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An Audit of the Financial Statements of the Teacher Retirement System of Texas Year Ended August 31, 1995

April 1996

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Key Points Of Report

An Audit of the Financial Statements of the Teacher Retirement System of Texas Year Ended August 31, 1995

April 1996

Overall Conclusion

Based on our audit, the Teacher Retirement System's (System) general purpose financial statements for fiscal year 1995 are accurately presented in all material respects, in accordance with generally accepted accounting principles. We noted no material internal control weaknesses or noncompliance with laws and regulations. However, other matters involving weaknesses in the internal control structure and its operation are summarized below.

Key Facts And Findings

- The System has implemented or made progress toward implementing most previous audit recommendations. However, three previous recommendations, discussed below, are repeated.
- As commented on in the System's prior year management letter, anticipated dividend income controls are generally effective; however, we again noted cases where controls did not function or were not applied as intended, particularly with international dividend income. In fiscal year 1995, dividend income covered by such controls totaled \$561 million, of which international equaled \$65 million.
- Although the System maintains considerable computer resources, the Security Administrator does not report directly to the Director of the Management Information Systems Department. Organizational placement of the Security Administrator can be critical to accomplishing its responsibilities and operating as an effective control. To accomplish its responsibilities and be an effective control, the Security Administrator should report to a position with sufficient independence and authority to take necessary corrective actions.
- Improvement of control procedures over the System's \$10 million in furniture and equipment and enhancement of controls to prevent accounting entries to closed periods are repeated from similar prior year comments.

Contact

Barbara Hankins, Audit Manager (512) 479-4700



Office of the State Auditor

Lawrence F. Alwin, CPA

This audit of the financial statements was conducted in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States.

Executive Summary

The fiscal year 1995 general purpose financial statements of the Teacher Retirement System of Texas (System) are accurately presented in all material respects, in accordance with generally accepted accounting principles. No material weaknesses in the System's internal control structure or material noncompliance with applicable laws and regulations were noted. However, in the course of the audit, we noted some areas in which the System can improve control over assets and recording of transactions.

Internal Control Matters

Included in Section 1 of this report are matters, not considered to be reportable conditions, relating to financial accounting and internal controls, which the System's management should be made aware of as follows:

- As commented on in the System's prior year management letter, anticipated dividend income controls are generally effective; however, we again noted cases where controls did not function or were not applied as intended. We tested a sample of dividends and found 6 of 20 were not properly anticipated before being deposited. The sample tested showed particular difficulties with anticipation of international stock dividends. In fiscal year 1995, dividend income covered by such controls totaled \$561 million.
- Although the System maintains considerable computer resources, the Security Administrator does not report directly to the Director of the Management Information Systems Department. Organizational placement of the Security Administrator can be critical to accomplishing its responsibilities and operating as an effective control. A

significant responsibility of the Security Administrator is to monitor the access of other programmers. The Security Administrator should not report to programmers whom he is responsible for monitoring. To accomplish its responsibilities and be an effective control, the Security Administrator should report to a position with sufficient independence and authority to take necessary corrective actions.

- Based on our follow-up of prior year recommendations, the System's control procedures relating to its \$10 million investment in furniture and equipment can still be strengthened. The System has not implemented procedures to track assignment of responsibility, transfers, exchanges, and return of assigned assets when employment is terminated. Additionally, adoption of System-wide policies related to furniture and equipment would serve to clarify responsibilities and promote adherence to control procedures.
- As commented last year, the System should continue to take steps to prevent postings to closed fiscal years in its investment accounting systems. We found two instances of postings to closed fiscal years during testing. The fixed-income subsidiary ledger does not have edit checks to identify and control entries to prior closed fiscal years. Entries posted directly to closed fiscal years may not be detected and do not properly update the investment subsidiary ledgers.

Executive Summary

Status of Previous Audit Recommendations

The System has implemented or made progress in implementing most previous audit recommendations. Three previous recommendations are repeated. The System should tighten controls and application of controls relating to anticipation of dividend income; improve controls over furniture and equipment; and ensure that investment subsidiary ledgers do not accept entries to closed periods.

