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**Management Review:
Virginia Supplemental Retirement System**

October 10, 1978

Joint Legislative Audit and Review Commission

Preface

The Joint Legislative Audit and Review Commission has been assigned statutory responsibility to carry out operational and performance reviews of State agencies and programs. Section 30-60, Code of Virginia, also provides that JLARC staff may assist the Auditor of Public Accounts in the completion of special reports. This report on the Virginia Supplemental Retirement System (VSRS) was initiated under §30-60.

In early 1978, the Auditor of Public Accounts discovered the fraudulent disbursement of trust funds from the retirement system. In view of several apparent deficiencies in VSRS administration, the Commission was asked to authorize a comprehensive management review. At the request of Governor John N. Dalton, staff assistance was also added from the Department of Management Analysis and Systems Development.

The Virginia Supplemental Retirement System is one of the largest public pension systems in the country. VSRS has more than 235,000 members and annuitants. Financial assets exceed \$1.3 billion. Employees of 385 different jurisdictions participate in VSRS membership. In view of this scope, VSRS should have the highest levels of management performance and accountability.

Management of VSRS has been substantially modernized in recent years, especially because of priorities assigned by the Board of Trustees to investments and member services. Improvements in physical facilities, staffing, and automated data processing have also been accomplished. Most importantly, retirement funding appears to be actuarially sound.

Some management areas have not received adequate attention. Recommendations intended to address each of those areas are contained in the report summary. It should be noted that the Joint Legislative Audit and Review Commission endorsed the recommendations on October 10, 1978 and transmitted them to the Governor and Board of Trustees of the retirement system. The Board of Trustees has been asked to report on steps taken to implement each recommendation by December 12, 1978.

On behalf of the Commission staff, I wish to acknowledge the cooperation and assistance provided by the Board and staff of the Virginia Supplemental Retirement System, the Auditor of Public Accounts, and the Department of Management Analysis and Systems Development during this review.



Ray D. Pethtel
Director

October 10, 1978

Report Summary

Management Review: Virginia Supplemental Retirement System

The early 1970's was a critical period for the Virginia Supplemental Retirement System (VSRS). The Board and executive staff were under heavy pressure to reduce delays in processing member refunds and to expedite routine paperwork. Investment management lacked professional expertise and was guided by outmoded investment policies. VSRS was understaffed and poorly equipped.

In response, the VSRS Board and Director took commendable steps to:

- overhaul the management of investments by adopting new policies and utilizing experienced professionals;
- introduce automated data processing equipment and systems to expedite member refunds and improve services;
- inform members about their benefits;
- improve working conditions by upgrading the physical plant and adding staff; and
- establish formal Board positions on pending legislation and retirement proposals.

Some important management functions have not received adequate attention either from the Board or from the Director.

GENERAL ADMINISTRATION

1. *Financial Practices.* Financial practices are poor. Generally accepted accounting requirements have not been met. Financial controls have been weak. Financial records and reports are deficient.

Recommendation: The Board, in conjunction with the Auditor of Public Accounts, should ensure that VSRS records are properly maintained and audited annually. Legislation should be introduced to require an audit be completed no later than December of each year. Financial statements must be based on audited information and provide a full and fair reflection of the VSRS financial condition. A complete set of financial statements should be included in the annual report.

2. *Financial Leadership.* VSRS does not have adequate financial management expertise. The Director had no experience in managing a large, financial organization when he was employed in 1973. Neither the Director nor the Board took decisive action to request necessary expertise

in financial management until 1977. Most day-to-day management supervision has been provided by data processing specialists. A mid-level accountant was responsible for all accounting practices and preparation of financial records prior to September, 1977.

VSRS has not yet shown evidence of the strong financial leadership essential in a \$1.3 billion enterprise. There is a potential conflict in responsibility between the Financial Manager position and a recently authorized Internal Auditor position.

Recommendation: An experienced, innovative chief financial officer should be hired, and the Board should become more involved in oversight of financial management. The audit subcommittee of the Board should request and receive periodic briefings from the Director, chief financial officer, and Internal Auditor. Regular tests should be made of accounting and control systems.

The Board should be increased from seven to nine members. The Comptroller should be an ex officio member of the Board. A nine-member board would provide the opportunity for representation from existing member interest groups, and an appropriate mix of expertise in investments, insurance, and financial management.

The Board should affirm that the chief financial officer (Financial Manager) has primary authority over financial affairs. The duties of the Internal Auditor should be clarified. He should be given responsibility for carrying out field audits of participating localities, and testing financial controls.

3. *Planning and Reporting.* The lack of comprehensive management planning at VSRS was first noted in a consultant study in 1971. With the exception of investment management, administrative and board-level planning has been informal and incomplete. VSRS does not have a documented organizational plan based on approved goals and objectives.

There are reporting deficiencies at two levels. First, functional reporting from operating divisions to the Director is not adequate to identify problems and trigger corrective actions. Second, VSRS staff is not systematically reporting to the Board on accomplishment of defined objectives.

Recommendation: VSRS needs to strengthen its planning process. (1) VSRS should prepare an organizational plan which documents the responsibility of each functional division; describes relationships between divisions; and establishes the number, type and qualifications of necessary personnel. (2) The administrative staff should develop exception reports to focus supervisory attention on chronic problems. (3) The Director should develop a management reporting system that includes routine information on accomplishment of organizational objectives and priorities. (4) The Board should accept greater responsibility for management planning.

The Board should require that the Director prepare an annual management plan. The plan should specify annual objectives, priorities,

strategies and performance measures; it should report on previous year's accomplishments. Approval of the annual plan by the Board would constitute a formal statement of management objectives that is not currently available. The management plan would also provide a systematic agenda for evaluating the Director's performance.

4. *Personnel Administration.* Personnel administration is carried out in a haphazard fashion. Only one job description in five is accurate. Nearly every work station lacks written task procedures. Personnel evaluations are mechanical and not useful in identifying persons with supervisory potential because almost all employees receive the highest ratings.

The work required of individuals in some jobs requires a different or higher level of skill, or entails more responsibility than is reflected in job classifications. The position of Special Services Assistant to the Director does not require a full-time employee.

Recommendation: VSRS should overhaul its personnel administration processes. Job descriptions should be prepared for each position. Written procedures which document the specific tasks involved at each work station should be prepared. Meaningful evaluations should be given to rate employees fairly and to help identify individuals with supervisory potential.

Two job classes (involving nine incumbents) should be reclassified. Three clerks in the Benefit Programs section should be reclassified as Retirement Analysts, and six clerks in the payroll, refund and social security sections should be reclassified as Fiscal Technicians. The position of Special Services Assistant to the Director should be eliminated at the earliest opportunity.

5. *Member Records.* Important member records are not adequately maintained. Some VSRS-1 forms have been misfiled or lost. A spot check of the files disclosed missing forms, duplicate forms, and uncorrected errors. There is no back-up to the beneficiary information contained on the VSRS-1. Some member information on computer files is erroneous, and there is no routine effort made to purge member records. Access to retirement files is not controlled.

Recommendation: The VSRS-1 files and member computerized records should be purged and corrected. Access to the file room and retirement files should be controlled. VSRS should develop back-up for the VSRS-1, either by microfiche or by duplicate form stored in another location. The file room should be made fireproof or fire resistant.

6. *ADP System Design.* The initial implementation of an ADP system between 1970 and 1973 was a failure in many respects. The effort was crippled by a lack of communication between VSRS and the Department of Automated Data Processing (now MASD), and a resulting lack of planning and design. Of greatest concern is the lack of an integrated general accounting system.

VSRS is presently redesigning its ADP accounting system with the aid of a consultant. The contract funds have been exhausted but the contractor has agreed to complete the job at no additional cost. A system concept has been developed but a detailed design has not been completed. The project is far behind schedule. It is not clear that weaknesses in the existing system will be corrected.

Recommendation: VSRS must ensure that a workable and appropriate ADP system is designed and installed. The consultant and VSRS have not established specific products to be delivered. Both VSRS and the consultant must agree on a satisfactory design plan and schedule and see that it is met. The Comptroller, Auditor of Public Accounts, and MASD should participate in the review of the design to ensure that it meets all State requirements.

RELATIONS WITH EMPLOYERS AND MEMBERS

7. *Training Employer Contacts.* The present methods of training and assisting employer contacts are inadequate. Presently, VSRS relies on a series of half-day seminars to train contacts. Twenty of 24 contacts interviewed by JLARC questioned their own effectiveness because of poor training or lack of current information. Two agency contacts interviewed had not been trained. The emphasis on seminars as the primary training vehicle does not appear to be effective.

There are two principal weaknesses in the present program. First, VSRS does not have clearly defined procedures for some important areas. Requests for assistance in these areas have been answered by conflicting or inconsistent advice from VSRS personnel. Second, the operations guide and the booklets provided by VSRS to complement the seminars are incomplete and not regularly updated. Twelve of the 24 agency contacts had not received a guide, and every agency contact who had a guide, reported it was of little value to them.

Recommendation: VSRS should place primary emphasis on preparing, distributing, and maintaining a comprehensive procedures manual. The manual should be loose-leaf for easy updating and have an index. Posting instructions should accompany all notices or changes in procedures.

The training seminars should be eliminated or substantially reduced in number. The personnel and budget resources saved should be used for designing the comprehensive manual, providing intensive individual training for new agency contacts, and troubleshooting.

8. *Publications.* VSRS publications are helpful but they may not be adequately distributed. Almost a third of the membership indicate that they have not received a member handbook. These individuals are less knowledgeable about their benefits and responsibilities under VSRS than those members who have a handbook. Agency contacts indicate that handbooks are often out-of-print.

Recommendation: VSRS needs to review methods of handbook distribution. Handbooks should be printed in adequate supply and revised when major benefits or procedural changes are made. One procedure might be to mail handbooks to new members and distribute revised books through agency contacts. Since agency distribution is the primary information channel, agency contact responsibility needs to be emphasized.

9. *Counseling Services.* The responsibility for providing counseling services is assigned to two different sections. Most member requests are limited to routine benefit estimates. The counselor in the Field Services section is required to perform some routine clerical duties and does not fully utilize her professional counseling skills.

VSRS staff may not be adequately prepared to deal with "walk-in" or telephone requests. JLARC staff observed one case in which a retired member personally visited the VSRS office to ask for a direct deposit of checks to his bank account. The clerk who handled the request told the member to go home and submit the request by letter. The procedure could have been handled by completion of a routine, standard VSRS form.

Recommendation: All requests for benefit estimates, and other routine assistance for members who call or visit VSRS, should be assigned to trained clerks in the Benefit Program section. The Field Services counselor should be assigned to develop comprehensive counseling and informational programs, address special cases, and support training for employer contacts.

10. *Blue Cross Deductions.* VSRS can be of greater assistance to retired members who want to have payments for Blue Cross/Blue Shield insurance deducted from their annuity checks. Presently, a long delay in initiating the automatic deduction process can result in lapse of coverage, or the need for a large advance payment to continue coverage. For several years, the State Office of Employment Relations and Blue Cross of Virginia have been attempting to simplify and accelerate the process of completing the transaction.

