

TEXAS STATE SECURITIES BOARD
Austin, Texas

ANNUAL INTERNAL AUDIT REPORT

Fiscal Year 2017

TEXAS STATE SECURITIES BOARD
Austin, Texas

Annual Internal Audit Report
Fiscal Year 2017

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Board Members and
Audit Committee Members
Texas State Securities Board
Austin, Texas

We performed tests of management's assertion about the effectiveness and efficiency of the internal control structure over the Enforcement Administration area of the Texas State Securities Board (SSB); and, its compliance with applicable sections of the Texas Securities Act, the Texas Administrative Code, and SSB's established policies and procedures for the 6 months ended February 28, 2017.

The results of our tests disclosed that SSB's internal control structure over the Enforcement Administration area and its established policies and procedures, were generally adequate and no material instances of noncompliance were noted; however, we did identify a certain matter, included in this report, that is an opportunity for strengthening internal controls and ensuring compliance with established policies and procedures. Based on the degree of risk or effect of this matter in relation to the audit objective(s), this matter was rated as either Priority, High, Medium, or Low, which is further described in the "Summary and Related Rating of Observations/Findings and Recommendations", which is included in page 11 of this report.

We also performed a follow-up of a finding and recommendation that was presented in the prior year annual internal audit report by SSB's predecessor internal auditor. This report reflects the results and implementation status of our follow-up procedures performed; and, includes all information required for the Annual Internal Audit Report.

We have discussed the comment and recommendation from the audit of the Enforcement Administration area; and, the implementation status from the follow-up performed, with various SSB personnel; and, will be pleased to discuss them in further detail; to perform an additional study of these matters; or, to assist you in implementing the recommendation from the audit of the Enforcement Administration area.

A handwritten signature in black ink that reads "Gonzaga/Gonzalez & Associates". The signature is written in a cursive, flowing style.

April 21, 2017 – Enforcement Administration
May 12, 2017 – Follow-up & Annual Internal Audit Report

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INTRODUCTION

The State Securities Board (SSB) is charged with the administration and enforcement of the Texas Securities Act (the Act). SSB's mission is to protect Texas investors. Consistent with that purpose, SSB seeks to ensure a free and competitive securities market for Texas, increase investor confidence; and, thereby encourage the formation of capital and the creation of new jobs in Texas. SSB investigates suspected violations of the Act and ensures that administrative, civil, or criminal enforcement actions are taken in appropriate circumstances. SSB also registers securities sold in Texas and the firms and individuals who sell securities or render investment advice in the state.

SSB was created in 1957 pursuant to the Act passed by the 55th Texas Legislature. This legislation was the culmination of four earlier statutes dating back to 1913. The Act provides for the registration of securities offered or sold in Texas and of firms and individuals who sell securities or render investment advice in the state. In certain circumstances a particular security or transaction may be exempt from the registration requirements of the Act. Whether or not an exemption from the registration provisions is available, the Act prohibits fraud in the offer or sale of securities in Texas.

SSB is overseen by a Board composed of five members appointed by the Governor, with the advice and consent of the Senate, for six-year overlapping terms. The Board adopts and periodically updates rules to ensure that investors are adequately protected and that unreasonable burdens on legitimate capital-raising activities are avoided. The Board appoints a Securities Commissioner, who serves at its pleasure, and serves as SSB's chief administrative officer and supervises the day-to-day activities of the staff.

SSB is organized into the following Divisions: Enforcement, Registration, Inspections and Compliance, General Counsel, and Staff Services.

2017 Internal Audit Plan

Following are the internal audits and other functions performed, as identified in SSB's 2017 Internal Audit Plan, that was prepared by SSB's predecessor internal auditor; and, approved by SSB's Board Members on January 24, 2017:

- Enforcement Administration
- Follow-up of Internal Audit Performed in Prior Years
- Other Tasks

This report contains the results of our audit of the Enforcement Administration area; reflects the results of the follow-up performed of the finding that was presented in the prior year annual internal audit report by SSB's predecessor internal auditor; and, meets the State of Texas Internal Audit Annual Report requirements.