It should also be noted that:

- Recommendations related to restrictions on computer access and market valuation of certain real estate mortgages were not completed until after follow-up work was conducted this year.
- Recommendations relating to policies for independent audits for the Insurance Fund and development of a comprehensive accounting policies and procedures manual are not repeated in this management letter but have not been fully resolved. Additional follow-up work will be required in future audits.

Summary of Management's Responses

Management concurred with the findings and recommendations in this report. The System is implementing a new investment accounting system they believe will resolve findings related to anticipation of dividend income and postings to closed periods. Additionally, effective April 1, the Security Administrator began reporting to the Director of the Management Information System. Recommendations concerning property and equipment will be considered by a new committee in the development of new procedures, which should be in place by June 1, 1996.

Summary of Objectives and Scope

The objective of this audit was to express an opinion on the System's financial statements for the year ended August 31, 1995. The scope of this audit included gaining an understanding of, and in some cases testing, the internal control structure, including controls over cash receipts, cash disbursements, investments, and journal vouchers. We also gained an understanding of the control environment and controls over fixed assets. Account balances tested included cash, accounts receivable, investments, accounts payable, revenues, expenditures, and fund balance.

Overview

The Teacher Retirement System (System) maintains an internal control structure on which it relies for safeguarding of assets, orderly conduct and recording of operations, financial reporting, and compliance with applicable laws and regulations. We gained an understanding of the System's control structure and tested compliance with laws and regulations deemed to be significant, as part of our audit to express an opinion on the System's general purpose financial statements. As stated in our report on the financial statements dated February 16, 1996, and our related reports on internal controls and compliance (Appendix 3 and Appendix 4 of this report), we noted no errors, noncompliance, or weaknesses that we consider material. However, in the course of the audit, we noted some conditions which we believe are significant enough to bring to the System's attention, along with our recommendations for improvement in those areas.

Section 1:

Internal Control Matters

We note the following matters, not considered reportable conditions as defined by the American Institute of Certified Public Accountants, and make recommendations to enhance internal controls.

Section 1-A:

Tighten Controls, and Application of Controls, Relating to Anticipated Dividend Income

(Similar Prior Year Comment)

Based on our review of a small sample of dividend deposits, we noted six which were not properly anticipated before being deposited. In each case the error was detected because the dividend was posted to the previous period of anticipated dividends. This caused the prior period to be overstated and reported on the next discrepancy report. The six errors were eventually corrected by Investment Accounting staff. According to Investment Accounting staff, the problems found result from late or improper dividend anticipation announcements received from the System's outside service.

Anticipation of dividend income is an important control process designed to ensure that the System receives all income due on its stock investments. In fiscal year 1995, dividend income totaled \$561 million. Undercollection or overcollection of dividends, and any errors made in recording transactions, results in discrepancies between anticipated and actual collections posted to the accounting system and reported as income. A reported discrepancy in the equity anticipation system database should, and generally does, cause investment accountants to investigate and take action to resolve the discrepancy. We found occasions when anticipated dividend income controls did not function or were not applied as intended.

Improperly anticipated dividends require Investment Accounting staff to expend additional efforts to find, document, and correct erroneous entries. The condition is especially troubling at year-end as Investment Accounting relies on the anticipation system for establishing reported dividend receivables which amounted to \$64 million at August 31, 1995. We noted immaterial errors in the amount reported for international dividends receivable resulting from incorrect or incomplete information in the anticipation system.

The sample tested showed particular difficulties with anticipation of international stock dividends. Anticipation of international stock dividends involves additional complexities over domestic equities. With international stocks, foreign taxes can be withheld and foreign currency translation is often required.

We noted instances of late anticipations for international dividends, incorrect dividend rates entered into the equity system, and inadequate follow-up to ensure discrepancies are properly resolved.