VSRS has indicated that Blue Cross and the State Office of Employment Relations are responsible for developing alternative procedures. However, VSRS is clearly involved in the matter because one of the services offered to retired VSRS members is automatic deduction of health insurance premiums.

Recommendation: VSRS should take a lead role in discussing the deduction procedures with Blue Cross and the State. VSRS should make any reasonable adjustments necessary in its operations to help simplify procedures.

BOARD OVERSIGHT OF ACTUARIAL ADVICE AND INVESTMENT MANAGEMENT

11. *Actuarial Advice.* There has not been sufficient communication between the Board and actuary. The Board has not been kept informed well in advance about changes in funding requirements. Actuarial information has not been clearly communicated to the General Assembly, Governor, or VSRS members.

Recommendation: Communication between the Board and the actuary needs to be increased. A policy should be established setting a minimum number of meetings each year. The Board should insist that the actuary present understandable information. The actuary should be held strictly accountable for accurate and timely forecasts, cost projections, and measures of fund soundness. The actuary should communicate to the Board those pending funding and benefit concerns which result from his professional assessments and judgements, as well as the results of formal studies required by legislation.

12. *Investment Oversight.* Investment policies and oversight are well developed. The Board has been especially active in investment management. Policies are appropriate, reasonable, and supported by analysis. The detailed performance measurement and candid advice received from the Investment Officer is particularly noteworthy.

Recommendation: The Investment Officer has often been referred to as a "consultant", or "part-time" staff employee. The vital role played by the Investment Officer makes it necessary that the Board be prepared with procedures to replace him should he choose to resign or retire from VSRS. Consideration should be given to acquiring additional investment advice by use of an investment advisory committee. New approaches to investment management, such as indexing of stocks, should be constantly monitored.

LEGISLATIVE OVERSIGHT

13. *Legislative Retirement Commission.* The General Assembly is acutely aware of its responsibility regarding state contributions and member benefits. There has been some form of organized legislative oversight of VSRS since the early 1970's. Eleven states have made legislative oversight of public pension systems a function of a permanent legislative commission.

Recommendation: The General Assembly should consider establishing a permanent legislative commission on VSRS to provide focus and continuity to the oversight function.

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I. Virginia Supplemental Retirement System

The Virginia Supplemental Retirement System (VSRS) is one of the largest public pension systems in the country. Its membership consists of more than 235,000 active and retired members. Its financial assets exceed \$1.3 billion. VSRS is a consolidated retirement system which provides benefits to nearly all State and local public employees, including teachers, and encompasses the distinctive pension plans that have been legislated for the State Police and the Judiciary.

The VSRS administration has been hallmarked by a number of events that occurred during this decade. In the early 1970's, two studies recommended that VSRS undergo major organizational and operational changes. Following a period of turnover in the Board of Trustees and the selection of a new Director, management of investments was overhauled, delays in processing applications for refunds were reduced, and record keeping activities were automated. Member services were supplemented by periodic newsletters for both active contributors and retirees. A new administrative headquarters building was acquired and additional staff were authorized.

Not all aspects of VSRS management have progressed at the same pace. In contrast to the Board's consistent involvement in investment management, there has been scant attention to financial management, including personnel, accounting controls, and information and reporting. And although member services and records maintenance have been upgraded, these activities continue to suffer from deficiencies.

The imbalance in management priorities became evident in February 1978, when the Auditor of Public Accounts discovered fraudulent payments of more than \$110,000 from system funds. At that time the Joint Legislative Audit and Review Commission was asked to make a thorough management review of VSRS in accordance with §30-60, *Code of Virginia*.

Scope and Objectives of the JLARC Review

In order to complement the financial audit being carried out by the Auditor of Public Accounts and to provide a comprehensive analysis of VSRS, a management review was structured to:

- review the policy formation and oversight activities of the VSRS Board of Trustees;
- assess the internal management of VSRS for personnel, data processing, and related activities;

- evaluate the effectiveness of services provided to active members and retirees; and
- assist the Auditor where appropriate in investigating possible fraud and abuse.

The findings and analysis contained in this report are based on interviews with past and present Board members, VSRS staff, and 24 employers who participate in VSRS. In addition, an analysis was made of Board minutes, job descriptions, internal procedures, financial records, and correspondence files. Two questionnaires were mailed to scientifically selected, representative samples of 527 active and 242 retired members.

The report consists of four chapters. The balance of this chapter reviews the growth of VSRS, its administrative organization, and information about retirement funding. Chapter II deals with financial management, planning and reporting, personnel, and records maintenance. Chapter III covers the Board's policy development and oversight in two vital areas--investment management and actuarial practices. Chapter IV concludes the report with a review of member services and communications between VSRS and its membership.

History and Growth of VSRS

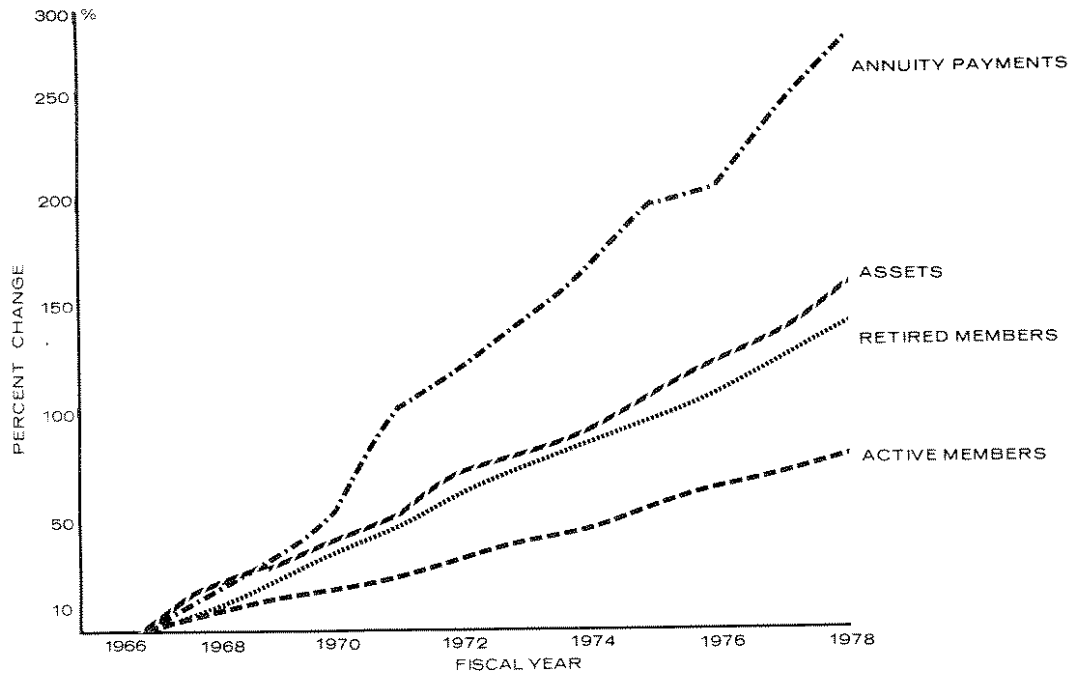
The first public pension system in Virginia was established in 1908 for public school teachers. In 1942 the Virginia Retirement System replaced the teachers' system and included teachers, administrative school employees and most State employees. A few years later the system was expanded to include employees of cities, counties, and other political subdivisions.

In 1950 public employees became eligible to participate in the federal Social Security program, and because State benefits were seen as a supplement to Social Security, the General Assembly reconstituted the pension plan as the Virginia Supplemental Retirement System. To date, however, there is little integration between VSRS benefits and social security. The supplementary nature of VSRS, and the degree to which benefits should be integrated, remain continuing concerns.

VSRS has grown steadily in members, annuitants, and assets (Figure 1). Active membership grew at an annual rate of about seven percent. The number of retirees grew even faster from less than 300 in 1952 to 30,000 by 1978. Financial assets increased from \$51 million in 1952 to \$638 million in 1971, and then doubled in seven years to \$1.3 billion, making VSRS one of the largest financial institutions in the State.

The growth in membership and assets has been accompanied by an expansion of VSRS staff. In 1952, there were 16 employees whose principal task was to keep member records. VSRS is now authorized 66 positions to carry out expanded administrative, clerical, and service functions.

Figure 1
GROWTH OF VSRS
FY 1966-1978



Source: VSRS Annual Reports and VSRS Staff.

Scope of VSRS

VSRS is considered a consolidated pension system because it covers many different groups of public employees in Virginia (Figure 2). Persons eligible for membership include employees of State and local government, teachers, administrative school employees, and employees of many public authorities. In contrast, some states have many different public employee retirement plans. Illinois, for example, has over 450.

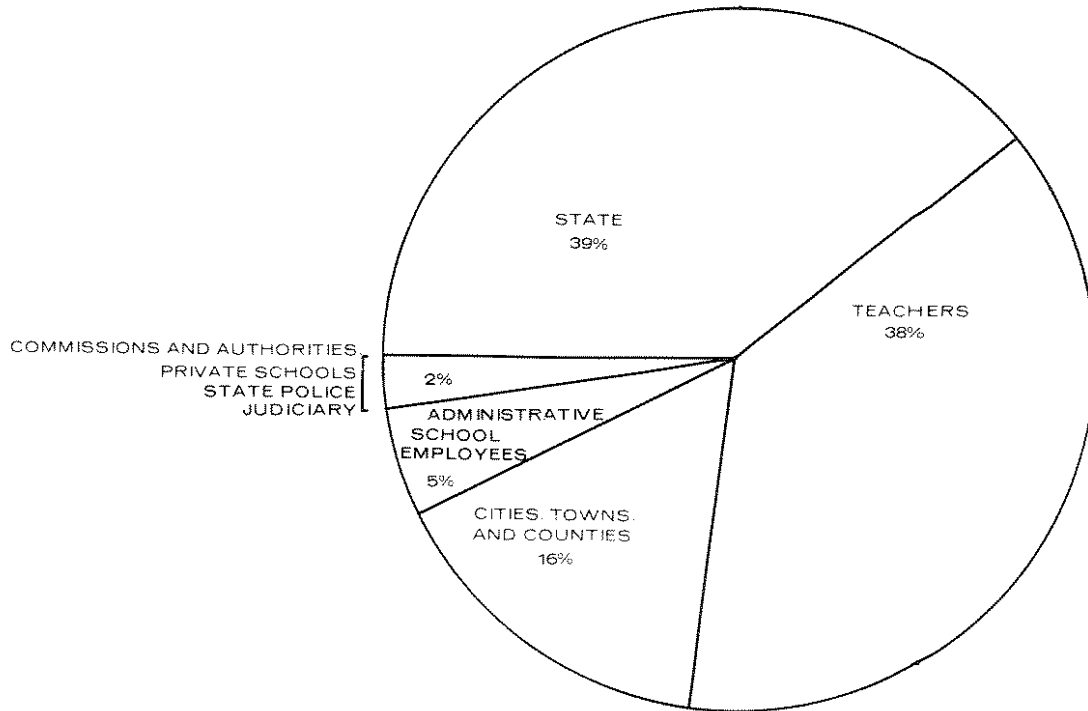
Two State pension plans established separately by legislation are affiliated with VSRS: the State Police Officers Retirement System and the Judicial Retirement System. These plans differ only in the nature of benefits paid to members. All other functions such as investment, administration, and record-keeping are carried out as a routine part of VSRS management.

