audit committee may go into closed session on any item listed on the agenda that meets the requirements of the Texas Government Code specified above, the Texas Open Meetings Act, or other statutes authorizing closed meetings. The length of these sessions will vary depending on the issues that need to be discussed by the board or audit committee. Reference to closed session will not be made on the agenda as none is required.

**TAB 7**

**Teacher Retirement System of Texas**  
**September 2013 Audit Committee Agenda Items Mapped to TRS Stoplight Report**

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

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

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

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

Title	Type	Status
<b>Finance Division</b>		
Employer Reporting Audit	Audit	Complete as revised*
Procurement and Contracting Audit	Audit	Board approved cancellation
1099 Reporting and Payment Processing	Advisory	Complete
Budget Transfer Inspection	Advisory	Complete
Accounting Standards Changes Monitoring	Advisory	Complete
Financial Audit Coordination	Advisory	Complete
<b>Investment Management Division</b>		
Investments Selection and Monitoring (Emerging Managers)	Audit	Complete
Derivatives Audit	Audit	Complete
Investment Policy Compliance Testing (quarterly)	Agreed-Upon Procedures	Complete
Contractual Allowance Identification	Consulting	Complete
Incentive Compensation Review	Advisory	Complete
Employee Trading Policy Compliance Monitoring	Advisory	Complete
Emerging Risks Monitoring	Advisory	Complete
Investment Committees Attendance	Advisory	Complete
Travel Inspection	Advisory	Complete
Coordination of SAO Audit of Incentive Compensation	Advisory (Added to Plan)	Complete
Coordination of SAO Ethics Policies Follow-Up Audit	Advisory (Added to Plan)	Complete
<b>Internal Audit Department</b>		
External Quality Assurance Review	Audit	Complete
Annual Internal Audit Report	Audit	Complete
Audit Recommendation Follow-up	Audit	Complete
Audit Plan	Advisory	Complete
Audit Committee Meetings Preparation	Advisory	Complete
Internal Audit Strategic Plan	Advisory	Complete**

\*Employer Reporting Project: Fiscal year 2013 tasks have been completed per the Board approved revisions to the Fiscal Year 2013 Audit Plan for this project. This project continues to Fiscal Year 2014.

\*\*Significant FY 2013 strategic plan initiatives completed to accomplish FY 2013 Audit Plan.

## Fiscal Year 2013 Internal Audit Advisory Services<sup>1</sup> June – August 2013

<b>BENEFIT SERVICES</b>
<b>TEAM PROJECT</b> <ul style="list-style-type: none"><li>• Executive Steering Committee Participation</li><li>• Business Rules Committee Participation</li><li>• Organizational Change Management Advisory Group Participation</li><li>• Monthly meetings with TEAM Project Manager</li><li>• Core Management Team: Standing Prioritization Review Meeting</li><li>• Independent Program Assessment Vendor Coordination and Support</li><li>• Assistance to TRS Project Management Office with identification of internal controls in the Line of Business commitments and Financial System Replacement requirements</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>• TRS-ActiveCare Request for Proposal (RFP) Meeting Participation (Non-voting)</li></ul>
<b>INVESTMENTS</b> <ul style="list-style-type: none"><li>• Personal Trading Monitoring, Weekly Meetings with Legal Services, Quarterly Reporting to Executive Director</li><li>• Monthly Securities Lending Update Meetings Participation</li><li>• Internal Investment Committee (IIC) Attendance</li><li>• Investment Management Division (IMD) Staff Meeting Attendance</li><li>• Monthly Council of Compliance Officers Conference Calls – provide relevant information to IMD</li><li>• Collaboration to Develop a Process Map for Internal Public Markets (IPM) private market deals</li><li>• Coordination of State Auditor’s Office CAFR Audit</li><li>• Quarterly Update Meeting with IMD Managing Director of Risk</li><li>• Quarterly Meeting with State Street Compliance group</li><li>• Review of changes to the Investment Policy Statement and Proxy Voting Policy</li></ul>
<b>FINANCIAL SERVICES</b> <ul style="list-style-type: none"><li>• Flowcharting Benefit Accounting’s Disbursement Process</li><li>• Budget Transfers Surprise Inspection</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>• Triage Procedures Update (develop framework for fraud and ethics investigations)</li><li>• Executive Requests</li><li>• Social Media Advisory Committee Participation</li><li>• Fraud, Waste and Abuse Prevention Committee Participation</li><li>• Website Advisory Committee Participation</li></ul>
<b>INFORMATION TECHNOLOGY</b> <ul style="list-style-type: none"><li>• Enterprise Security Project Team Participation</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 Performance Measures - Fiscal Year 2013  
4TH Quarter Ending August 31, 2013**