- In one case, the System anticipated \$3,109,472.43 based upon a dividend rate of \$2.574706 supplied by its external service. The dividend rate was incorrect and should have been \$2.1885. The System actually received and posted to the accounting ledger \$2,643,051.45. To account for the difference between anticipated and actual income received, \$446,420.84 was input as foreign tax withheld in the anticipation system database. However, no taxes were actually withheld as the System received the gross amount of dividends.
- The System received a dividend of \$118,668.36, but had originally anticipated only \$110,780.04. Investment Accounting staff determined that the gross rate for the dividend was \$.2276 per share, for total dividends of \$139,609.84. However, the Investment Accounting staff could not locate the correction form (TRS297) to show that the change in anticipated dividends entered was properly approved. The difference of \$20,941.48 was input to the anticipation database as foreign taxes withheld.
- The current anticipation system does not have the capability to translate foreign currency dividends to U.S. dollars. This causes additional difficulties in anticipating the proper amounts.
- Investment Accounting relies almost exclusively on its custodian bank, which is contractually obligated to monitor foreign taxes and to collect taxes from foreign governments. Investment Accounting does not review foreign companies to determine which ones typically withhold taxes. However, Investment Accounting staff regularly eliminate discrepancies between foreign dividends actually received and anticipated amounts by posting to foreign taxes withheld on the stock system without supervisory approval.

Recommendations:

The importance of careful execution of control procedures relating to the anticipation of dividend income should be reemphasized. The System should take steps to strengthen controls, and the application of controls, by implementing the following recommendations:

- Determine the cause and effects of entries being posted to the wrong dividend payment dates and take appropriate corrective action. A solution to this problem will save System resources.
- Obtain accurate and timely dividend announcement information for foreign stocks and make proper determinations between gross and net dividend rates.
- Emphasize the need for complete and accurate follow-up of discrepancies noted on foreign stocks. Supervisory approval for entries of foreign taxes withheld should be conducted to ensure adequate follow-up was done.
- Consider obtaining currency translation capabilities to correctly anticipate foreign dividends.
- Identify foreign countries that typically withhold taxes. Accurately track balances of foreign taxes withheld and determine the possibility of collection.

Management's Response:

TRS contracts with its custodian for the proper declaration and collection of dividends and the accurate collection and payment of foreign taxes on international transactions. The current software system does not have full accrual accounting or international transaction processing capabilities. Thus, information received from custodians and confirmed by outside services must be monitored manually on an "after the fact" basis. As a result, there is an increased number of errors and adjustments for the recording of dividend income.

In August of 1995, the System purchased a portfolio management and accounting software package which will provide a substantial increase in the processing and reporting capabilities within the investment accounting department. The software will automate a number of manual processes and provide additional internal controls and exception reports than were possible in the previous system. The new system can automatically account for currency translation and foreign taxes on a full accrual basis. As a result, management can better prevent discrepancies noted in the information received by TRS from custodians and other outside services, particularly in the area of foreign transactions. Emphasis will be placed on proper follow-up and documentation of discrepancies noted by management. Full implementation of the software for equities and fixed income is expected to be completed in June 1996 and December 1996, respectively.

Section 1-B:

Relocate the Computer Security Function Within the Organizational Structure to Better Reflect its Priority

The Computer Security Administrator (Administrator) does not report directly to the Director of the Management Information Systems Department. Under the System's current organizational structure, the Administrator reports to the Computer Operations Supervisor. Organizational placement of the computer security function can be critical to accomplishing its responsibilities and operating as an effective control.

To accomplish its responsibilities and be an effective control, the Administrator should report to a position with sufficient independence and authority to take needed corrective actions. Some of the Administrator's responsibilities include enforcing security policies and procedures, removal of access due to termination of an employee, and monitoring and detecting unauthorized accesses. The Administrator must be independent so that proper judgement will be used when monitoring accesses within the computer system. The Administrator is responsible for monitoring the access of all employees including other computer programmers within his department. Proper independence is not maintained if the Administrator reports to individuals whom he also monitors. The Administrator should report to a person with sufficient authority to ensure that security policies and procedures are enforced for all of the System's employees.

The computer security function is an integral control process. It helps decrease the risk of errors and irregularities in automated data through monitoring access and enforcing security policies. As the System maintains considerable computer resources, the importance of an effective computer security function is significant.