Membership is mandatory for all employees of jurisdictions which participate in VSRS with three exceptions:

- (1) Persons who are 60 or older when first hired by any participating employer are not eligible for VSRS membership;

Figure 2

VSRS ACTIVE MEMBERSHIP
APRIL 1978



Source: VSRS Membership Files.

- (2) Individuals employed prior to the date a jurisdiction joined VSRS may elect membership; and
- (3) Membership is an option for employees of institutions of higher education which sponsor separate retirement plans.

VSRS coverage was extended to include private school teachers in the past but has since been repealed. Teachers who joined VSRS retained their membership. Presently, teachers in 28 private schools are members of VSRS.

There are 385 local governments, school districts, and authorities participating in VSRS. Legislation enacted in 1973 required all cities, counties, and towns over 5,000 population to join VSRS or to establish a retirement plan which would provide benefits equal to at least two-thirds of those available under the

State plan. Only 11 local governments have elected to maintain their own retirement programs.*

Source of VSRS Funds

Funds for VSRS come from employees, employers, and investment income (Table 1). Total employee contributions have more than doubled over the last eight years. Investment earnings have averaged about a quarter of total VSRS income, an amount in line with the nationwide experience of large public retirement systems.

Table 1

SOURCE OF VSRS FUNDS
FY 1971-1978
(Millions of Dollars)

<u>Fiscal Year</u>	<u>Employee Contribution</u>	<u>Employer Contribution</u>	<u>Net Investment Earnings</u>
1971	\$ 47.3	\$46.3	\$34.2
1972	51.2	46.8	36.7
1973	60.1	36.0	39.0
1974	65.9	36.9	39.3
1975	87.3	45.6	28.2
1976	92.2	52.9	54.5
1977	101.9	66.9	62.1
1978	107.0	76.5	60.6
Average Increase Per Year	12.7%	8.7%	13.0%

Source: VSRS Financial Statements 1971-1977 (unaudited).

The decline in employer contributions in 1973 and 1974 was due to an actuarially calculated decrease in State contributions on behalf of State employees and teachers. The State contribution rates are recalculated every two years and remain significantly below the employee rate (Table 2).

According to a 1978 consultant's review of VSRS, the State contribution rate has been low over the past decade in the face of benefit improvements and inflation. As a result, there has been some

*Counties: Arlington, Fairfax, and Powhatan. Cities: Charlottesville, Danville, Falls Church, Newport News, Norfolk, Portsmouth, Richmond, and Roanoke.

Table 2

CONTRIBUTION RATES FOR STATE
EMPLOYEES AND TEACHERS
AS PERCENT OF PAYROLL OR PAY

<u>Biennium</u>	<u>State for State Employees</u>	<u>State for Teachers</u>	<u>Weighted Average for Teachers and State Employees</u>	<u>Employee Contribution from State Employees and Teachers</u>
1968-1970	3.09%	5.77%	4.13%	5.50% ¹
1970-1972	2.91	5.40	4.32	5.50
1972-1974	1.66	3.09	2.43	5.50
1974-1976	2.19	3.32	2.82	5.00
1976-1978	2.16	4.44	3.25	5.00
1978-1980	3.31	5.93	4.64	5.00

¹First \$1,200 of salary was exempt from contributions.

Source: George B. Buck Consulting Actuaries, Report on VSRS,
August 9, 1978.

underfunding of the retirement system. In 1978, the Board and General Assembly took steps to make up the past funding deficiencies. State contributions for State employees and teachers will steadily increase over the next decade, and will exceed employee contributions in total, and as a percent of payroll, by the 1980-1982 biennium (Table 3). This will bring Virginia more in line with national trends which show employee contributions decreasing as a percent of total receipts.

Table 3

PROJECTED CONTRIBUTIONS AND CONTRIBUTION RATES
FOR STATE EMPLOYEES AND TEACHERS
(Millions of Dollars)

<u>Biennium</u>	<u>Employees</u>		<u>Employer (State)¹</u>	
	<u>Dollars</u>	<u>Percent of Payroll</u>	<u>Dollars</u>	<u>Percent of Payroll</u>
1978-1980	\$225	5.0%	\$208	4.6%
1980-1982	284	5.0	350	6.1
1982-1984	359	5.0	532	7.4
1984-1986	453	5.0	718	7.9
1986-1988	571	5.0	956	8.4

¹Weighted average of State employee and teacher rates.

Source: VSRS Actuary.

Future Demands - The Increase in Retired Membership

Pension systems come under increasing pressure whenever the number of retirees increases at a faster rate than active members (Figure 1). This trend is characteristic of most state public pension systems today, including VSRS. While active membership in VSRS almost tripled between 1961 and 1977, the number of retirees increased almost sixfold.

The increase in active members reflects the general growth of State and local government. The increase in retirees, however, reflects not only growth but also the fact that VSRS, as with most public pension systems, is not actuarially mature. Pension systems which are not mature have a faster growth in the number of retirees than in active members. In contrast, a mature pension system has a stable number of active members and a balance between the number of persons who retire each year and the number of retired members who die. Until maturity is reached, which will take another 35 to 50 years in Virginia, the ratio of active members to retirees will steadily decrease (Table 4).

Table 4

RATIO OF ACTIVE TO RETIRED MEMBERS OF VSRS

<u>Fiscal Year</u>	<u>Active Members</u>	<u>Retired Members</u>	<u>Ratio of Active to Retired</u>
1961	70,000	4,700	14.9:1
1966	95,000	7,800	12.2:1
1971	133,100	13,700	9.7:1
1974	160,200	19,700	8.1:1
1977	199,400	27,000	7.4:1
1978	208,000	30,000	6.9:1

Source: VSRS Annual Reports and VSRS Staff.

The importance of an expanding retired membership is that it results in increasing retiree payrolls, both in real terms and relative to the assets of the retirement system. In only eight years, payments to retired members of VSRS increased by 270 percent, from \$27 million in 1971 to almost \$100 million in 1978.

The average annual benefit paid to retirees also rose sharply (Table 5). This increase is due to three factors: a general increase in salary scales as a result of inflation, an increase in average years of service credited toward retirement, and cost of living supplements. Retired members of VSRS have received substantial cost of living increases in their retirement benefits since 1970. A person who retired in 1965, for example, would have received an 87 percent increase in his original benefit through July 1978.

Table 5

INCREASE IN AVERAGE ANNUAL BENEFITS
PAID TO RETIREES OF VSRS

<u>Fiscal Year</u>	<u>Retirement Payments</u>	<u>Retired Members</u>	<u>Average Annual Benefits Paid Per Retiree</u>
1971	\$26,969,266	13,700	\$1,969
1972	31,646,294	15,800	2,003
1973	38,915,259	17,300	2,249
1974	50,289,867	19,700	2,553
1975	62,500,000	21,800	2,867
1976	70,180,269	24,200	2,900
1977	90,317,655	27,000	3,345
1978	99,109,998	30,000	3,304

Source: VSRS financial statements (unaudited) and annual reports.

The increase in retirement payments has had a marked effect on several measures of the demand placed on a retirement system. These are (1) the ratio of assets to benefits paid out, and (2) the ratio of annual income to annual outgo. Both of these ratios can be used to compare retirement systems although, as is true with all such measures, they are useful primarily to observe trends and make general comparisons. As indicated in Table 6, both ratios have declined steadily.

Table 6

DECREASING RATIOS OF VSRS ASSETS TO BENEFITS
AND ANNUAL INCOME TO ANNUAL OUTGO

<u>Fiscal Year</u>	<u>Ratio of Assets, to Benefits Paid¹</u>	<u>Ratio of Income to Outgo²</u>
1971	23.3:1	3.5:1
1972	23.1:1	3.2:1
1973	20.8:1	2.4:1
1974	17.6:1	2.1:1
1975	15.5:1	2.3:1
1976	15.4:1	2.4:1
1977	13.3:1	2.1:1
1978	13.2:1	2.0:1

¹Total assets divided by retirement payments.

²Contributions plus investment income divided by retirement payments plus refunds.

Source: VSRS financial statements (unaudited).

These ratios, in and of themselves, do not necessarily indicate that the funding of VSRS is in jeopardy. For one thing, national data indicate that the ratio of assets to benefits for VSRS is comparable to other large public pension systems. In addition, there are a number of actuarial assumptions which influence the rate at which assets are accumulated. Nevertheless, decreasing ratios such as are shown in Table 6, coupled with the steady increase in the number of VSRS retirees and the size of retirement payments, confirm that increasing demands are now being placed on the pension system. In order for VSRS to be able to meet these demands, it must be well managed and adequately funded.

VSRS Interaction with the General Assembly

The General Assembly has the responsibility for establishing the level and type of retirement benefits. These benefits are administered through the Board of Trustees.

Board Activity. Although the Board does not establish benefits, the nature of the benefit structure is a primary concern. The type of benefits provided are important to the administration and funding of the retirement system. In recognition of this, the Board has maintained a policy of reviewing proposed benefit changes and taking positions on them, particularly those which could significantly affect the actuarial soundness of the fund. For example, in 1972 the Board recommended a maximum limit on benefits for employees covered by both VSRS and Social Security. This recommendation was adopted by the General Assembly in 1972 but repealed in 1973. Prior to the 1977 session of the Assembly, the Board held a special meeting to vote and establish a common position on proposed legislative changes prior to legislative sessions.

Legislative Oversight. Subcommittees of the House Appropriations and Senate Finance Committees provided legislative oversight of VSRS prior to 1977. During the 1977 session, a Joint Retirement Subcommittee made up of House and Senate members was established to study the benefit structure. The Joint Subcommittee was further expanded in 1978 as the Virginia Retirement Study Commission, and includes representatives from various public groups including the Virginia Education Association, Virginia Governmental Employees Association, Virginia League of Counties, and the Municipal League. This Commission has a broad mandate to study the benefits and actuarial practices of VSRS, and report to the General Assembly during the 1979 session.