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INTERNAL AUDIT OBJECTIVES

In accordance with the **International Standards for the Professional Practice of Internal Auditing**, the audit scope encompassed the examination and evaluation of the adequacy and effectiveness of SSB's system of internal control and the quality of performance in carrying out assigned responsibilities. The audit scope included the following objectives:

- **Reliability and Integrity of Financial and Operational Information** – Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
- **Compliance with Policies, Procedures, Laws, Regulations and Contracts** – Review the systems established to ensure compliance with those policies, procedures, laws, regulations, and contracts which could have a significant impact on operations and reports, and determine whether the organization is in compliance.
- **Safeguarding of Assets** – Review the means of safeguarding assets and, as appropriate, verify the existence of such assets.
- **Effectiveness and Efficiency of Operations and Programs** – Appraise the effectiveness and efficiency with which resources are employed.
- **Achievement of the Organization's Strategic Objectives** – Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

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I. **Compliance with Texas Government Code 2102: Required Posting of Internal Audit Information**

To comply with the provisions of Texas Government Code, 2102.015 and the State Auditor's Office, within 30 days after approval by SSB's Board, SSB will post the following information on its website:

- An approved fiscal year 2018 audit plan, as provided by Texas Government Code, Section 2102.008.
- A fiscal year 2017 internal audit annual report, as required by Texas Government Code, Section 2102.009.

The internal audit annual report includes any weaknesses, deficiencies, wrongdoings, or other concerns raised by internal audits and other functions performed by the internal auditor as well as the summary of the action taken by SSB to address such concerns.

II. **Consulting and Nonaudit Services Completed**

The internal auditor did not perform any consulting services, as defined in the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing* or any non-audit services, as defined in the *Government Auditing Standards*, December 2011 Revision, Sections 3.33-3.58.

III. **External Quality Assurance Review**

The internal audit department's most recent *System Review Report*, dated October 7, 2015, indicates that its system of quality control has been suitably designed and conforms to applicable professional standards in all material respects.

IV. **Internal Audit Plan for Fiscal Year 2017**

The Internal Audit Plan (Plan), prepared by SSB's predecessor internal auditor, included one audit to be performed during the 2017 fiscal year. The Plan also included a follow-up of the finding that was presented in the prior year annual internal audit report, other tasks as assigned by the Board, and preparation of the Annual Internal Audit Report for fiscal year 2017.

Risk Assessment

Following are the results of the risk assessment performed by SSB's predecessor internal auditor, for the 18 potential audit topics that were identified:

| HIGH RISK | MODERATE RISK | LOW RISK |
|------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|
| Personnel Processes Enforcement Administration Information System - Security | Legal Services Accounting & Budgeting Business Continuity Dealer Registration Applications & Processing Securities Registration & Processing Performance Measures Reporting Cash Disbursements, Travel, & Payroll Cash Receipts & Fee Processing Inspection & Compliance Mailroom Services Fixed Asset Services Executive Administration Historically Underutilized Business (HUB) Compliance Information Technology System Development | Open Records Request |

In the prior 3 years, internal audits were performed in the following areas:

Fiscal Year 2016:

- Payroll Processes

Fiscal Year 2015:

- Conducting Inspections

Fiscal Year 2014:

- Processing Cash Receipts and Disbursements

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The internal audits and other tasks performed for fiscal year 2017 were as follows:

| <u>Report No.</u> | <u>Audits/Report Titles</u> | <u>Report Date</u> |
|-------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|
| 1. | Enforcement Administration <i>Objective:</i> To determine whether the Enforcement Administration area applied and complied with established policies and procedures and applicable laws and regulations when conducting inspections. | 4/21/2017 |
| 1. | Annual Internal Audit Report – Follow-Up of Prior Year Internal Audits | 5/12/2017 |
| - | Other Tasks Assigned by the Board | None |

V. Executive Summary

Enforcement Administration Area

Background

The Enforcement Division (the Division) of the Texas State Securities Board (SSB) is responsible for conducting investigations to detect and prevent violations of the Texas Securities Act (the Act), including illegal sales of unregistered nonexempt securities, sales of securities by unregistered dealers, and/or fraud committed in connection with the sale of securities; and, pursuing appropriate administrative, civil, or criminal actions against firms or individuals that violate provisions of the Act.

The Division is comprised of a division director, 6 assistant directors, 9 enforcement attorneys, 7 financial examiners, 5.5 administrative assistants, and 1 legal assistant. The Division operates in the Austin office and 5 branch offices located in Corpus Christi, Dallas, Houston, Lubbock, and San Antonio.

Enforcement Database

The Enforcement Database, also referred to as the TUB, is the internal database used to maintain the Division's files. Only the Division's legal assistant and administrative assistants have full access to the TUB, while all other Division employees have restricted access.