Recommendation:

The computer security function should be relocated within the organizational structure and report directly to the Director of Management Information Systems. This would properly reflect its priority within the agency and enable it to function more effectively with the necessary independence and authority.

Management's Response:

The Security Administrator and assistant have been transferred from Computer Operations to report directly to the Director of Management Information Systems effective April 1, 1996.

Section 1-C:

Improve Controls over Furniture and Equipment

(Prior Year Comment)

Based on our follow-up of prior years recommendations, the System's control procedures relating to its \$10 million investment in furniture and equipment can still be strengthened in the following areas:

- Track assignments of responsibility, transfers, exchanges, and return of assigned assets when employment is terminated.

Based on interviews with the System's personnel, these weaknesses mentioned in the prior year Management Letter to the System, still remain.

- Newly hired employees do not sign a form acknowledging that they have accepted custody of property. Until the annual inventory is performed, there is no documentation, except the fixed-asset master file (INVY system) listing of property by room, to identify property in a new employee's possession.
 - No procedures exist to document transfers of furniture and equipment between employees or exchanges of equipment with vendors.
 - When an employee terminates, there are no procedures to verify that all property assigned to the employee or in the employee's possession is returned to the system.
- Process items returned, exchanged, or purchased on an emergency basis through the INVY System.

The System stressed the need to ensure personnel communicate with the property manager when equipment is exchanged with a vendor so that proper records can be maintained. However, no specifically documented policies exist to ensure that this communication is conducted on a consistent and sustained basis.

- Implement systemwide policies related to furniture and equipment.

Based on follow-up interviews conducted, System personnel discussed the lack of documented policies related to employees' responsibilities over furniture and equipment. Specific policies would serve to clarify responsibilities and promote adherence to control procedures established by the System.

Effective controls over furniture and equipment reduce the risk that assets may be lost, stolen, or misused without timely detection and appropriate corrective action.

Recommendations:

We recommend that the System implement procedures to:

- Implement specific systemwide policies and procedures for controls over furniture and equipment.
- Include in written policies that equipment returned to vendors, exchanged with vendors, or purchased on an emergency basis, must be tracked through the INVY system.
- Assign responsibility for property and equipment to individual employees and obtain acknowledgment from the employee.
- Track and record transfers between employees and exchanges with vendors.
- Verify that all property in a departing employee's possession is returned to the System upon termination.

Management's Response:

A new property manager has been appointed and a committee has been formed to develop system-wide guidelines and procedures for controls over furniture and equipment. Each recommendation will be considered in the development of the procedures, which should be in place by June 1, 1996.

Section 1-D:

Enhance Controls in the Fixed-Income Subsidiary Ledger to Prevent Entries to Closed Periods

(Prior Year Comment)

The prior year issue of posting entries to closed fiscal years has not been resolved. The fixed-income subsidiary ledger still has no edit checks to identify and control entries to prior closed fiscal years before they are posted. Previous fiscal years are closed out on the System's subsidiary ledger carrying forward any balances to the new fiscal year and are no longer reviewed regularly by accounting staff. Entries posted to closed fiscal years do not update balances carried forward in the System's current investment ledger and may go undetected.

During a review of investment income for fixed income securities, two transactions were entered during fiscal year 1995 but were posted to previous closed fiscal years. One interest transaction was entered May 10, 1995, and back dated to September 17, 1990. Another transaction was entered July 13, 1995, and back dated to January 5, 1994. The two transactions in question were for \$79,166.67 and \$193,500 respectively. Had edit checks to detect these unusual entries been in effect, these two

transactions would not have been automatically accepted in the fixed income subsidiary ledger.

Postings to closed fiscal years were discovered during an audit last year as well. As a general rule, once the accounting for a fiscal period has been closed, the system should not allow entries to be assigned to that period. Without edit checks, the risk is increased that prior years data, unintentionally or intentionally, may accumulate undetected erroneous postings over time. Edit checks will prevent unintentional or intentional (i.e. correcting) entries from being improperly posted to closed periods. If an entry is needed to correct a closed fiscal year, the balance forward account should be properly adjusted. Otherwise, entries posted to prior periods would not have the intended result of correcting balances.