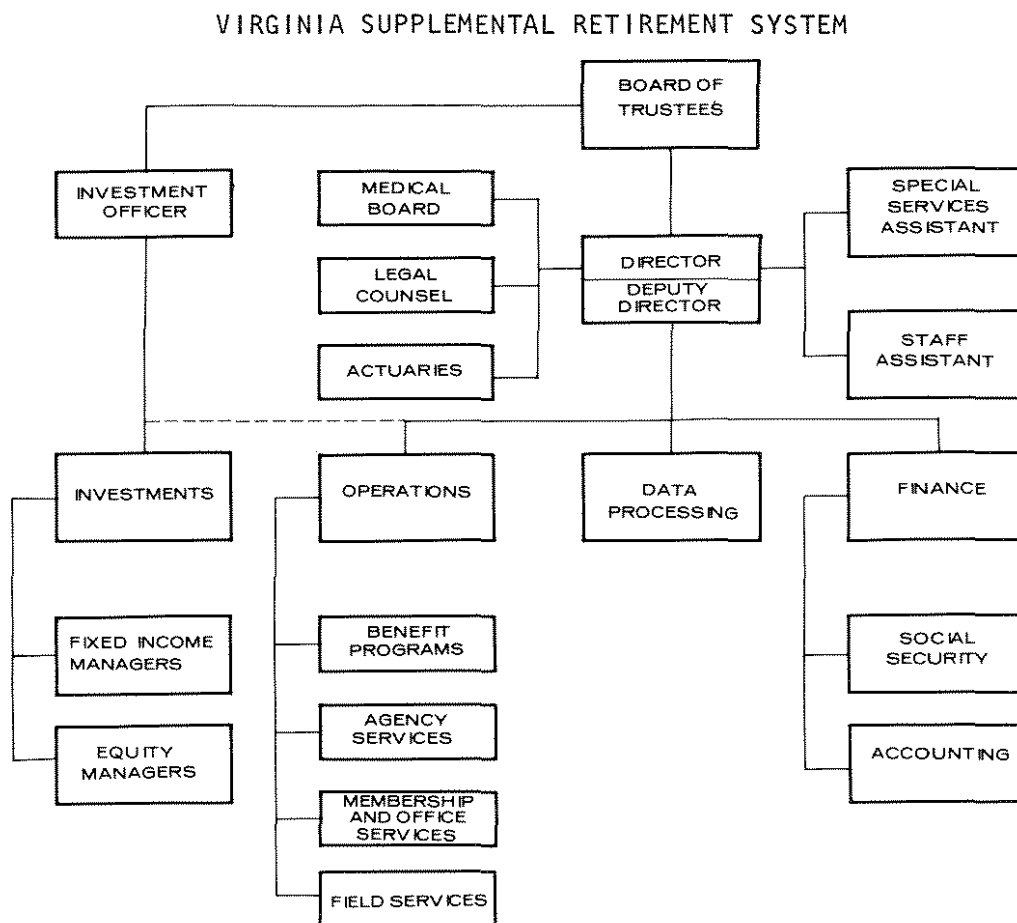
Eleven states have established permanent legislative retirement commissions, and at least five more have introduced bills that would establish a permanent commission. These commissions have the advantage of providing a focus for legislative oversight of the retirement system. Five of the 11 commissions include representatives from public employer groups, while the others are made up of legislators and State officials.

When the current study commission authorization expires, the General Assembly may want to consider establishing a permanent retirement commission in its place. A permanent commission would provide continuity in oversight and may be advisable given the complexity of pension systems, particularly in actuarial assumptions and benefits.

Organization of VSRS

The present organization of VSRS has evolved as a result of several management and consultant studies carried out since 1971 (Figure 3). Policy formulation and oversight is vested in a seven member Board of Trustees which is appointed by the Governor. The Board appoints the Director. Administrative operations are carried out in four departments: Investments, Data Processing, Finance, and Operations.

Figure 3



Source: VSRS.

The Investments Department is headed by a private consultant who reports to and serves at the pleasure of the Board. The department manages trust funds utilizing internal personnel as well as four, private investment management firms.

The Data Processing Department is responsible for recording and maintaining all member information on central data files. Data processing activities related to investments use computers owned by a private firm under contract to VSRS.

The Finance Department is responsible for receiving, depositing, and accounting for all funds handled by VSRS. Included in these are the employee and employer contributions for retirement, group life insurance, and social security.

The Operations Department is the only one which provides direct services to members. Among its many functions are payroll reporting, processing refunds, counseling individuals nearing retirement, providing benefit estimates, processing applications for retirement, and preparing the monthly retiree payroll. The department also prepares VSRS publications and holds training seminars for State and local agency employees who interact with VSRS.

Evolution of the Board's Role

Prior to 1970, VSRS is reported to have had a passive Board of Trustees and a strong Director. Between 1970 and 1973, however, several events brought about marked changes in the role played by the Board. A new gubernatorial administration coupled with several retirements of Board members resulted in the appointment of six new members to what was then a nine member Board. In addition, the VSRS Director retired after having served in that capacity for 20 years.

Board activity increased significantly in the following years with two areas receiving major attention: investment management and member services.

Investment Management. Board minutes from 1970 to the present indicate that investment management has been foremost in Board deliberations. This is not surprising since effective investment of pension system assets is an important fiduciary responsibility. Concern about investment policies also reflects the training and professional expertise which some of the newly appointed members brought to the Board.

The involvement of professionals in the management of VSRS' investments prior to 1972 was severely limited. Although the Trustees employed an outside investment firm to advise them, the actual authorization to purchase or sell securities did not occur until the Board met. In general, the Board had a "buy and hold" philosophy which permitted little turnover in securities even

though more active trading might have resulted in higher returns. While such policies were widely accepted for public pension fund management during the 1950's and 1960's, they did not make the best use of investments as a means of reducing employer and employee costs.

The 1970 Governor's Management Study Commission found several deficiencies in VSRS investment management and recommended a number of major changes. The changes were designed primarily to increase the involvement of investment professionals, and upgrade the responsiveness of investment decision making.

In order to implement the Commission's recommendations, the Board took several steps. First, low yield investments were sold and the proportion of investments in common stocks was increased in hopes of greater earnings. Second, VSRS staff and outside management firms began to buy and sell securities within guidelines established and monitored by the Board. The Board hired a consultant to assist in the development of investment guidelines and in the selection of management firms.

The net effect of the changes which were implemented between 1970 and 1972 was to reduce the Board's day-to-day involvement in investment decisions by shifting management responsibilities to seven managers, six on contract to VSRS and the seventh directly employed by the system. In place of day-to-day involvement, the Board began to concentrate on policy formulation and oversight. Guidelines were established to control the quality and diversification of investments, and the Board employed a sophisticated monitoring system to measure and assess manager performance. These changes, while significant, have not reduced the Board's continued emphasis on oversight of the investment portfolio.

Processing of Member Services. In contrast to the management of investments, where Board involvement was direct, the Board's role in overseeing improvement of member services was more indirect. Interviews held with past and present Board members indicate that backlogs in processing routine member services plagued VSRS during the early 1970's. Delays of as much as two years were encountered in processing requests for refunds. Communications with members also suffered. There was little or no provision made for informing members of changes in the law, benefits or procedures. A consultant study of VSRS, initiated by the Board in 1971, concluded that the system was experiencing a general deterioration in the timeliness of member services.

The backlogs and delays in processing services resulted in poor public relations and generated many complaints to Board members and legislators. Concern about the delays was translated into an implicit Board mandate to VSRS's administration that backlogs and bottlenecks were to be reduced.

According to Board members, the present Director of VSRS was employed primarily because of his experience in public relations and liaison with public employees. The Board monitored progress in upgrading services through discussion and informal reporting of work load data during Board meetings. In addition, the Board moved to facilitate better communication with members by the authorization of a newsletter. Processing of member services has received major attention from management over the last five years and significant progress has been made.

Board members interviewed by JLARC staff are generally satisfied with the evolution of the Board's role since 1970. Investment management is seen as a particularly strong area. The reduction in backlogs and processing delays, and corresponding improvement in VSRS's public image, are also viewed with satisfaction. The important area of VSRS benefits and their long-term impact on the fund is presently under review by the Joint Study Commission of the General Assembly.

Overall, the Board's active posture and strong leadership have resulted in significant improvements in the management of investments and to a lesser extent, member services. However, Board oversight has been selective in area and depth of review. As a result, some improvements have come at the expense of other important functions of a retirement system. Specifically, the reduction in service backlog was achieved, at least in part, by inattention to and in some cases, elimination of financial controls. Unfortunately, the elimination of these controls facilitated the theft of more than \$110,000 from the retirement system. Many other aspects of general administration have not received the attention required in large and complex organizations such as VSRS.

II. General Administration

Most efforts to improve general management at VSRS have concentrated on acquiring better physical facilities, installing newer equipment, and adding staff. Several important functions such as financial management, planning, management reporting and personnel administration have received little attention.

FINANCIAL MANAGEMENT

Sound financial management and record keeping are vital to VSRS. In 1978, income totaled more than \$244 million from employee and employer contributions and investment earnings. Retiree payrolls for 30,000 individuals were nearly \$100 million. \$300 million in social security withholding funds were processed. However, VSRS does not have the accounting system, records, financial leadership and expertise, or financial oversight required for this large retirement system.

The widespread lack of financial controls and poor accounting practices at VSRS, reported by the Auditor of Public Accounts, result from weak financial management which has characterized the agency for a number of years. It is particularly important that prior to September 1977, none of the senior VSRS staff were experienced financial managers. In fact, evidence available from staff interviews, Board minutes, and official correspondence indicates that no decisive action was begun to upgrade financial management until 1976. There is some evidence that the Board may not have been fully aware of the many weaknesses until that time.

Lack of Financial Controls

The preliminary findings of an audit being made by the Auditor of Public Accounts (APA) confirm a widespread lack of financial control within VSRS. Among the APA findings are:

- there has been no significant effort on the part of VSRS since 1972 to reconcile accounting ledgers. The accounting records were in such poor condition that the APA, supported by a private consulting firm, has spent over one year trying to reconcile the accounts;
- during the initial phase of a five-year audit, one of the two primary member accounts was found to be out of balance with supporting information by \$10 million;

- adequate records were not maintained of claims and premium payments for the VSRS group life insurance policy held by Life of Virginia. The single control document kept by VSRS was a hand written notebook which was never reconciled;
- in 1976 the VSRS certified to the State Corporation Commission that an audited balance of VSRS premiums on deposit with Life of Virginia was accurate. According to APA, no certification was possible due to the poor condition of VSRS records;
- prior to early 1978, refunds were routinely made without verification that the member had, in fact, contributed the amount of the refund requested;
- refund payment vouchers were signed by VSRS administrators and then returned to the clerk who prepared the voucher. The procedure violated the basic principle of separation of duties among employees who disburse funds; and
- generally accepted accounting practices have not been followed in many instances. Controls over both internal transfers of funds and disbursements have not been adequately developed. Without sound financial procedures, VSRS cannot provide the level of accountability required of a public pension system.

Condition of Financial Statements

VSRS does not produce adequate financial reports which can be used to inform the Board, General Assembly or members of its financial condition. The only financial reports regularly received by the Board are: a monthly summary of administrative expenses which is used to review the budget; and a summary of VSRS receipts and disbursements which shows cash flow. There is no monthly report which shows assets, liabilities and fund balance. Furthermore, no annual statement of financial condition is prepared.