Investigation Suspense (I/S) Files

The Division becomes aware of suspected violations of the Act by performing market surveillance; receiving tips and complaints from the public; and, through referrals from federal and state agencies. An investigation suspense (I/S) file is opened based on the information gathered; and, is assigned to an investigator (attorney or financial examiner), who conducts a pre-investigation to determine the likelihood a violation has occurred and whether a full investigation is required. Information is gathered from multiple sources; including, the Financial Industry Regulatory Authority (FINRA); the Department of Public Safety (DPS); Securities and Exchange Commission's (SEC) Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System; the CLEAR fraud investigation database system; and, SSB's Enforcement and Registration databases.

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If the investigator determines that a violation has not occurred or that the Division does not have jurisdiction, they will prepare a closing memo or complete a Request for File Closing form, which is reviewed and approved by the division director or the assistant director from the Austin office.

As of February 28, 2017, 203 I/S files were opened and 182 I/S files were closed.

Opening an Investigation

The Division typically opens an investigation, or converts an I/S file into an investigation, by completing an Opening Data Sheet (ODS) when an in-depth examination involving the sale of a security is necessary, a probable violation has occurred, it is likely that proof of a violation will result in action, or a subpoena is required to proceed. The division director or the assistant director from the Austin office are responsible for approving or denying the ODS. An investigation can consist of interviewing or obtaining information from the investors, victims, witnesses and suspects; issuing subpoenas; obtaining search warrants; reviewing financial information; etc.

Subpoenas

SSB has the authority to issue a subpoena. An Application for Administrative Subpoena form is completed by the investigator and includes justification for the subpoena, proposed recipient, and documents or testimony sought. The division director or the assistant director from the Austin office are responsible for reviewing and approving the subpoena request form and draft of the subpoena. After approval is obtained, the subpoena is reviewed and signed by the Commissioner or Deputy Commissioner.

As of February 28, 2017, 68 subpoenas were issued.

Closing an Investigation

Once an investigation is completed, it may result in the issuance of a civil or criminal referral, an administrative action, or the closing of the investigation if a violation was not detected. Similar to closing an I/S file, the investigator will complete a Request for File Closing form or prepare a closing memo, which is reviewed and approved by the division director or the assistant director from the Austin office.

As of February 28, 2017, 17 investigations were opened and 56 investigations were closed.

Following are the three types of enforcement actions that may result from an investigation:

1. Administrative Actions – Actions that include cease and desist orders issued to stop ongoing conduct; emergency orders issued against parties engaging in or about to engage in illegal or fraudulent conduct that threatens immediate and irreparable harm to the public; and, agreed orders issued when the individual consents to the order. A memorandum of proof and a draft order is prepared, and reviewed and approved by the division director or the assistant director from the Austin office and the Commissioner or Deputy Commissioner. If an order is contested by the recipient, a hearing is held at the State Office of Administrative Hearings (SOAH). A recommendation is made by SOAH and provided to the Commissioner, who makes the final decision. After the final decision is made, each party has the right to appeal the final order to the Travis County district court.

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As of February 28, 2017, 4 administrative orders were issued, with one that included a \$100,000 administrative fine paid to the General Revenue Fund.

2. Civil Referrals – Referrals designed to obtain an injunction, restitution, or other equity relief. A memorandum of proof or an affidavit describing the underlying unlawful conduct and evidence to prove such is prepared for review and approval first by the division director or the assistant director from the Austin office and then by the Commissioner or Deputy Commissioner. The Commissioner or Deputy Commissioner signs the referral letter that is addressed to the Attorney General and attaches the memorandum of proof or affidavit and exhibits.

As of February 28, 2017, 1 civil referral was issued.

3. Criminal referrals – Referrals designed to obtain a criminal conviction for violations of the penal provisions of the Act, which generally involve fraud. A referral letter, signed by the division director or assistant director, is drafted and outlines the facts and evidence gathered to prove beyond a reasonable doubt that a violation of the Act has occurred. All referrals are reviewed and approved by the division director before being sent to a state or federal prosecutor.

As of February 28, 2017, 6 criminal referrals were issued.

If the investigation results in one of these 3 enforcement actions, the investigator will complete an Enforcement Action Report (EAR) which is sent to the administrative assistant, to update a spreadsheet used for reporting performance measures. The administrative assistant also sends a weekly email to all Division employees with the enforcement actions reported for the respective week.