Recommendation:

The System should enhance controls in the fixed-income subsidiary ledger system by adding an edit check that would not allow an accountant to make entries which would cause the system to apply that entry to a closed fiscal period. The edit check should include all critical date fields. Supervisory review should be required if override of the system is necessary for prior period corrections.

Management's Response:

We concur with the recommendation. An investment accounting software system should restrict all types of entries made to closed fiscal years without appropriate supervisor authorization. In attempting to implement this recommendation made in the prior year, the System determined that it would require significant resources to modify the current software system to prevent these types of entries. The new portfolio management accounting and software system maintains edit checks that will prevent posting to any period other than the month that is currently in process. An entry posted to a previous period may only be performed by the Investment Accounting Manager after sufficient documentation has been gathered for the correction. Implementation of the new software system for the fixed income portfolio is expected to be completed in December 1996.

Section 2:

Status of Previous Audit Recommendations

The System has implemented, or made progress in implementing, previous audit recommendations relating to the following topics:

- The timeliness, completeness, and quality control of investment reconciliations were improved.

- Procedures for anticipation of interest income from fixed-income investments were improved. However, anticipation of dividend income continued to show exceptions in our testing, therefore, some new and repeated recommendations are made this year. See Section 1-A of this report for recommendations.
- Improvements have been made to restrict programmers' access to computer resources, although some of our recommendations from the prior year were not implemented until after follow-up work was conducted this year. Excessive access to the Annuity Payroll and Payee Address System was also not resolved during fiscal year 1995. Excessive access was removed during our follow-up work after we pointed out to the System's management that our recommendation had not been completely implemented.
- Our recommendation that the System develop a written policy designating the timing and scope of independent audits of insurance claims and retention charges was not fully resolved. The Insurance Department Head drafted a memorandum to the Director of Internal Audit stating audit plans for the insurance fund. This memorandum does not constitute official policy within the System. The need to establish procedures to properly develop systemwide policies has been commented on by the Internal Audit Department. The System is moving forward with plans for developing a process to implement policies. Management has agreed that policies over audits of the insurance fund will be made a part of this process. Therefore, the comment and recommendation have not been repeated this year but will be followed up on in subsequent audits.
- Progress has been made on development of a comprehensive accounting policies and procedures manual. The General Accounting and Investment Accounting Departments have agreed on a format for writing policies and procedures and have written several drafts. We chose not to repeat the prior year comment but will continue to follow up on the implementation of the manual next year.
- Based on interviews with the System's staff, communication among General Accounting, Investment Accounting, and Investment departments has improved.
- We continued to note investment accounting errors mostly in conjunction with our test of investment income anticipation procedures. Most errors were eventually corrected, and no significant errors were noted. Our comment concerning taking appropriate actions to reduce investment accounting errors is not specifically repeated. Recommendations made relating to anticipation of dividend income procedures are considered sufficient to resolve errors found.
- We again discovered entries posted to prior year closed periods. This comment and recommendation is repeated in Section 1-D of this report.

- Recommendations concerning reporting securities clearing balance and market valuation of certain real estate mortgages were implemented.
- Audit adjustments to the System's subsidiary real estate corporations were posted to the General Ledgers maintained by the Real Estate Accounting Department.
- Recommendations concerning improvement of controls over furniture and equipment were not implemented and have been repeated in Section 1-C of this report.

Objective, Scope, and Methodology

Objective

The purpose of this audit was to express an opinion on the System's general purpose financial statements for the fiscal year ended August 31, 1995. We designed audit procedures to provide reasonable assurance of detecting material errors or irregularities. We also designed procedures to verify compliance with laws and regulations that may have a material effect on the System's financial statements.

