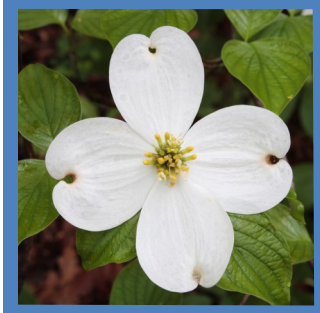

VIRGINIA RETIREMENT SYSTEM

REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2015

Auditor of Public Accounts
Martha S. Mavredes, CPA
www.apa.virginia.gov
(804) 225-3350

AUDIT SUMMARY

Our audit of the Virginia Retirement System (Retirement System) for the year ended June 30, 2015, 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 Retirement System as of and for the year ended June 30, 2015, and issued our report thereon, dated December 15, 2015. Our report, included in the Retirement System's Annual Report, is available at the Auditor of Public Accounts' website at www.apa.virginia.gov and at the Retirement 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 Retirement System's financial statements, we were also required to audit information prepared by the Retirement System for all of the participating employers. In October 2015, the Virginia Retirement 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 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 Resources section of our website.

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INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Improve Process for Reporting Investments to the Comptroller

The Virginia Retirement System's (Retirement System) process for preparing and submitting investment related financial information as required by the Department of Accounts (Accounts) within the Comptroller's Directive, specifically the submissions collectively referenced as Attachment 24, did not operate effectively. The collective attachments include required information as established by pronouncements set by the Governmental Accounting Standards Board (GASB) that are necessary for financial reporting for investment related information. The Comptroller's Directives establish compliance guidelines for state agencies and address reporting requirements that are necessary for agencies to provide information to Accounts for the preparation of the Comprehensive Annual Financial Report (CAFR) as required by the Code of Virginia. Accounts requires the Retirement System to submit information as prescribed in the Comptroller's Directives and individuals preparing and reviewing the submissions are required to certify the accuracy of the information provided to Accounts.

The Retirement System did not submit the attachments by the established deadlines. Further, the Retirement System did not conduct thorough reviews sufficient enough to ensure some of the classifications in the submissions were complete and materially accurate. While the total dollar values provided to Accounts were accurate, the Retirement System did not identify several material misclassifications prior to submitting the information to Accounts, which resulted in several resubmissions. Untimely submissions and correcting resubmissions increase the risk that the Commonwealth might fail to produce its audited CAFR by the deadline mandated in the Code of Virginia.

The misclassifications found were primarily a result of a lack of thorough review during compilation of Attachment 24 submissions and minimal detailed written procedures. The Investment Accounting Division originally submitted parts of Attachment 24 without an authorized reviewer's signature.

The Retirement System should implement a review process that ensures the Investment Accounting Division submits accurate and timely investment information to Accounts for the preparation of the Retirement System and Commonwealth's CAFR footnotes and schedules. The individuals preparing and certifying the attachment submissions should ensure that they have read and understand the instructions for the attachments. Additionally, the Retirement System should establish and adhere to written policies and procedures that detail preparation of Attachment 24 items.

Commonwealth of Virginia

Auditor of Public Accounts

Martha S. Mavredes, CPA
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 15, 2015

The Honorable Terence R. McAuliffe
Governor of Virginia

The Honorable Robert D. Orrock, Sr.
Vice-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, 2015, 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, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Retirement 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 Retirement System's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Retirement 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 Process for Reporting Investments to the Comptroller," 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 Retirement 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 Retirement System's Response to Findings

We discussed this report with management as we completed our work. The Retirement System's response to the findings identified in our audit is described in the accompanying section titled "Agency Response." The Retirement 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 Virginia Retirement System has taken adequate corrective action with respect to audit findings reported in the prior year.

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: February 5, 2016

SUBJECT: Response to APA's - VRS Report on Audit for the Year Ended June 30, 2015

INTERNAL CONTROL FINDING AND RECOMMENDATION

Improve Process for Reporting Investments to the Comptroller

The Virginia Retirement System's (Retirement System) process for preparing and submitting investment related financial information as required by the Department of Accounts (Accounts), within the Comptroller's Directive, specifically the submissions collectively referenced as Attachment 24, did not operate effectively. The collective attachments include required information as established by pronouncements set by the Governmental Accounting Standards Board (GASB) that are necessary for financial reporting for investment related information. The Comptroller's Directives establish compliance guidelines for state agencies and address reporting requirements that are necessary for agencies to provide to Accounts for the preparation of the Comprehensive Annual Financial Report (CAFR) as required by the Code of Virginia. Accounts requires the Retirement System to submit information as prescribed in the Comptroller's Directives and individuals preparing and reviewing the submissions are required to certify the accuracy of the information provided to Accounts.