Audit Objective, Scope, and Methodology

Objective

The objective of our audit was to gain an understanding of the Enforcement Administration area and the processes in place for conducting investigations to determine whether SSB applied and complied with established policies and procedures and applicable laws and regulations.

Scope

The scope of this audit covered the 6-month period from September 1, 2016 through February 28, 2017.

Methodology

The audit methodology included a review of laws and regulations; SSB's established policies and procedures, and other internal and external documentation; and, interviews with SSB personnel.

We obtained and/or reviewed the following information:

- a. Sections of the Texas Securities Act (the Act) and the Texas Administrative Code (TAC) related to the Enforcement Administration area.

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- b. SSB's Enforcement Policy and Procedure Manual and other policies related to the Enforcement Administration area.
- c. Enforcement Division's organizational chart.
- d. A listing of current Enforcement Database users with their respective access.
- e. A listing of investigation suspense files (I/S) and investigations opened and closed during the period from September 1, 2016 through February 28, 2017; and, the supporting documents for the selected items.
- f. A listing of administrative orders, criminal referrals, civil referrals, and subpoenas issued during the period from September 1, 2016 through February 28, 2017; and, supporting documentation for selected items.
- g. A listing of administrative fines collected during the period from September 1, 2016 through February 28, 2017.
- h. Samples of Enforcement Action Reports, Opening Data Sheets, Application for Administrative Subpoena forms, and Request for Closing forms.
- i. Selected weekly "Enforcement Action Reported" reports.

We performed various procedures to achieve the objective of our audit; to include, the following:

- 1. Reviewed and obtained an understanding of the applicable sections of the Act, the TAC, and SSB's policies, procedures, and practices in place related to Enforcement Administration area.
- 2. Conducted interviews with the division director and Deputy Commissioner to document the Division's formal and/or informal processes and controls related to the Enforcement Administration area.
- 3. Obtained a listing of I/S files that were opened and closed during the period from September 1, 2016 through February 28, 2017, and selected 10 of the 203 I/S files opened and 10 of the 182 I/S files closed to ensure the request to open the file was retained, division director approval was obtained to close the file, and information entered in the TUB was accurate.
- 4. Obtained a listing of investigations that were opened and closed during the period from September 1, 2016 through February 28, 2017, and selected 2 of the 17 investigations that were opened and 3 of the 56 investigations that were closed to test for the following attributes:
 - a. Opening Data Sheet was properly completed and approved by the division director.
 - b. An acknowledgement letter was sent to the complainant confirming receipt of compliant, if applicable.

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- c. The Application for Administrative Subpoena was completed and approved by the division director, if a subpoena was issued.
 - d. Subpoena was signed by the Commissioner, if a subpoena was issued.
 - e. Evidence to support violation of the Act.
 - f. Application for Information form was properly completed for CLEAR report requests.
 - g. Request for File Closing form is completed and signed by the division director.
5. Obtained and reviewed a listing of current Enforcement Database users with their respective access to ensure only the authorized users have full access and all others have restricted access.
6. Selected 3 of the 26 weekly "Enforcement Action Reported" reports to ensure the number of I/S files and investigations reported was accurate compared those entered into the Enforcement Database.
7. Obtained a listing of administrative orders and assessed administrative fines issued during the period from September 1, 2016 through February 28, 2017, and selected 1 of the 4 administrative orders issued to ensure compliance with Sections 23, 23-1, and 23-3 of the Act and Chapter 106 of the TAC; an Enforcement Action Report was properly completed; and, the order was properly approved by the Commissioner or Deputy Commissioner.
8. We obtained a listing of criminal and civil referrals issued during the period from September 1, 2016 through February 28, 2017 and selected 1 of the 6 criminal referrals issued and the only civil referral issued to test the following attributes:
 - a. Division director's approval.
 - b. Referral letter signed by the Commissioner or Deputy Commissioner for civil referrals or the director or assistant director for criminal referrals.
 - c. Enforcement Action Report was properly completed.