Target Performance	Activity	Status
1. Plan and execute employer audit activities with significant direction and input from TRS subject matter experts	Coordinated with management on the development of employer self-audit tools per the revised project approved by board in June 2013; project will continue into FY 2014	Achieved
2. Facilitate and monitor timely hiring and coordination of TEAM Independent Program Assessment (IPA) vendor	Provided coordination and support of IPA vendor for identifying, communicating, and reporting risks	Achieved
3. Execute 80% of audit and agreed-upon procedures projects (80% allows for flexibility due to changes in TRS business practices and special requests)	Completed 87% of audit and agreed-upon procedures projects in board approved revised FY 2013 Audit Plan	Achieved
4. Complete external quality assurance review with no significant compliance exceptions	Completed External Quality Assurance Review in April 2013; subsequently reported at the June 2013 Audit Committee	Achieved
5. Enhance trust through transparency and ongoing two-way communication with trustees and executive management through regular meetings, requests for audit plan input and feedback on performance	<ul style="list-style-type: none"> <li>• CAE conducted recurring meetings with Executive Director, attended Executive Council meetings, and met with chief officers as needed</li> <li>• CAE met with Audit Committee Chair quarterly</li> <li>• CAE gathered input from trustees and executive management for the annual audit plan development</li> </ul>	Achieved
6. Enhance value through allocating time for special requests throughout the year	Allocated 970 hours for unscheduled projects (for listing of scheduled and unscheduled advisory projects, see <b>page 4</b> under <b>Tab 7</b> )	Achieved
7. Identify and utilize at least two internal or external resources to train and mentor audit staff in employer reporting and information technology	<ul style="list-style-type: none"> <li>• Worked with Benefit Accounting and Legal Services staff to gain knowledge on employer reporting and related TRS Laws and Rules</li> <li>• Worked with external service providers on outsourced audit projects and advisory projects in Information Technology</li> </ul>	Achieved

**Internal Audit Performance Measures - Fiscal Year 2013  
4TH Quarter Ending August 31, 2013**

Target Performance	Activity	Status
8. Systematically monitor emerging investment issues and impact to TRS via the investment compliance program	<ul style="list-style-type: none"> <li>• Attended regular meetings with Deputy CIO and Managing Director of Risk to maintain current on investment issues</li> <li>• Monitored investment related issues through daily news services and discussed at weekly meetings of IA Investment compliance staff</li> </ul>	Achieved
9. Spend a minimum of 75% of total available department hours (excludes uncontrollable leave) for professional staff on direct assurance, consulting, and advisory services	Year-to-date calculation is 78% of total available department hours (excluding uncontrollable leave) spent on direct assurance, consulting, and advisory services.	Achieved
10. Facilitate success of external financial audit by effectively providing audit support, coordinating meetings, reserving facilities, and gathering schedule requests to enable timely outcomes with no surprises	State Auditor's Office Report on the Audit of Fiscal Year 2012 Comprehensive Annual Report (CAFR) was reported to the Audit Committee in December 2012.	Achieved

**Legend: Target Status**

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

**Teachers Retirement System of Texas  
Internal Ethics and Fraud Investigations  
Incident Report Activity Summary  
1/1/2010 (inception) through 8/31/2013**

<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

<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.