VSRS does prepare three subsidiary reports on a monthly basis: a detailed listing of VSRS receipts and disbursements, a trial balance, and a balance sheet for the fund. The supporting statements are a somewhat better reflection of financial condition, however, they are difficult to read and lacking in several areas. For example:

- the balance sheet does not recognize most accounts receivable. As of June 30, 1977, \$15.6 million in accounts receivable were not reflected on any financial statement;
- not all liabilities are recognized. Retired members who choose the standard retirement option are guaranteed the receipt of all their contributions. While the amount of these contributions is a liability, it is not reflected on financial statements;
- deferred losses on the sale of securities are carried as an asset without explanation; and
- there is no recognition of the actuarial liability on the balance sheet.

The lack of detail in the present VSRS balance sheet can be illustrated by comparing its format to that of a balance sheet for public pension systems recommended by the Municipal Finance Officers Association, a recognized authority for state and local financial reporting formats (Appendix I). Three other supporting statements recommended by the MFOA are not prepared: a statement of operations (showing changes in financial condition); a statement analyzing changes in reserves; and an actuarial balance sheet. Without these documents, the Board cannot be fully informed about the financial condition of VSRS.

The weaknesses in financial statements also limit the ability of VSRS to produce an annual report that meets the minimum recommended requirements for public disclosure. Since VSRS does not produce complete financial statements, the annual report itself cannot fairly present the VSRS financial condition. In fact, the annual report now prepared is limited to a one-page summary of receipts and disbursements and does not even show the basic information of system assets, liabilities and fund balances.

Concerns about the clarity and completeness of VSRS financial statements have been raised in two previous management studies. Although steps have been taken in the past to improve the clarity of statements given to the Board, there has been significantly less attention to completeness. The Board should place a high priority on obtaining adequate financial statements on a monthly and annual basis.

Need for Annual Audits. VSRS has not had a financial audit since 1972. Since the recent reorganization of the Office of the Auditor of Public Accounts, the frequency of audits has been changed. According to the Auditor of Public Accounts, audit staff have been assigned to VSRS almost continually since 1972; but, the poor condition of financial and accounting records has prevented

the completion of an audit. Completion of an annual audit is an essential control and should be performed in accordance with generally accepted practices.

The Board should make every effort to see that financial records are kept properly so that an audit can be completed annually. Legislation should also be introduced to require that an audit of VSRS be completed no later than December of each year. In the event that circumstances prohibit a timely audit by the APA, the Board and the APA could contract with an independent accounting firm to complete the audit.

Lack of Leadership in Financial Management

The present weaknesses in financial management are primarily the result of a lack of qualified personnel. VSRS has not had the kind of strong financial leadership necessary for a billion dollar organization. The present Director acknowledged he was inexperienced in accounting and financial management when he was hired in 1973. Additional staff with these skills were not hired until 1977. Personnel and procedural changes are necessary to strengthen financial management.

Need for Financial Leadership. Prior to 1977, accounting systems and fiscal controls were the day-to-day responsibility of an accountant who had worked for VSRS for 26 years following graduation from high school. The individual is a competent and dedicated employee, but was not trained or qualified to design, maintain, and monitor the increasingly complex financial system.

Supervisory authority for financial management prior to 1977 was assigned to an Operations Manager. The Assistant Director of VSRS also played a major role in financial oversight. Both the Operations Manager and the Assistant Director, however, were data processing specialists and were primarily concerned with developing a new data processing system.

Evidence is clear that both these individuals, who have since left VSRS, did not provide leadership in financial management. Interviews with current VSRS staff confirm that these individuals were not sensitive to the need for basic financial and accounting safeguards. In several cases, financial controls were eliminated in an effort to expedite data processing. Several of the VSRS staff report they were concerned about lack of control in financial and accounting procedures, and brought their concern to the attention of VSRS management. However, the Director reaffirmed the authority of the Operations Manager and Assistant Director. Adequate financial controls were not installed.

A consultant study done in 1976 raised specific questions about the quality of financial management. The study cited the fact that the Assistant Director was addressing his supervisory

responsibilities for financial administration "...as his schedule permitted". According to the consultant:

"Constraints on the work time of the Assistant Director result in the lack of modern financial reporting, and the systematic management of any financial questions that may arise. It is critical...that a fully competent financial executive with requisite training and experience be engaged."

Despite a clear lack of adequate financial leadership, the first personnel action to obtain a financial manager did not occur until 1977. Records of the Department of Personnel and Training indicate that VSRS requested the addition or modification of 39 positions since July 1973; 35 of which were approved. Three of these requests dealt with financial personnel; however, all three were for accountants or mid-level supervisors--positions which would not have significantly strengthened financial leadership.

The Director has stated that other informal efforts were made to upgrade the level of financial expertise between 1973 and 1977. However, these efforts have not been documented, and did not involve informing either the Governor or the General Assembly of the lack of financial expertise within VSRS.

The request for a financial manager was forwarded to the Department of Personnel and Training in June 1977. The request was followed by a letter from the Board of Trustees urging quick approval of the request. The Board Chairman's letter cited a "...serious and frightening lack of proper financial control in the Retirement System..." as justification for prompt approval of the position request. The letter proved unnecessary because the financial manager position request was approved by the Department of Personnel and Training two days before the Board letter was written.

A financial manager was hired in September 1977. While the addition of this position improved the organizational setting for financial management, the need for top-level financial leadership has not diminished. VSRS continues to lack the kind of financial management expertise necessary in a large, complex public pension system.

The Board should take an active role in obtaining an innovative financial manager experienced in managing a large financial organization. In order to attract candidates who have had relevant experience, it may be necessary to increase the current salary range for the position. Presently, the Financial Manager position has a salary range of \$18,700-\$25,600. A range at least equivalent to the fiscal officers of major State agencies would be appropriate. For example, the salary ranges for the chief fiscal officers of the Departments of Welfare, and Highways and Transportation are \$21,400-\$28,000.

The Board may also need to offer a salary above the entry level in order to attract the most suitable candidate. According to the Department of Personnel and Training, above-entry-level appointments are routinely approved provided an agency demonstrates evidence of a valid recruitment effort and the need for a higher salary to obtain a qualified individual for the job.

An Internal Audit Function. In an effort to improve monitoring of financial controls, VSRS has requested approval to hire an internal auditor. The basic responsibility of the internal auditor would be to review and test internal controls and suggest how they can be improved. According to the position request form, the internal auditor would report to the Director and an audit subcommittee of the Board.

Although an internal auditor appears to be needed, the working relationship of the auditor and financial manager have not been clearly defined to ensure that the financial manager retains control of, and responsibility for, the financial and accounting systems. As a result, the establishment of an internal auditor could undermine the leadership role expected of the financial manager.

For example, the job description for the internal auditor states that he is to "deal with the methods of reconciling accounts, financial presentations...and any other mechanism used in production of the system's financial reports". The job description of the financial manager makes him responsible for the preparation of financial statements, a responsibility which could conflict with that assigned to the auditor. The Board should establish clear specifications for the job of financial manager and internal auditor to ensure that each position is used in the most appropriate way.

The auditor could also develop a means for conducting field audits of participating localities. Most localities which are members of VSRS have never been field-audited to determine whether the financial documentation and reports they submit are accurate. As a first step, emphasis should be placed on auditing those localities which are known to have difficulty in following reporting procedures used by VSRS.

Board Composition for Financial Oversight

The Board needs to exercise a stronger role in reviewing financial activities of VSRS. The recent appointment of an audit subcommittee will be helpful to provide a focus for heightened Board oversight of financial affairs. The audit subcommittee would be particularly useful if it were to request and receive periodic briefings from the Director, financial manager and internal auditor on proposed changes to the accounting and control systems, and the results of current work within the financial division of VSRS.

Board oversight of financial affairs could also be strengthened with the appointment of additional members who have expertise in financial management. Prior to 1977, Board members included the Comptroller as one of four ex officio Board members. Legislation enacted in that year removed the ex officio members. While a 1971 consultant's report found the nine member Board to be appropriate in size and composition, in 1976 the same consultant was critical of the heavy concentration of ex officio State officers.

It can be argued that a concentration of State officials, who might possibly overrepresent the employer's (State's) interests, could jeopardize the independence of the Board. However, it is also generally agreed by many past and present Board members that the Comptroller, due to his position as chief fiscal officer of the State, offered considerable expertise of value to the Board. JLARC interviews with Board members found substantial interest in returning the Comptroller to the Board of Trustees. The Comptroller's accounting expertise would be particularly valuable on the audit subcommittee.

If the Comptroller were returned to the Board, it would be necessary to eliminate an existing appointment or to add a ninth member to avoid the possibility of a tie vote. One option would be to add a fourth member from the private sector, experienced in banking or insurance, who has a strong background in accounting and financial management. Adding a Board member with particular abilities in private sector financial management would provide a good complement to the Comptroller.

PLANNING AND REPORTING

VSRS does not have a well developed planning process. Management reports which are required for effective planning are largely unavailable. These weaknesses were noted in the 1971 consultant study which concluded that the inability of VSRS to direct and control organizational change forced it to respond to events as they occurred.

Planning and the use of management reports which provide information to the planning process are essential to good management. However, VSRS is deficient in four key areas of planning and reporting: (1) the use of exception reporting to identify problem areas; (2) systematic management reporting from various departments to the Director; (3) organizational planning to support reorganization, personnel changes, and internal communications; and (4) long-range planning which involves the Board of Trustees.

Exception Reporting

Supervisors are not kept systematically informed about chronic administrative problems. As a result, follow-up action is

often not taken where it is needed. Two examples of the need for exception reporting are payroll reporting and social security withholding.

Payroll Reporting. Each employer participating in VSRS submits a monthly or semimonthly payroll report and a check for the amount of employee contributions. The payroll report documents each member's contribution to the retirement system for each pay period. The amount of total contributions and the payroll report must balance. Otherwise, it is not possible to verify that all contributions have been received or that members have been properly credited for their contributions. The following case illustrates how a lack of exception reporting can allow continued errors in administrative procedures to go uncorrected.

Contributions and supporting payrolls for judges and other members of the Judicial Retirement System (JRS) are sent to VSRS by the office of the State Supreme Court. The amount contributed by JRS members and the supporting payroll have been out of balance for over two years.

A VSRS clerk noted errors in JRS payrolls. Although the VSRS clerk returned the payrolls for correction, none of the errors were resolved and the clerk made no effort to notify supervisory personnel of the incorrect accounts. As a result, the accounts grew further out of balance each month.

JLARC staff notified JRS supervisors of the erroneous payrolls during this review.

The JRS accounts are still in error. The Supreme Court staff state they do not have the manpower to review and revise payroll reports covering two years. Systematic exception reporting would have identified and corrected chronic reporting problems before they got out of hand.

Processing Social Security Taxes. A second activity which would benefit from exception reporting is the processing of social security taxes. VSRS is responsible for forwarding social security withholding taxes for public employees to the federal government, along with information on how much should be credited to each individual's account. The Social Security Administration (SSA) will not credit an individual's account unless the name and social security number match the SSA computer records. If the name and social security number do not match, a list is sent to VSRS for correction. VSRS, in turn, sends a copy of the list to the employer for correction. Corrections made by localities are then forwarded to SSA.