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VI. Observations/Findings and Recommendations

SUMMARY and RELATED RATING of OBSERVATIONS/FINDINGS and RECOMMENDATIONS

As SSB's internal auditors, we used our professional judgment in rating the audit findings identified in this report. The rating system used was developed by the Texas State Auditor's Office and is based on the degree of risk or effect of the findings in relation to the audit objective(s). The table below presents a summary of the findings in this report and the related rating.

| Summary of Observations/Findings & Recommendations and Related Ratings | | |
|-------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|
| Finding No. | Title | Rating |
| 1 | Criminal Referral Approval | Low |
| Observation No. | Title | Rating |
| 1 | Policies and Procedures | Low |
| | <p style="text-align: center;"><u>Description of Rating</u></p> <p>A finding is rated <i>Priority</i> if the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern and reduce risks to the audited entity.</p> <p>A finding is rated <i>High</i> if the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern and reduce risks to the audited entity.</p> <p>A finding is rated <i>Medium</i> if the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.</p> <p>A finding is rated <i>Low</i> if the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.</p> | |

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OBSERVATIONS/FINDINGS and RECOMMENDATIONS

| Report No. | Report Date | Name of Report | Observations/Findings and Recommendations | Current Status (Fully Implemented, Substantially Implemented, Incomplete/Ongoing, or Not Implemented) with brief description if not yet implemented | Fiscal Impact/Other Impact |
|------------|-------------|----------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------|
| 1 | 4/21/2017 | Enforcement Administration | <p>1. Criminal Referral Approvals</p> <p>The Enforcement Division's policies and procedures state that the division director is responsible for approving all referrals for criminal prosecution. Our testing of 1 criminal referral indicated that the division director's approval was not documented; however, we obtained and reviewed the email, which had the referral as an attachment that was sent to him for his review. We understand from the division director that although all referrals are emailed to him for his review, his approval is not documented.</p> <p>We recommend that the Division comply with the established policies and procedures to ensure the division director not only reviews and approves the referrals but also establishes procedures to document the approval before they are issued.</p> <p>Management's Response</p> <p>The Enforcement Division has implemented procedures to include documentation within each file relating to a referral for criminal prosecution that reflects approval by the division director of the referral before it is issued.</p> <p><u>Observation</u></p> <p>1. Policies and Procedures</p> <p>The Enforcement Division's Policy and Procedures Manual (Manual) has been updated to reflect the Division's current practices and remains in draft form; however, has not been finalized and approved.</p> <p>It is our understanding that the Manual will be finalized in May 2017.</p> <p>Management's Response</p> <p>The Enforcement Division's Policies and Procedures Manual, currently under revision, will be approved in final form in May 2017.</p> | | <p>Ensure compliance with SSB policies and procedures.</p> <p>Ensure SSB policies and procedures are up-to-date and finalized.</p> |

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| Report No. | Report Date | Name of Report | Observations/Findings and Recommendations | Current Status (Fully Implemented, Substantially Implemented, Incomplete/Ongoing, or Not Implemented) with brief description if not yet implemented | Fiscal Impact/Other Impact |
|------------|-------------|----------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------|
| 1 | 5/12/2017 | 2017 Follow-Up | <p>Follow-Up of Prior Year Audits</p> <p>Following is the status of the recommendations made during fiscal year 2016 that had not been fully implemented.</p> <p><u>Personnel Processes</u></p> <ol style="list-style-type: none"> 1. Educational Qualifications Documents <p>Supporting documentation, such as copies of transcripts, or degree(s) should be retained in the personnel files when the Minimum Qualifications of a job posting includes graduation from an accredited four-year college or university.</p> | Fully Implemented | To ensure educational qualifications were verified. |

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VII. External Audit Services Procured in Fiscal Year 2017

SSB procured the internal audit services documented in the approved Internal Audit Plan for fiscal year 2017. No other external audit services were performed.

VIII. Reporting Suspected Fraud and Abuse

SSB has provided information on their website home page on how to report suspected fraud, waste, and abuse to the State Auditor's Office (SAO) by posting a link to the SAO's fraud hotline. SSB has also developed a Fraud Prevention Policy that provides information on how to report suspected fraud, waste, and abuse to the SAO.

IX. Proposed Internal Audit Plan for Fiscal Year 2018

The risk assessment performed during the 2017 fiscal year was used to identify the following *proposed* area that is recommended for internal audit and other tasks to be performed for fiscal year 2018; however, the area to be audited may change based on the results of the risk assessment that will be performed by the current internal auditor for fiscal year 2018. The Internal Audit Plan for Fiscal Year 2018 will be developed and presented to the Audit Committee and/or Board, for acceptance and approval, at a meeting to be determined at a later date.

- Information Technology – Security
- Follow-up of Prior Year Internal Audits
- Other Tasks Assigned by the Board

X. Organizational Chart