## **Practice Advisory 2120-3: Internal Audit Coverage of Risks to Achieving Strategic Objectives**

### **Primary Related Standards**

#### **2120 – Risk Management**

**2120. A1** – The internal audit activity must evaluate risk exposures relating to the organization’s governance, operations, and information systems regarding the:

- Achievement of the organization’s strategic objectives.
  - Reliability and integrity of financial and operational information.
  - Effectiveness and efficiency of operations and programs.
  - Safeguarding of assets.
  - Compliance with laws, regulations, policies, procedures, and contracts.
- 

1. Executive management is responsible for identifying and managing risk in pursuit of the organization’s strategic objectives. It is the board’s responsibility to ensure that all strategic risks are identified, understood, and managed to an acceptable level within risk tolerance ranges. Internal audit should have an understanding of the organization’s strategy, how it is executed, the associated risks, and how these risks are being managed.
2. To enable internal audit to focus on the critical risks to the organization, the organization’s strategy should be a foundational element when developing a risk-based audit plan. This will align internal audit with the organization’s strategic priorities and help ensure its resources are allocated to the areas of significant importance.
3. When developing the audit plan, internal audit should leverage the work of management and other assurance functions to help identify the risks that present the most significant threats and opportunities to the achievement of an organization’s strategic objectives.
4. Strategic threats and opportunities will drive management’s creation and prioritization of the organization’s short-term and long-term strategic initiatives or the organization’s most significant investments to deliver value to its stakeholders.
5. Internal audit should consider providing assurance services related to these strategic initiatives when developing its audit plan. This will allow internal audit to assess whether the strategic risks are being managed to an acceptable level through evaluating some or all of the mitigation efforts. It also may provide the opportunity for internal audit to deliver advisory services that directly impact the organization’s evolution.
6. After determining the strategic risks to include in the audit plan, internal audit should assess whether all the required skills and knowledge exist in the internal audit department to execute applicable assurance or advisory engagements. Specialized

skills and knowledge may need to be sourced (internally or externally) before the internal audit department is qualified to perform the work.

## NEWS RELEASE 06/27/13

### GASB ISSUES IMPLEMENTATION GUIDE FOR PENSION PLANS

**Norwalk, CT, June 27, 2013**—The Governmental Accounting Standards Board (GASB) today published an Implementation Guide for the new GASB standards regarding financial reporting for state and local government pension plans. The *Guide to Implementation of GASB Statement 67 on Financial Reporting for Pension Plans* is an authoritative resource designed to assist preparers and auditors of state and local government pension plan financial reports as they prepare to implement the standards, which are effective for periods beginning after June 15, 2013.

Prepared by the GASB staff, the Implementation Guide answers key questions about putting the new standards into practice. Topics addressed in the Guide include:

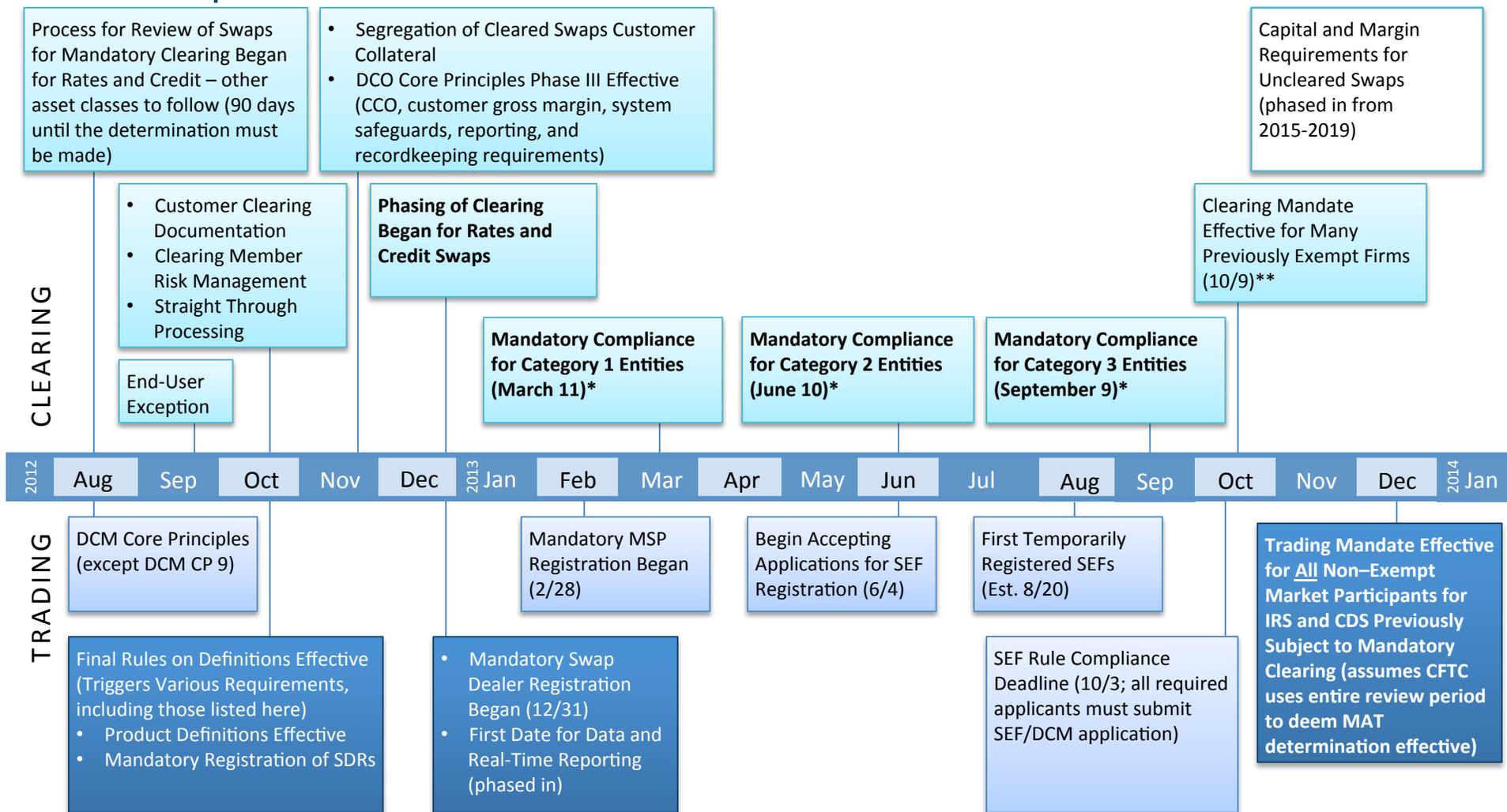
- The scope and applicability of [GASB Statement No. 67, Financial Reporting for Pension Plans](#)
- The classification of pensions as defined benefit or defined contribution
- The determination of the number of pension plans that should be reported
- The recognition of certain transactions and other events in defined benefit pension plan financial statements
- Note disclosures and required supplementary information
- The calculation of the net pension liability

“During the development and after the issuance of Statement 67, users, preparers, and auditors of pension plan financial reports posed questions to the GASB staff regarding the application of the standards,” said GASB Chairman Robert H. Attmore. “This Implementation Guide is written in a question and answer format and provides illustrative examples to assist stakeholders when applying the new standards for pension plan reporting.”

Mr. Attmore continued, “We are also pleased to announce that a digital version of the Guide will be the first guide to be offered on the GASB website as a download at no cost. Furthermore, all subsequent guides will be available on the [GASB website](#) at no cost moving forward.”

A hard copy bound edition of the Guide can be ordered for \$46.50 plus shipping by visiting the [GASB store](#), or by calling the GASB Order Department at (800) 748-0659.

An additional implementation guide for GASB Statement No. 68, Accounting and Financial Reporting for Pensions, will be available in early 2014. The provisions in Statement 68 are effective for periods beginning after June 15, 2014.



\* Categories of entities for the mandate are listed on the other page. Alternative compliance dates exist for swaps on iTraxx indices subject to mandatory clearing: April 26, 2013 for Category 1, July 25, 2013 for Category 2, and October 23, 2013 for Category 3.

\*\* Category 1 or 2 entities previously exempt from the clearing mandate under the 2012 cross-border exemptive relief become subject to the mandate if they fall under the new US person definition in the final Guidance.

Note: All dates referenced in the timeline are **effective** dates of the rules, not the date on which the rules are finalized by vote.