JLARC reviewed the files of 12 participating employers who had repeated reporting errors to determine why corrections were not made. In seven of the 12 cases, the employer had failed to send amended data to VSRS over at least a two-year period. Although the employer is primarily responsible for correcting errors, VSRS, as social security administrator, has a responsibility to review the files of all employers and follow-up on those that fail to submit corrections.

However, VSRS makes only a limited attempt to follow-up the failure of employers to return amended data. As a result, some public employees have not been credited with all of their social security withholdings. In one case reviewed by JLARC, an individual had not been credited for withholding taxes dating back as far as 1970 even though the employee's name appeared on the federal exception list four times. The failure to post these taxes to members' accounts could affect social security benefits.

VSRS must develop adequate exception reporting in order to systematically identify uncorrected problems and bring them to the attention of management. Presently, a follow-up notice to the employer is sent stating the corrective action that should be taken. If the second notice does not result in correction, there is no systematic procedure for bringing the problem to the attention of management. Employers who chronically fail to submit corrections should be brought to the attention of the Director and, if necessary, the Board of Trustees.

Management Reporting

VSRS does not have a well developed process of internal management reporting which relates daily activities to organizational objectives. Internal communication between the Director and his staff has been primarily verbal, informal, and unsystematic. The lack of more systematic reporting hinders communication among the staff and makes it difficult to hold staff accountable for their performance.

The lack of reporting has been recognized as a deficiency by VSRS staff and some efforts have recently been made to develop a reporting system. Beginning in August, 1978, biweekly written reports are required from each department. The Deputy Director intends to use these reports and program budgeting manuals to serve as a basis for an internal planning process. VSRS should continue to develop management reporting which stresses systematic comparisons of activity with the plans and objectives of the retirement system.

Organizational Planning

VSRS has undergone several reorganizations since 1970, and is presently considering another restructuring of responsibilities

and personnel. These reorganizations have not been supported by systematic planning. For example, VSRS staff had not developed an organization chart to support the latest reorganization proposal until requested to do so by JLARC. There is little documentation on management's objectives for the reorganization, how duties and responsibilities are to be realigned, or how personnel are to be used. Without this documentation, the proposed reorganization can not be justified.

VSRS staff should develop an organizational plan which details the duties of functional divisions, internal relationships between departments, and personnel needs of the agency. This plan is necessary to provide a basis for reorganization. The organization chart prepared by VSRS for JLARC is a good first step in identifying, consolidating, and strengthening supervisory roles and organizational relationships.

Board Role in Planning

The Board of Trustees has not played a major role in planning. The lack of Board involvement in planning has resulted in unclear objectives and priorities for VSRS, and has limited the ability of the Board to evaluate management performance.

In 1971 a consultant recommended that the Director prepare an annual report for the Board on the administration of the system. The report was to include a section on the Director's recommendations for planned improvements in administration. There is no evidence to indicate such a report was ever made. According to the Board minutes, the Director reported on general administrative matters once in 1973 and once in 1976, but the reports were verbal and not based on a formal planning document. In contrast, the Board has received a comprehensive, written, annual investment report from the Investment Officer for each of the last five years.

The exclusion of the Board from a meaningful agency planning process prohibits the establishment of clearly defined VSRS objectives and priorities. Presently, Board intent is not documented because the minutes of Board meetings are not complete enough to constitute a statement of agency goals. Discussions during Board meetings and verbal suggestions for management improvement do not provide an adequate basis for long-range planning and control.

The limited role of the Board in establishing objectives and priorities is illustrated by the fact that the Director recently sent a detailed statement of objectives to the Secretary of Administration and Finance without Board review. The statement was requested by the Secretary as part of the State's program budgeting process. Although this statement is the most complete listing of objectives and timetables available, it is of questionable validity because it has not been reviewed and approved by the Board.

Without more systematic and formal planning, the Board cannot ensure that its objectives are clearly stated, that management strategies have been well developed, or that managers are held accountable for performance.

The Board should require that the Director and his staff prepare an annual management report to include a long-range plan for Board review. The plan should specify organizational objectives, schedules for their completion, how they are to be achieved, and performance measures to be used in evaluating the previous year's performance. The development of a long-range plan would better integrate the policy-making role of the Board with the specific planning necessary for management. It would also strengthen the oversight and control responsibilities of the Board by requiring management to be explicit in its appraisal of objectives, problems and performance.

PERSONNEL AND STAFFING

VSRS personnel administration needs to be improved in order to clearly define and meet agency personnel requirements. Three problems are particularly evident: inaccurate job descriptions, a lack of well-defined and written procedures for most jobs, and ineffective evaluations of employee performance.

Inaccurate Job Descriptions

Written job descriptions are important to provide consistency in selecting and evaluating employees, and to ensure that employees are compensated fairly. JLARC staff conducted desk audits of 63 full-time positions in VSRS. Employees were interviewed to determine what duties they performed, and their responses were then compared to the current job description for each position.

One-third of the job descriptions for personnel positions in VSRS are clearly inaccurate (Table 7). For example, some job descriptions describe tasks performed by other employees. Five job descriptions are outdated and one even predates the establishment of VSRS in 1952. Other inaccurate job descriptions are of more recent origin but refer to reporting relationships which no longer exist. An additional 38 percent of the job descriptions need some revision, while only 21 percent are accurate.

VSRS must revise all job descriptions to make them current and accurate reflections of actual job duties. The revised descriptions should then be reviewed to ensure comparability of salaries for similar positions. In carrying out the review, particular attention should be given to identifying unneeded positions, or positions that should be reclassified. Based on the JLARC desk audits, one position is clearly excess and a number of positions need to be reclassified.

Table 7

VSRS JOB DESCRIPTIONS COMPARED TO ACTUAL DUTIES

<u>Status</u>	<u>Number</u>	<u>Percent</u>
Correct	13	21%
Need some revision	24	38
Incorrect	20	32
No description	<u>6</u>	<u>9</u>
Total	63	100%

Source: JLARC.

Excess Position. The position of Retirement System Special Services Assistant is not required on a full-time basis and should be eliminated or reclassified to include other duties. The present Special Services Assistant position was created in 1975 at the direction of the Department of Personnel and Training following a VSRS request for a second Assistant Director position. Only one Assistant Director position was felt to be justified, and the former Assistant Director position was reclassified as a Special Services Assistant. The salary of the Special Services Assistant is now \$22,400.

The Special Services Assistant has two primary duties: administration of the Judicial Retirement System (JRS) and State Police Retirement System (SPORS), and legislative liaison. A desk audit found these duties do not require full-time effort.

JRS and SPORS are special retirement programs which, although now consolidated with VSRS, provide separate benefits to qualified members of the previous, separate plans. The Special Services Assistant reviews and interprets retirement applications with regard to the prior guaranteed benefits. JRS is a small system (283 members) and has only a few retirements each year. SPORS has been in existence long enough that most State policemen are not eligible for benefits under earlier plans. Moreover, the actual processing of retirement applications for both plans is done by other VSRS staff.

The Special Services Assistant is also supposed to serve as liaison to the General Assembly. However, JLARC staff noted that the Director or Deputy Director in fact represent VSRS before study commissions and committees of the legislature.

Reclassification of Positions. The positions of nine employees should be reclassified to better reflect the work performed. Two different classifications appear to be called for: Retirement Analyst and Fiscal Technician.

The Retirement Analyst classification would be suitable for clerks in the Benefit Programs section who prepare retirement estimates on request from members. In addition, the clerks provide information about the kinds of benefits members are entitled to under various retirement options.

The preparation of benefit estimates requires a degree of judgement beyond that of a routine clerical job. The analysis and interpretation of benefit options requires interpersonal skills and a general understanding of the needs of persons nearing retirement. Therefore, the salary range for Retirement Analysts should be higher than that of the Clerk D position now allotted to the Benefit Programs section.

The Fiscal Technician position is an existing classification within the State personnel system. A Fiscal Technician exercises initiative and responsibility in carrying out financial transactions. There are several positions for which this classification would be appropriate. For example, the Clerk D position in the Agency Services section supervises the processing of employer/employee contributions and payrolls for retirement and group life insurance. Payroll processing is basically a routine audit and adjustment function, but the supervisory duties of the Clerk D are more appropriate to a Fiscal Technician.

Fiscal Technician classifications would also be appropriate for clerks in the Membership and Agency Services section who are required to prepare refund vouchers and audit financial records. Preparation of a refund voucher involves complex procedures and a careful review of several sets of financial records.

In addition, one of the three clerks in the Social Security section who audit, correct and followup on payments for employer/employee social security contributions could reasonably be reclassified as a Fiscal Technician. This individual would serve as troubleshooter for difficult cases while the other two clerks process routine social security payments which are not believed to be in error.

Need For Written Job Procedures

The development of accurate job descriptions is hampered by the lack of written procedures for most positions. Procedures specify tasks to be performed by the agency--what is to be done, who is responsible, and how tasks are to be accomplished. Clearly defined procedures are the basis for defining positions within the organization and are essential for training employees.

VSRS has not established well-defined procedures for most positions. Two previous management studies and an audit of the social security accounting function performed by the Social Security Administration recommended that written procedures be developed for

each position. These recommendations have not been implemented. The lack of clearly defined procedures can result in inconsistent or incorrect performance of duties, and limits the ability of supervisors to hold employees accountable for performance.

The need for established written procedures is illustrated by the fact that several employees have resorted to developing their own procedures in the absence of direction from management. Some clerks have developed handwritten lists of duties. Others have developed more formal procedures.

For example, the Benefit Programs section is responsible for processing retirement applications and certifying death claims on the group life insurance policy. Although no written procedures have been established by VSRS management, the supervisor of this section has developed a checklist to be followed in processing and preparing calculations of retirement benefits. In addition, the supervisor has prepared a policy manual consisting of benefit determination precedents which is cross-referenced to the appropriate legislative section.

Despite such examples of individual initiative, most positions do not have any type of written description of the job to be performed or the way it should be accomplished. The inaccuracy of job descriptions and the lack of written procedures mean that many of the agency's basic functions are poorly defined. Therefore, VSRS should develop job descriptions and procedures guides for each full-time position. Assistance in these tasks could be made available from the Department of Personnel and Training and the Department of Management Analysis and Systems Development.

Personnel Evaluation and Supervisor Selection

VSRS uses the basic format for employee evaluations required by the Department of Personnel and Training. Employees are rated on the basis of their work habits, amount of work performed, quality of work, cooperation, intelligence and initiative. Ratings are given by supervisors and are discussed with each employee.

In practice, however, VSRS personnel evaluations do not appear to differentiate significantly among employees. A random sample of employee files showed that almost all ratings are in the highest ranges, either very good or excellent. The ratings are particularly suspect because VSRS has not established performance criteria for most positions and job descriptions are not accurate. Without such criteria, evaluations must be highly subjective.

