



VIRGINIA RETIREMENT SYSTEM

REPORT ON AUDIT FOR THE YEAR ENDED JUNE 30, 2016

Auditor of Public Accounts
Martha S. Mavredes, CPA

www.apa.virginia.gov

(804) 225-3350



AUDIT SUMMARY

Our audit of the Virginia Retirement System (System) for the year ended June 30, 2016, found:

- the financial statements are presented fairly, in all material respects;
- an internal control finding requiring management's attention; however, we do not consider it to be a material weaknesses; and
- no instances of noncompliance or other matters required to be reported under Government Auditing Standards.

We have audited the basic financial statements of the System as of and for the year ended June 30, 2016, and issued our report thereon, dated December 15, 2016. Our report, included in the System's Annual Report, is available at the Auditor of Public Accounts' website at www.apa.virginia.gov and at the System's website at www.varetire.org.

RETIREMENT SYSTEM EMPLOYER SCHEDULES

The Commonwealth and its localities were required to implement Governmental Accounting Standards Board Statement No. 68, which covers accounting and reporting of pension activity by employers, beginning in fiscal year 2015. Therefore, in addition to our audit of the System's financial statements, we were also required to audit information prepared by the System for all of the participating employers. In September 2016, the System provided the actuarial valuation reports, schedules of the applicable pension amounts, footnote disclosure information, and other financial reporting guidance to the participating state and local government employers for their fiscal year 2016 financial statements. Likewise, our Office published the reports that included our audit opinions over the plan schedules and applicable pension amounts for the state employee, teachers, and political subdivision retirement plans. All of this information is available on the [New Pension Standards](#) section of our website.

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INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Improve Reporting of Cash and Investments – Partial Repeat

The Virginia Retirement System (System) Investment Accounting Division (Division) has not fully implemented corrective action to ensure it has an adequate process in place for accurately reporting cash and investment financial information to the Department of Accounts (Accounts) and in its own financial statements and footnotes.

Accounts relies on the accuracy of the System submissions of attachments and supplemental items as required by the Office of the Comptroller Directive No. 1-16 to incorporate the System's financial information into the Virginia Comprehensive Annual Financial Report (VA CAFR). The System is required to report its cash and investments activity in a standardized format as prescribed by Accounts in Attachment 23 – Schedule of Cash, Cash Equivalents, and Investments as of June 30 (Attachment 23). The System is also responsible for fairly presenting its basic financial statements, including the completeness, accuracy, and proper classification of footnote disclosures.

The System's cash and investment activity is significant and inaccurate reporting can result in lack of compliance with applicable Governmental Accounting Standards Board (GASB) standards, material misstatements, and material misclassifications. Resubmissions of attachments with material errors also slows progress in Accounts' compilation of the information and jeopardizes the timeliness of the preparation of the VA CAFR. Review of the fiscal year 2016 Attachment 23 identified multiple material misclassifications, resulting in six communications from the Division to Accounts spanning September to early December 2016 to provide the appropriate corrections. The misclassifications primarily involved inaccurate categorizations of assets in investment types, incomplete amounts of securities highly sensitive to interest rate changes, improper classification of time segments used in interest rate risk disclosures, incomplete credit ratings, and improper inclusion of assets measured at cost in the fair value hierarchy. Two misclassifications resulted in adjustments to the System's Statement of Fiduciary Net Position and several misclassifications resulted in adjustments to the System's footnote disclosures.

The System, by the nature of its operations, has an extensive portfolio that consists of numerous investment types that require special consideration for financial reporting for both the System's Comprehensive Annual Financial Report (VRS CAFR) and the VA CAFR. Investment types and duration methodology for the VRS CAFR do not mirror those of the VA CAFR. During the preparation of Attachment 23, the Division did not sufficiently communicate with Accounts about the differences in investment types and duration methodology between the VRS CAFR and VA CAFR in order to identify the most appropriate and consistent approach for completing Attachment 23. Prior to submission of Attachment 23 and compilation of the VRS CAFR, the Division did not apply a review process that was sufficient to identify and correct material misclassifications.

Since the prior year, the Division has worked on improvements to the Attachment 23 preparation process by establishing written procedures. To further improve the process, the System should communicate with Accounts to be proactive in identifying and resolving differences in investment types and duration methodology between the VRS CAFR and VA CAFR prior to submitting Attachment 23. The System should also develop and utilize a more detailed review process to analyze the completeness and accuracy of investment information prior to submission of Attachment 23 and compilation of the VRS CAFR.