Scope

The most significant accounts examined included Long-term Investments, Short-term Investments, and Cash in State Treasury, totaling \$35.7 billion, \$1 billion, and \$404 million, respectively. Also examined were the revenues and expenses/expenditures of the Pension and Expendable Trust Funds. Revenues and expenses of the Pension Trust Fund totaled \$5.7 billion and \$1.9 billion, respectively. Revenues and expenditures of the Expendable Trust Funds totaled \$201 million and \$185 million, respectively.

Methodology

We gained an understanding of the System's internal control structure, including the overall control environment, certain computer-related controls, and controls over cash balances, cash receipts and accounts receivable, cash disbursements and accounts payable, investments, journal vouchers, and fixed assets. We tested controls over cash disbursements, investments, and journal vouchers.

We also tested certain accounts, including cash, investments, accounts receivable, accounts payable, fund balances, revenues, and expenses/expenditures. Tests of accounts primarily included tests of details supporting entries, confirmations, and analytical review. We also performed procedures to test compliance with significant requirements related to investments, fund balance reserves, and retirement annuities.

Other Information

Fieldwork was conducted from October 1995 through February 1996. The audit was conducted in accordance with professional standards, including:

- Generally Accepted Government Auditing Standards
- Generally Accepted Auditing Standards

The audit work was performed by the following members of the State Auditor's Office staff:

- Bill Wood, CPA (Project Manager)
- Karl Johnson, CPA
- Sandy Bootz
- Randy Davis, CPA
- Terry Harris, CPA
- Ron Oaks
- Jim Stolp
- Barbara Hankins, CPA (Audit Manager)
- Craig Kinton, CPA (Director)

Additionally, we were directly assisted by and utilized audit work performed by System internal auditors. Reliance was also placed on the opinion of other auditors in relation to the System's equity in real estate property held for sale.

Profile of the Teacher Retirement System

Operations

The Teacher Retirement System was established by amendment to the Texas Constitution in 1936 and enactment of statutes in 1937 to provide a retirement program for persons employed in public education in professional and business administration, supervision, and instruction. Benefits were later expanded to include disability, death and survivor benefits. In 1949, membership was expanded to include all employees of public education. The System operates primarily under V.T.C.A., Texas Government Code, Title 8, Subtitle C. During August 1995, the System employed approximately 399 employees.

The System administers retirement benefits for all public education employees. The System also administers the Texas Public School Retired Employees Group Insurance Program for retired public education employees and Public School Active Employees Insurance Reserve. Each of these programs is included as a part of the reporting entity of the System because of the oversight responsibility exercised by the System's Board of Trustees. The System is a component unit of the State of Texas and is included in the State's comprehensive annual financial report.

Statistics for the System's programs as of August 31, 1995, were as follows:

Teacher Retirement Program

Individual Retirement Accounts	631,153
Retirees	138,034

Retired Employees Group Insurance Program

Retirees Enrolled	95,591
Spouses and Dependents Covered	13,706

Public School Active Employees Insurance Reserve

This fund provided for a comprehensive study of coverage and participation in the Texas Public School Retired Employees Group Insurance Program for active public school employees. No insurance was provided in fiscal year 1995. As a result of the study and legislation passed by the Texas Legislature, 74th Reg. Ses., Senate Bill 9, an optional health insurance program for school districts will be available beginning in fiscal year 1996. This fund collected almost \$5 million in contributions from school districts during fiscal year 1995 for research and to fund the insurance program.