An evaluation process which produces uniformly good ratings is ineffective for identifying persons with supervisory potential. Since all present mid-level supervisors were promoted to their present positions from within the organization, this

deficiency has had an adverse effect on the selection of supervisory personnel. In fact, three of the five individuals presently supervising operational sections have not exercised the level of supervision which is required. Lack of effective supervision was identified as a contributing factor in the fraud perpetrated by VSRS clerks.

Both personnel evaluations and policy for selecting supervisors must be strengthened if VSRS is to improve the effectiveness of its administration. Clearly defined criteria based on accurate descriptions for each position are needed. A more meaningful employee evaluation process will aid in identifying individuals with supervisory potential.

RECORDS MAINTENANCE

VSRS maintains a wide variety of information on its membership. Each member has an individual account which reflects his or her employment history and records contributions to the retirement system. Individual records also include beneficiary information, retirement applications and information relating to death and disability claims. It is essential that these records be adequately maintained. Erroneous or incomplete records can affect a member's retirement, insurance and refund benefits.

In order to process the large volume of member records, VSRS has automated much of its data processing. The initial effort between 1970 and 1973 to automate record-keeping was seriously deficient. VSRS is now redesigning its data processing system but has encountered a number of delays.

Maintenance of Member Records

One of the most important member records is the VSRS-1. This form is a primary source document which establishes an individual as a member of VSRS. The VSRS-1 is also a legal record of beneficiaries who are entitled to VSRS benefits in the event of a member's death. Despite the importance of this form, the VSRS-1 files are inadequately maintained.

JLARC interviews with employers revealed that some VSRS-1's have been misfiled or lost. For example, VSRS staff recently informed a participating employer that 35 of their employees did not have a VSRS-1 on file. However, the employer produced copies of the VSRS-1 forms which had been sent to VSRS.

A spot check of VSRS-1 files by JLARC staff revealed missing forms, duplicate forms and uncorrected errors. In one case, a member had tried to correct an erroneous social security number on his VSRS-1 by sending a copy of his social security card

to VSRS. Although the copy of the social security card had been placed in the file, the VSRS-1 record had not been corrected.

The VSRS-1 files are not adequately protected. There was no fire protection for the room until the Governor (at the suggestion of JLARC) urged that the file room be provided increased security. Even with an alarm system, fire damage would be extremely serious because there is no backup to the VSRS-1 forms. VSRS has been involved in court suits filed because VSRS-1 forms were not available to resolve legal questions about beneficiary or estate rights. The loss of large numbers of VSRS-1's would create a serious problem for the VSRS membership.

VSRS must focus more supervisory attention on the maintenance of VSRS-1 files. A major effort is presently underway to update the files. However, the files should also be purged to delete the records of members who have withdrawn from the retirement system. Following this housecleaning effort, the agency should establish a systematic review process which includes periodic purges, spot checks and controlled access to the file room. Backup for the VSRS-1 forms should be provided by the use of duplicate forms or microfiche.

Member information stored on computer files is also erroneous or incomplete in some cases. The Auditor of Public Accounts has found about 5,000 erroneous accounts which show either a negative balance in the amount contributed by the employee, or duplicate balances in two different accounts. Some information is also incomplete. For example, many members do not have their full employment history on the computer file. Therefore, subsidiary documents must be searched to determine the number of years of service that should be credited to members as they near retirement.

VSRS needs to routinely purge computer records to locate and correct obviously erroneous information. A study should be made of the cost effectiveness of adding membership information presently not on the file to the computer records. Such information might include beneficiary and prior employment history data.

A policy governing the maintenance and destruction of records should also be established. Lack of such a policy in the early 1970's resulted in the destruction of some information that later had to be reconstructed. Presently, the agency keeps boxes of files for deceased members and maintains computer records on thousands of employees who have left the system without obtaining a full refund of their contribution. The rapidly increasing membership will place continually greater demands on the data storage capabilities of VSRS. Therefore, policies should be established to determine when and how such records should be destroyed.

Automated Data Processing

VSRS began to automate its accounting and member records in the early 1970's when it became evident that manual record systems could no longer keep pace with the growth of the retirement system. The Division of Automated Data Processing (DADP) assisted VSRS in designing an automated system between 1970 and 1973. A review of correspondence between VSRS and DADP indicates that necessary planning did not precede the implementation effort. As a result, the VSRS system was implemented in a piecemeal fashion and is not responsive to agency needs.

According to DADP files, implementation of automated systems for VSRS was crippled by a lack of communication between the two agencies. VSRS staff played only a limited role in providing DADP with information about the record-keeping needs of a retirement system. VSRS personnel recognized some of the weaknesses in the design of the system, but lacked the expertise to effectively communicate their concerns. Also, DADP personnel tended to interpret VSRS criticism as resistance to change, and held many VSRS staff in low regard.

DADP, on the other hand, failed to provide basic assistance and advice to VSRS. For example, a detailed plan for the implementation of an automated system was never prepared--a fact that DADP later admitted was "clearly a case of abrogation of management responsibility". DADP did not effectively assist VSRS in adapting automated data processing to the needs of a retirement system, and VSRS management proved unable to control and direct the implementation process.

As a result of poor planning and design, VSRS now relies on a combination of fragmented manual and automated records which do not provide effective control over member contributions or disbursements. The following case study illustrates the problems created by the lack of an integrated data processing system.

VSRS relies on two sets of accounts to record member contributions: the general ledger account and individual member contribution accounts (MCA). The general ledger accounts are maintained manually and record summary totals of the MCA. The MCA is computerized and keeps a record of each member's contributions. Comparing one account balance against the other is a vital check to ensure that totals are correct and that members have been properly credited for their contributions.

However, audit findings indicate there has been a serious breakdown in the performance of necessary checks between the MCA and general ledger accounts. Different documents have been used to update the two accounts, adjustments were made in

one account but not in the other, and the two balances are not compared in a meaningful fashion. As a result, the State Auditor found the two accounts to be out of balance by over \$10 million.

Interviews with VSRS staff highlighted a variety of other deficiencies in planning the data processing systems. Actuarial records were destroyed without adequate consideration of their importance. Financial controls that had previously been in use were discarded without replacement. Finally, the new ADP system was put into operation without adequate testing and without a period of duplicate operation of the old and new systems. Errors which occurred when the new system was put in place were carried forward and became part of the permanent data file. Consequently, individual records of some members are probably in error.

Redesign of the VSRS System. As a result of the many deficiencies in the existing system, VSRS contracted with a consulting firm to design a new information system in July, 1977. The firm's bid for the contract was \$22,500, well below those of two competing firms. Some Board members doubted the ability of the consultant to satisfy the project requirements. Nevertheless, a contract was signed which called for a three-phase development of a revised system. No completion date was specified in the contract, but the consultant assured VSRS by letter that a new system would be designed and implemented by January 1, 1978.

The redesign effort is far behind its original schedule and is unlikely to be completed before January 1, 1979. The \$22,500 fee has been expended but only one of the three phases is complete. Planning for the new system has been inadequate and the revised time schedule may not allow sufficient time for designing and programming.

Planning for the new system appears fragmented and may not result in an integrated ADP system which will meet all VSRS needs. VSRS and the consultant have developed a timetable for developing four separate components of an ADP system: benefit calculation, annuitant payroll, refund processing, and member accounting. The components are highly interrelated because they use common information. The projected timetable, however, shows each component being developed separately and does not indicate how the four will form a unified system.

Scheduling has also been a problem with the redesign effort. VSRS and its consultant have projected a very optimistic timetable. Few deadlines have been met to date, and there is no evidence that the current schedule can be met. The projected schedule for programming the new system appears to have been based more on guess work than a careful analysis of project requirements. Systems personnel of the State Auditor's office and MASD have expressed doubt that the projected schedule is feasible.

The failure to define and design an integrated information system and the development of unrealistic project schedules would seem to indicate that VSRS could repeat mistakes made during the initial systems development in 1972 and 1973. Even if the present deadline is met, VSRS may still lack a complete information system which will serve all financial and operational needs.

VSRS cannot afford a repetition of earlier mistakes and should revise the present schedule for systems development. The new schedule should contain a deadline for completing the detailed design for the entire system before subsystem designs are developed. Once the overall design is approved by VSRS, the Comptroller, Auditor of Public Accounts, and Department of Management Analysis and System Development should review and approve the design before programming is initiated.

CONCLUSION

VSRS has lacked systematic management. Problems tend to be addressed as they arise, with the most visible deficiencies receiving the bulk of management attention. A sound organizational plan has not been developed. Important gains made in one administrative area have been offset by deterioration in other administrative areas.

Financial management has been seriously neglected. VSRS is primarily a financial organization and must have appropriate financial expertise on its staff. The historic lack of such expertise has resulted in unacceptable financial controls and accountability. In order to correct this deficiency, the Board should place a first priority on employing an experienced financial manager who can be held accountable for all aspects of financial and accounting activities within VSRS.

The Board also needs to strengthen its own oversight role over financial affairs. Presently, the Board of Trustees has a good mix of individuals who represent employee interests and individuals with professional experience in investments. However, the present composition of the Board does not necessarily provide for members who are experienced in financial management. Adding the Comptroller and a ninth member from private banking or insurance to the Board would serve this purpose.

VSRS must develop a more organized and planned approach to management. Basic management tasks such as preparation of job descriptions, job procedure statements, purging records, and developing internal reporting systems have not been carried out. Attention to this kind of management detail, and systematic planning which involves the Board, are essential.

III. Actuarial and Investment Oversight

Two major functions of VSRS are unique to a retirement system. First, the Board and General Assembly must determine the rate at which funds should be accumulated to pay for future benefits. This involves establishing funding policies and practices. Second, the Board must determine how best to profitably and safely invest the assets of VSRS. Investment income is a major source of funding for a retirement system and can substantially reduce the contribution requirements for employers and employees.

The Board oversees actuarial policies and investment management with the assistance of consulting specialists. VSRS has a contract with a national actuarial firm to provide advice and recommendations on funding the retirement system. An Investment Officer advises the Board on policies, guidelines, and performance measures for investment management. The Board retains responsibility for establishing and overseeing the policies and practices which satisfy the legal and ethical demands of retirement system administration.

ACTUARIAL POLICY AND OVERSIGHT

Actuarial policies and practices determine how a fund should be built up to pay for current and future retirement benefits. A number of the actuarial policies of VSRS are established by law, some are set by the Board. The actuary uses mathematical procedures to determine the appropriate contribution rates necessary to meet expected retirement costs in the future. He also advises the Board of the long-range cost effects of changes in benefit provisions and financing, and informs the Board of changes in the overall soundness of the retirement fund. The Board retains the responsibility for establishing actuarial policies and practices not specified in law, and for accepting or rejecting the advice of the actuary.

Actuarial policies are of great importance. Inappropriate policies can disguise the cost of benefits promised employees, shift the burden of paying for current services to future taxpayers, and, in some cases, create a fiscal crisis of major proportions. Because the impact of actuarial shortcomings may not become apparent for many years, sound policies and oversight procedures are essential.