Martha S. Mavredes, CPA
Auditor of Public Accounts

Commonwealth of Virginia

Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 15, 2016

The Honorable Terence R. McAuliffe
Governor of Virginia

The Honorable Robert D. Orrock, Sr.
Chairman, Joint Legislative Audit
And Review Commission

Board of Trustees
Virginia Retirement System

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS

We have audited in accordance with the 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, the financial statements of the **Virginia Retirement System** as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the Virginia Retirement System's basic financial statements, and have issued our report thereon dated December 15, 2016.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the System's internal control over financial reporting to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the System's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. We did identify a deficiency in internal control over financial reporting entitled “Improve Reporting of Cash and Investments,” which is described in the section titled “Internal Control Findings and Recommendations,” that we consider to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the System’s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

The System’s Response to Findings

We discussed this report with management as we completed our work. The System’s response to the findings identified in our audit is described in the accompanying section titled “Agency Response.” The System’s response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Status of Prior Findings

The System has begun but not completed adequate corrective action with respect to the previously reported finding “Improve Process for Reporting Investments to the Comptroller.” Accordingly, we included a finding titled “Improve Reporting of Cash and Investments” in the section entitled “Internal Control Findings and Recommendations.”

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with Government Audit Standards in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

AUDITOR OF PUBLIC ACCOUNTS

ZLB/clj




Virginia
Retirement
System

1200 East Main Street
P.O. Box 2500
Richmond, VA 23218-2500
Toll-free: 1-888-VARETIR (827-3847)
Website: www.varetire.org
Email: vrs@varetire.org
Fax: 804-786-1541

Patricia S. Bishop
Director

MEMORANDUM

TO: Martha S. Mavredes
Auditor of Public Accounts

FROM: Patricia S. Bishop 
Director

DATE: January 12, 2017

SUBJECT: Response to APA's - VRS Report on Audit for the Year Ended June 30, 2016

INTERNAL CONTROL FINDING AND RECOMMENDATION

Improve Reporting of Cash and Investments – Partial Repeat

VRS Response:

VRS understands the significance of its investment portfolio and the negative impact of changes made to Attachment 23 once it has been submitted. As noted above, VRS implemented a number of changes to improve the timeliness and quality of all of our CAFR preparation work and especially the information provided to the Department of Accounts.

During the development of the information for the FY 2016 Attachment 23 submission there were several changes made that impacted the data in the submissions. These changes resulted in inconsistency in the categorization of some unique assets as compared to prior years and necessitated changes in the categorization of some assets. While the value of these assets was not impacted, the classification and perceived risk associated with those assets was.

In addition, VRS staff modified the process for assigning maturities to certain fixed income securities based on prior discussions with APA and the Department of Accounts. Upon further review, the changes that were implemented did not adequately account for variations between the actual maturity and the expected duration.

VRS is committed to producing timely and quality information for the Commonwealth's CAFR as well as for the VRS CAFR. Our efforts of continuous improvement will begin immediately. We will be reviewing each of the comments and questions raised by the auditor and developing additional documentation of the processes used for each of those items. We will also be reviewing the categorization of the entire investment portfolio with the Investment Division's Compliance

Department. This will allow staff conducting financial reporting activities to improve its understanding of the nature of each of the investments and better determine whether any special accounting treatment may be required for financial reporting. We will apply resources to provide additional review of submissions. For those areas where the reporting by VRS appears to be inconsistent with current guidance from DOA, we will reach out to DOA for additional clarification and guidance to reduce these differences to the extent possible.

While the adjustments provided by VRS to DOA were generally necessary for a proper recording of the VRS investment in the Commonwealth's CAFR, the number of corrected submissions was driven in part by the pace, timing, and extended length of the audit work in the investment area. VRS made attempts to respond in a timely manner and keep the DOA staff informed as items were identified rather than waiting for the completion of the audit work to submit the changes.

Summary:

We remain committed to improving the overall process, including but not limited to, outreach to both DOA and APA regarding timeliness, expectations and enhanced internal review and oversight. We appreciate the efforts of the APA staff in working through this complex area with VRS.

If you have any questions concerning the above items, please call me at 771-7332.

cc: VRS Board of Trustees

VIRGINIA RETIREMENT SYSTEM

As of June 30, 2016

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