**This timeline was updated on July 26, 2013. Please note that this document reflects Delta Strategy Group's projections and the information is subject to change.**

## Summary of Phasing and Implementation Timeline

REPORTING	SWAP DEALER AND MAJOR SWAP PARTICIPANT REGISTRATION	CLEARING	TRADING
<ul style="list-style-type: none"> <li>As of September 20, 2011, Futures Commission Merchants (FCMs), Derivatives Clearing Organizations (DCOs), and entities subject to the Commission's previous special call were subject to the Large Trader Reporting rule.</li> <li>Mandatory SDR registration began October 12, 2012.</li> <li>Reporting hierarchy (if equal they decide, or, if only one is a US person, the US person reports): SD&gt;MSP&gt;Non-SD/MSP financial counterparty (FC)&gt;Non-SD/MSP non-financial counterparty (NFC)</li> </ul> <p><b>SDR/Real-time public reporting for CDS/IRS involving a SD or MSP:</b></p> <ul style="list-style-type: none"> <li>SDs: April 10, 2013 or upon registration</li> <li>MSPs: upon registration</li> <li>FC: April 10, 2013</li> <li>NFC: July 1, 2013</li> </ul> <p><b>SDR/Real-time public reporting for equity, Fx, and "other commodity" swaps</b></p> <ul style="list-style-type: none"> <li>SD or MSP: April 10, 2013 or upon registration</li> <li>FC: May 29, 2013</li> <li>NFC: August 19, 2013</li> </ul> <p><b>Reporting of historical swaps:</b></p> <ul style="list-style-type: none"> <li>SDs (CDS/IRS): January 30, 2013; (other classes) March 30, 2013 or upon registration</li> <li>MSPs: upon registration</li> <li>FC: September 30, 2013</li> <li>NFC: October 31, 2013</li> </ul>	<ul style="list-style-type: none"> <li>The National Futures Association (NFA) is accepting applications from <a href="#">SDs</a> and has begun granting provisional registration.</li> <li><b>The first date for mandatory registration of SDs was December 31, 2012. The first date for mandatory registration of MSPs was February 28, 2013.</b></li> <li>SDs must comply with 4s requirements upon registration or as the requirements become effective (i.e. capital, reporting, recordkeeping, business conduct standards, trading, risk management, disclosure, conflicts, antitrust, and chief compliance officer) unless no-action relief has been granted.</li> <li><b>Related rules:</b> External Business Conduct Standards; Internal Business Conduct Standards; Capital &amp; Margin; Reporting/Recordkeeping Rules (SDs/MSPs must comply with these related rules by the compliance dates specified in each rule).</li> </ul>	<ul style="list-style-type: none"> <li>The Commission finalized the credit and interest rate swaps being cleared as of February 1, 2012 that are subject to the clearing mandate. The CFTC will vote out remaining asset classes in separate proposals (no future dates have been determined). The final determination included hard compliance dates, as reflected in parentheses below. Only swaps subject to the mandate that are transacted after the date in parentheses must be cleared:</li> <li><b>Category 1 (March 11, 2013):</b> SDs/MSPs and "Active Funds" (Private Funds trading 200+ swaps per month/past year) that are not "3<sup>rd</sup> party subaccounts."</li> <li><b>Category 2 (June 10, 2013):</b> Commodity Pools, Private Funds that are not "Active Funds," and people "predominantly engaged in" banking activities or activities that are financial in nature, that are not "3<sup>rd</sup> party subaccounts."</li> <li><b>Category 3 (September 9, 2013):</b> pension funds, "3<sup>rd</sup> party subaccounts," and all others subject to the mandate.</li> </ul>	<ul style="list-style-type: none"> <li>Swap Execution Facilities (SEFs) may begin applying for registration upon publication of the final SEF Core Principles (June 4, 2013). We expect the CFTC to provisionally approve the first applications in a group to avoid giving an advantage (est. August 20, 2013).</li> <li>To be granted temporary registration applicants must submit a complete application and certify substantial compliance with the SEF Core Principles. Formal registration will occur at a later date.</li> <li>SEFs may begin listing swaps during the pendency of their application. Once a mandatory clearable swap is "made available to trade" (by self certification or CFTC approval) by a DCM or SEF, 30 days later the transaction must occur through a DCM/SEF. The mandate would apply to any DCM/SEF listing the swap (or economic equivalent).</li> <li><b>Phasing of trading mandate:</b> 30 days after compliance with mandatory clearing, an entity would be required to comply with the trading mandate.</li> <li><b>Remaining trading rules to be finalized:</b> DCM Core Principle 9.</li> </ul>