The Retirement System did not submit these attachments by the established deadlines. Further, the Retirement System did not conduct thorough reviews sufficient enough to ensure some of the classifications in the submissions were complete and materially accurate. While the total dollar values provided to Accounts were accurate, the Retirement System did not identify several material misclassifications prior to submitting the information to Accounts, which resulted in several resubmissions. Untimely submissions and correcting resubmissions increase the risk that the Commonwealth might fail to produce its audited CAFR by the deadline mandated in the Code of Virginia.

The misclassifications found were primarily a result of a lack of thorough review during compilation of the Attachment 24 submissions and minimal detailed written procedures. The Investment Accounting Division originally submitted parts of the Attachment 24 without an authorized reviewer's signature.

The Retirement System should implement a review process that ensures the Investment Accounting Division submits accurate and timely investment information to Accounts for the preparation of the Retirement System and Commonwealth's CAFR footnotes and schedules. The individuals preparing and certifying the attachment submissions should ensure that they have read and understand the instructions for the attachments. Additionally, the Retirement System should establish and adhere to written policies and procedures that detail preparation of Attachment 24 items.

VRS Response:

The Virginia Retirement System (VRS) recognizes the underlying need for accurate and timely information for both VRS and the Department of Accounts to complete the preparation of the Comprehensive Annual Financial Report (CAFR). The VRS also acknowledges that there were issues related to portions of the Attachment 24 submissions. However, in this case, it is important to provide some context and perspective for the changes that were made. VRS has over 15,000 different investment positions. Each of these must be analyzed for inclusion at a summary level in Attachment 24. During the course of completing the work for the FY 2015 CAFR, APA identified areas where the data presented in Attachment 24 was incorrect. These were primarily in the schedule of Foreign Currency Investments and the schedule containing fixed income securities. In each of these schedules, the totals of the information included was correct and had been reconciled to the accounting records, but the presentations were determined to be incorrect because they were inconsistent with the method employed by DOA or the categorization could have been improved.

The items in the Foreign Currency Investment schedule related to classification of the assets. There were several items in the Real Assets FX Overlay accounts that were related to common and preferred stocks. Because the VRS Equity Department oversees these accounts and they were invested in foreign equities, they were recorded as equities. After discussions with APA staff, APA communicated its position that since the foreign currency exposure was related to the Real Assets account, it should be classified as Real Assets rather than Equities. As a result, VRS submitted an updated Attachment 24 to reflect the suggested changes. While the presentation could have been made either way, VRS understands the points raised by APA staff and will incorporate that basis for presentations in our updated procedures for preparing Attachment 24.

The Government Accounting Standards Board Statement No. 40 *Deposit and Investment Risk Disclosures* requires (among other things) the disclosure of interest rate risk information for fixed income securities. There are several methods that can be used for this disclosure, including segmented time distribution and effective duration. The Department of Accounts elected to use the segmented time distribution method for the Commonwealth's CAFR and VRS elected to use

the effective duration method for the VRS CAFR. The effective duration model more closely portrays how larger investing agencies of the Commonwealth manage their investment risk because they are not, on the whole, holding debt securities to maturity as the segmented time distribution model implies. The data received from the master custodian, BNY Mellon, includes clear information on the duration, but does not have the segmented time distribution data easily available on all of the securities. VRS has to import the BNY Mellon data and translate the data to develop the segmented time distribution information. This introduces an extra layer of complexity and increases the possibility of error when the calculations are performed. During the audit, it was determined that a formula error in the debt securities worksheet caused a few securities to have the incorrect time to maturity. This resulted in incorrect groupings in the segment time distribution data in the Attachment 24 submission and resulted in resubmission of the data. An additional review will be incorporated in the processes used to produce the segmented time distribution information to ensure that the data included in Attachment 24 is accurate.

VRS will review all of its procedures related to the preparation of the financial and other information for the VRS CAFR and those that relate to the attachments and other submissions required by the Department of Accounts, including the information in Attachment 24. VRS will also evaluate the need for additional and/or modified data from BNY Mellon to support the preparation process and whether additional reconciliations and reviews might be appropriate. In addition to these data quality efforts, we will also ensure that the submissions to DOA, including Attachment 24, have the required approvals documented and are submitted in accordance with the schedule established by DOA.

Summary:

We appreciate the thoroughness and competence of the review of our financial operations. We are confident that your suggestions will assist us in continuing to maintain a financial reporting process that complies with Commonwealth policies and standards, supports the Department of Accounts in their statement preparation and reflects best practices.

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

cc: VRS Board of Trustees

AGENCY OFFICIALS

Virginia Retirement System

BOARD MEMBERS
As of June 30, 2015

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Chairman

Diana F. Cantor
Vice Chairman

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Wallace G. "Bo" Harris, Ph.D.
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William H. Leighty
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Patricia S. Bishop
Director