Significant Events

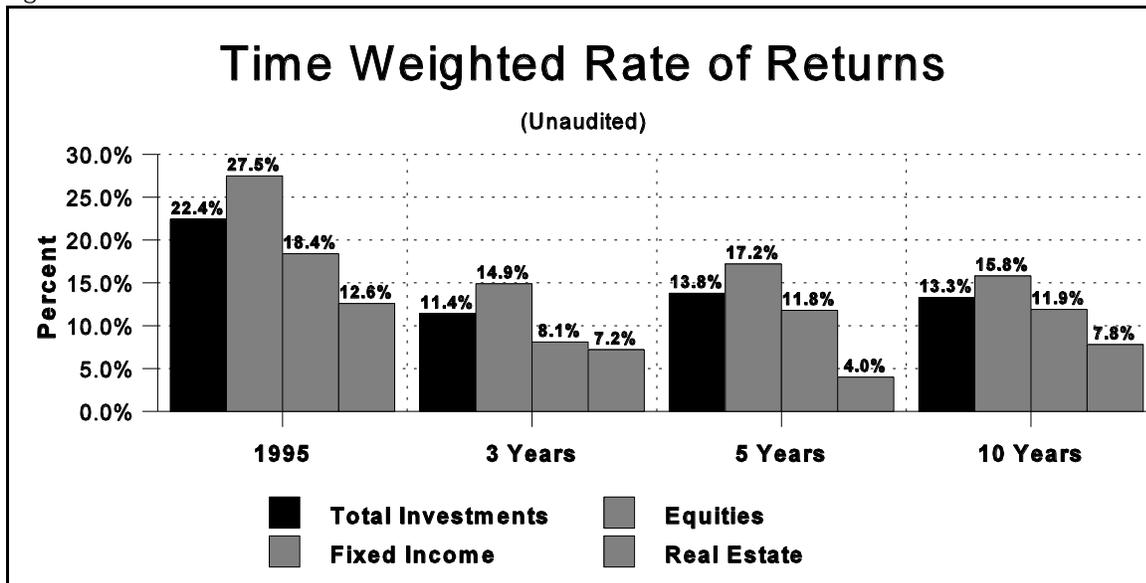
The 74th Texas Legislature approved the largest payment increase for annuitants ever enacted in Texas. This annuity improvement provided increases for more than 119,000 retired members at an actuarial cost of \$1.6 billion.

The funding period for the System's unfunded actuarial accrued liability (UAAL) increased from 2.2 to 14 years, primarily as a result of recognition of the annuity increase approved by the 74th Legislature. The annuity increase, and the year's actuarial experience, increased the UAAL from \$825 million to \$2 billion.

Progress in property dispositions for the System's subsidiary real estate corporations was made with the sale of seven properties from September 1994 through December 1995. These transactions generated net proceeds of more than \$224 million, including performing notes taken as partial consideration of \$44.2 million.

Total time weighted rates of return for the Pension Trust Fund were as follows:

Figure 1



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Appendix 3:

Auditor's Report on Internal Controls

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OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
State Auditor

AUDITOR'S REPORT ON INTERNAL CONTROLS

February 16, 1996

Board of Trustees
Teacher Retirement System of Texas

Members of the Board:

We have audited the general purpose financial statements of the Teacher Retirement System of Texas (System), a component unit of the State of Texas, as of and for the year ended August 31, 1995, and have issued our report thereon dated February 16, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

The management of the System is responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the general purpose financial statements of the System for the year ended August 31, 1995, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Board of Trustees
Teacher Retirement System of Texas
February 16, 1996
Page 2

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted other matters involving the internal control structure and its operation that we have reported to the management of the System in our management letter, within the Detailed Findings and Recommendations section. Less significant issues were directly communicated to appropriate System personnel during the course of our audit.

This report is intended for the information of the audit committee, management, and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,

A handwritten signature in cursive script, appearing to read "Lawrence F. Alwin".

Lawrence F. Alwin, CPA
State Auditor

Appendix 4:

**Auditor's Report on Compliance with Laws and Regulations
Material to the General Purpose Financial Statements**

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OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
State Auditor

**AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS
MATERIAL TO THE GENERAL PURPOSE FINANCIAL STATEMENTS**

February 16, 1996

Board of Trustees
Teacher Retirement System

Members of the Board:

We have audited the general purpose financial statements of the Teacher Retirement System of Texas (System), a component unit of the State of Texas, as of and for the year ended August 31, 1995, and have issued our report thereon dated February 16, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations is the responsibility of management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the System's compliance with certain provisions of laws and regulations. However, the objective of our audit of the general purpose financial statements was not to provide and opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the audit committee, management, and the Legislative Audit Committee. However, this report is a matter of public record and its distribution is not limited.

Sincerely,



Lawrence F. Alwin, CPA
State Auditor

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