## PROTIVITI FLASH REPORT

### The HIPAA Omnibus Rule is Here: What Does It Mean for You?

February 7, 2013

On January 17, 2013, the Department of Health and Human Services (HHS) released the HIPAA Omnibus Rule, with a compliance deadline of September 23, 2013. The good news is that, for the most part, the widely anticipated Final Rule for HIPAA remains aligned with the proposed rule; however, organizations should be mindful of the following key changes:

- **Definition of a breach** – The new rule requires organizations that experience a security incident to prove, through a documented risk assessment, that there is a low probability that the affected data has been compromised; otherwise, the organization will need to report a breach. Historically, organizations only had to focus on determining if there was a risk of harm to the affected individuals. Now the focus is on whether or not the data was compromised at all, regardless of whether it is anticipated that the affected individuals experienced any form of harm whatsoever. This change is anticipated to increase the amount of disclosures that organizations will need to report.
- **Business Associate applicability** – All subcontractors of both Covered Entities (CEs) as well as Business Associates (BAs) are considered Business Associates themselves if they create, receive, maintain or transmit electronic protected health information (ePHI). In the past, the regulation put the onus for the security of ePHI on the entity utilizing the services of the subcontractor. In the Omnibus Rule, subcontractors are to be held equally responsible for adhering to the HIPAA regulations and must have the necessary controls and Business Associate Agreements (BAAs) in place. Additionally, the conduit exception has been limited. This exception provides an exemption from the HIPAA regulations to any organization that transmits data for a CE or BA but cannot access the data. The updated definition makes this requirement clearer. If a vendor or contractor can access the data, even if it has established practices to avoid accessing this data, then it will be seen as a BA and will be required to comply with the regulations.
- **Patients' rights enhanced** – Patients now have the ability to restrict disclosure of treatment information to their health plan if they pay in full out of pocket. Additionally, patients have the right to receive electronic copies of their patient records. This is no longer just a Meaningful Use requirement.

In response to these changes, organizations should be addressing, at a minimum, the following:

1. Update the incident response process to include a documented risk assessment to determine if there is a low probability that PHI has been compromised. This risk assessment should include the following four factors as identified in the Omnibus Rule to determine this probability:
  - The nature and extent of the PHI involved;
  - The unauthorized person who used PHI or to whom the disclosure was made;
  - Whether PHI actually was acquired or viewed; and
  - The extent to which the risk to PHI has been mitigated.

The preamble of the Omnibus Rule provides guidance on how to apply these four factors and should be referenced when updating the incident response process. See page 308 of the regulation at [www.ofr.gov/OFRUpload/OFRData/2013-01073\\_PI.pdf](http://www.ofr.gov/OFRUpload/OFRData/2013-01073_PI.pdf).

Additionally, organizations should revisit their HIPAA Security risk analysis and re-evaluate those factors that could contribute to compromised PHI. There continues to be an increased emphasis placed on the importance of encryption for protecting PHI from being compromised. Through the risk analysis, organizations should evaluate if the media devices and network transmissions that have not been encrypted have an elevated risk that may finally warrant an investment in this area. Risk analysis continues to be a critical area of focus for the HHS. Increasingly, regulatory fines are being levied against organizations that have not completed this HIPAA Security requirement.

For more detailed information on what should be included as part of the HIPAA risk analysis process, read Protiviti's white paper, [HIPAA Security – Prepare Now or 'Wait and See'?](#)

2. Update all BAAs to include the change in the definition of a breach and to point out the requirement for the BA to establish a BAA with any subcontractors with which it partners that may create, receive, maintain or transmit PHI. Existing agreements must be updated to comply with the requirements no later than September 22, 2014, and all new BAAs entered into or renewed after January 25, 2013, will need to comply with these new requirements.
3. Update the organization's notice of privacy practices (NPP) to include the right to restrict disclosure of treatment from health plans if paid in full at the time of treatment. The organization should ensure it has a process in place to comply with this right to restrict disclosure. The NPP must also include a statement that the covered entity is required to notify affected individuals following a breach of unsecured PHI.

By now, we should all realize that the increased scrutiny on safeguarding patient information is not going away. However, many organizations continue to fall behind in taking the necessary steps to comply with the requirements. We can only expect enforcement to become more stringent as breaches continue to occur on a daily basis.

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## About Protiviti

Protiviti ([www.protiviti.com](http://www.protiviti.com)) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE® 1000 and Global 500 companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

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## Internal Audit Staff Quarterly Accomplishments

- Amy Barrett received the Certified Information Systems Auditor (CISA) certification.
- Brian Gomolski has passed the exam for the Certified Information Systems Auditor (CISA) and is in the process of obtaining his certification.
- Toma Miller received the Certified Government Auditing Professional (CGAP) certification.
- Hugh Ohn, Terry Harris, and Toma Miller attended the 2013 Audit Conference sponsored by the State Auditor's Office.
- Jan Engler attended the Institute of Internal Auditors International Conference where she was invited to appear in a two-minute video speaking on the topic of "The Advantages of Internal Audit Strategic Planning" for the IIA AuditChannel.tv.
- Hugh Ohn and Brian Gomolski attended the Institute of Internal Auditors' training on implementing the 2013 Internal Controls Framework issued by the Committee of Sponsoring Organizations (COSO).
- Hugh Ohn and Brian Gomolski performed an on-site due diligence visit to the State Street Bank offices in Boston, MA.
- Terry Harris will join the Legal Services Department effective September 2, 2013. The Investment Compliance function has been transferred from Internal Audit to Legal Services. Mr. Harris will be part of the Compliance, Ethics, and Litigation team in Legal Services.

# STATE STREET AGENDA

## TEACHER RETIREMENT SYSTEM OF TEXAS - STATE STREET SERVICES REFRESHER

WEDNESDAY, JULY 24<sup>TH</sup> 2013

*Location: Lafayette Conference Center (Lake Ontario), Boston, MA*

### TRS ATTENDEES

Hugh Ohn, TRS Internal Audit  
Brian Gomolski, TRS Internal Audit

### SSB ATTENDEES:

Craig teDuits, *Relationship Manager*  
John Powell/ Aana Singh, *Securities Lending*  
Patrick Duggan, *Accounting Services*  
Erin Brandl-Moynihan, *Asset Manager Services (Client Trade Support)*  
Brando Izquierdo/ Greg Brown, *State Street Limited Partner Services*  
Lori Stranz, *Business Continuity*  
Kamran Makhdumi, *State Street Investment Analytics*  
Lynne Robertson, *Corporate Compliance*  
Peter Sullivan, *Global Trade Processing*

<u>TIME (EST)</u>	<u>TOPIC / SUBJECT MATTER</u>	<u>LEAD</u>
9:00 AM	MEETING OBJECTIVE & KICK-OFF	Craig teDuits
9:15 AM	TRADE SUPPORT – INTERNAL & EXTERNAL	Erin Brandl-Moynihan
9:45 AM	FUNDS TRANSFER & TRANSACTION VALIDATION	Peter Sullivan
10:00 AM	BREAK	
10:15 AM	INVESTMENT ACCOUNTING	Patrick Duggan
11:00 AM	PERFORMANCE MEASUREMENT & ANALYTICS	Kamran Makhdumi
12:00 PM	LUNCH	
1:30 PM	LIMITED PARTNER SERVICES (LPS)	Brando Izquierdo / Greg Brown
2:00 PM	CORPORATE COMPLIANCE	Lynne Robertson
2:20 PM	BUSINESS CONTINUITY	Lori Stranz
2:45 PM	BREAK (WALK OVER TO STATE STREET FINANCIAL BLDG)	
3:00 PM	SECURITIES LENDING	John Powell / Aana Singh
4:00 PM	WRAP-UP	Craig teDuits