VSRS actuarial policies are currently being reviewed by both the Board and the General Assembly. Board members have expressed concern about the advice they have received from the consulting actuary, and there is evidence that the actuary has not always provided timely advice to the Board. The Board has also been slow to develop important actuarial oversight measures for use as planning tools and as information for legislative and public disclosure.

Current Reviews of VSRS Policy

The cost of VSRS benefits is expected to increase substantially for the next several biennia. According to a recently completed actuarial study, the higher costs are generally the result of salary inflation and improved benefits. Employer contribution rates have been insufficient to keep pace with increasing costs over the last decade. This has led to some underfunding of VSRS, although there is no evidence to suggest that VSRS cannot meet its obligations.

The General Assembly is acutely aware of its responsibility to keep VSRS adequately funded. In 1978 the Virginia Retirement Study Commission initiated its own review of VSRS actuarial policies and benefits. The Study Commission has employed an actuarial consultant to evaluate the benefit structure, policies, and practices from the legislative perspective. The current review should provide an independent assessment of the soundness of the retirement fund, and the appropriateness of the policies and oversight procedures of the Board. Among the items which should receive attention are several which could affect the future soundness of VSRS.

Controlling the Unfunded Liability. Every two years the VSRS consulting actuary estimates the cost of pension benefits already earned by members. This represents the "debt" owed by the system to its members and is called the accrued liability. If assets on hand are not sufficient to offset the total accrued liability, the difference represents an unfunded liability. VSRS presently has an unfunded liability of \$890 million (Table 8).

Table 8

ACTUARIAL ESTIMATES FOR VSRS¹ (Millions of Dollars)

	<u>State Employees</u>	<u>Teachers</u>	<u>Local Employees</u>	<u>Total</u>
Estimated Future Cost of Benefits Already Earned	\$632.0	\$1,093.1	\$250.7	\$1,975.8
Assets	369.0	598.4	118.0	1,085.4
Unfunded Liability	263.0	494.7	132.7	890.4

¹Based on most recent valuations. Estimates for State employees and teachers as of June 30, 1976. Estimates for local employees as of June 30, 1977.

Source: VSRS Actuary.

It is important to note that every pension system has some unfunded liabilities. For example, when a pension system is established the benefits are usually made retroactive to include the entire employment history of the initial membership. Since contributions do not begin until a system is established, an unfunded liability is immediately incurred. Another source of unfunded liability is caused by an improvement in benefits. When VSRS changed its benefit computation and based the formula on the employee's highest three years salary rather than highest five years, there was an automatic increase in the unfunded liability.

An unfunded liability of \$890 million is not an unusually large amount for a large State pension system, nor does it necessarily mean that VSRS is not soundly funded. Figures in Table 8 show that VSRS had assets which offset 55 percent of the total estimated accrued liability. In contrast, Connecticut's State Employee Retirement Fund in 1976 had \$123 million in assets to offset liabilities of almost \$1.3 billion--a ratio of assets to accrued liabilities of only nine percent. The State and teacher systems in Massachusetts have an unfunded liability of \$3.8 billion, only 19 percent of which was offset by assets. According to the Pension Task Force Report of the U. S. Congress, the 25 largest state and local public pension plans have a median ratio of assets to accrued liabilities of 58 percent, compared to 55 percent for VSRS.

There is no generally accepted standard as to what constitutes a minimally acceptable ratio of assets to liabilities. In addition, the computation of actuarial estimates can produce greatly different estimates depending on the methods used. A ratio similar to that of VSRS, if computed using accepted methods, indicates that a system can meet its current obligations to retired members, and should be reasonably capable of remaining sound if growth in the unfunded liability can be controlled.

However, the unfunded liability of VSRS has been growing steadily. Between 1970 and 1976, the unfunded liability for State employees and teachers increased from approximately \$300 million to over \$750 million. This increase has been attributed to liberalized pension benefits, the use of actuarial assumptions prior to 1978 which did not accurately reflect salary inflation, and a \$16 million shortfall between appropriations and expenditures for cost-of-living supplements paid to retirees during the 1976-1978 biennium.

Steady increases in the unfunded liability can indicate a consistent shortfall between the cost of benefits and the contribution rate used to fund the system. Controlling the growth of the unfunded liability over time is generally regarded as the minimally acceptable means of maintaining the soundness of a pension system. However, the most recent actuarial study, completed in August 1978, concluded that the funding practices currently in use would allow the unfunded liability to continue to grow and could, in time, weaken the soundness of VSRS.

Most state systems, including VSRS, also make some effort to reduce the size of the unfunded liability by amortizing it over a number of years. However, the method used by VSRS to amortize the unfunded liability is not a widely used approach. Most states amortize the liability over a fixed time period, but VSRS uses a sliding time period which has the effect of reducing the liability at a much slower rate. A 1971 actuarial study recommended that VSRS amortize the unfunded liability over a fixed period. The recommendation was not adopted.

The actuarial study for the Retirement Study Commission should include recommendations to control the growth of the unfunded liability. A determination is also needed as to whether the method currently used by VSRS to pay off the unfunded liability is appropriate.

Advance Funding of Benefits. Advance funding means that the estimated cost of each employee's retirement benefits is set aside during the year in which it was earned. An alternative funding method is to pay for benefits when the employee retires. There are two major advantages to advance funding: (1) the cost of benefits earned today is borne by the taxpayers who receive today's services, and (2) the funds set aside now can be invested to provide another source of income for the pension system, and thereby reduce employer and employee contribution requirements.

VSRS funds major service-related retirement benefits in advance. However, several other benefits such as disability retirement and cost-of-living supplements are not funded in advance. According to two previous consultant studies, these benefits could result in increasing future costs. Cost-of-living supplements alone are expected to triple over the next ten years, from \$54 million in the 1978-80 biennium to \$163 million in 1986-88. The current review should address the question of whether these benefits should be fully funded in advance.

Level Contribution Rate. The objective of VSRS as specified in the *Code* is to maintain a relatively level rate of employer contributions, measured as a percent of total payroll. The level contribution goal is recommended by most authorities although some variation from year-to-year is expected due to differences between anticipated and actual experience. However, VSRS will not satisfy the level contribution objective over at least the next decade (Table 9). The employer contribution rate for State employees will increase from 2.6 percent to 5.3 percent of total payroll, while contributions for teachers will jump from 4.25 percent to almost 9 percent. There are no trend projections available for localities participating in VSRS, but similar increases for many jurisdictions are likely.

A long-term trend of increasing employer contribution rates could indicate deficient funding. The 1978-1988 period may be insufficient to assess how well VSRS is funded. However, the current review should obtain additional estimates to determine whether VSRS

Table 9

PROJECTIONS OF EMPLOYER CONTRIBUTION RATES
1978-1988

<u>Biennium</u>	<u>State Employees</u> ¹	<u>Teachers</u> ¹
1978-1980	2.61%	4.25%
1980-1982	3.87	5.94
1982-1984	4.83	7.31
1984-1986	5.02	8.08
1986-1988	5.28	8.79

¹Contributions as a percent of total payroll.

Source: VSRS Actuary.

is capable of fulfilling the level contribution requirement stated in the *Code*.

Actuarial Condition of Localities. Although the evidence suggests that VSRS can meet its obligations to State employees and teachers for the foreseeable future, the actuarial condition of some participating localities is less certain. The *Code* specifies that VSRS is not liable for the retirement benefits of local employees beyond the amount already contributed and held by VSRS. A locality which becomes financially unable to make the necessary contributions is considered to be in default, and employees of the locality would have legal claim only to those assets held in the locality's separate account. This would mean that in most cases employees of a locality in default would lose retirement benefits that they had already earned.

A number of localities participating in VSRS have assets which are small in relation to current retirement payments and accrued liabilities. For example, one Virginia city has a ratio of assets to current retirement payments of only 3:1 compared to 13:1 for VSRS as a whole. Another city has only \$3.3 million in assets to offset \$11.9 million in benefits already earned. As of June 1977, there were at least 30 participating localities with assets equal to less than 30 percent of accrued liabilities. At least nine localities could exhaust funds in their retirement account within the next year. Under a 1978 amendment to the *Code* these localities will be required to supplement their contribution in order to avoid paying retirement benefits from general VSRS assets or the contributions of active members.

The possibility exists that VSRS and the General Assembly will be called upon to absorb the actuarial deficit of a defaulted locality at some time in the future. Although not liable under law, the system would be under considerable pressure to protect the earned retirement benefits of local employees. In fact, VSRS has

already accepted the actuarial liability for employees of one small regional library which defaulted on its required contributions. A similar demand from the employees of one or more large jurisdictions could adversely affect the funding of VSRS.

Previous actuarial reviews have not addressed the actuarial condition of participating localities. Nevertheless, 23 percent of the VSRS membership are local employees, and the adequacy of funding for localities affects the retirement system. The Retirement Study Commission may want to determine the condition of actuarial funding for all participating localities. If the actuary identifies localities which are underfunded, steps should be taken to ensure that the funding weaknesses are corrected through increased contributions.

Communication With Actuary

Most communication between the Board and the VSRS actuary is channeled through the Director. There was no direct communication between the actuary and Board prior to 1969 and interaction between the Board and actuary has been sporadic since that time. A number of Board members interviewed by JLARC expressed concern about the ability of the actuary to interpret and clarify actuarial practices as they pertain to Board needs. A lack of effective communication resulted in a serious disruption in Board review of projected State contributions during the preparation of the 1978-1980 biennial budget.

The State contribution for the 1978-1980 biennium increased by 90 percent over the 1976-1978 total, from \$113 million to \$217 million. This increase was due to several factors:

- an increase in retirement payments for cost-of-living supplements;
- an increase in total salary costs for teachers and State employees due to additional employees and cost-of-living increases;
- an increase in contributions due to underestimations of 1976-1978 salaries, data changes, amendments to the benefit package, etc; and
- an increase in contributions due to a change in assumptions used by VSRS.

The full effect of these increases was not disclosed to the Board until June, 1977 when many localities, as well as the State, were well into the budget cycle for the upcoming fiscal period. In May the actuary first briefed the Board on several assumptions that should be changed as a result of a five year study of experience between 1972 and 1976. At that time, the actuary

stated that these changes would "increase the system costs, perhaps substantially", but he did not indicate the extent of the increases. When the full magnitude of the increased costs became apparent in June, the Board became greatly concerned that the actuary had offered little or no prior warning about the size of the change in contribution requirements.

Of particular concern to the Board was a proposed change in assumptions recommended by the actuary to allow for inflationary cost increases in the salary scales. One of the most critical actuarial assumptions deals with the expected rate of salary increase since retirement benefits are based on the three highest years' salary. Underestimation of future salary levels can contribute to unrealistically low contribution rates. "Cost-of-living" salary adjustments have become routine as high inflation rates outdate the value of pay structures. These salary adjustments are made across-the-board, and are in addition to salary increases resulting from promotion and merit. VSRS has routinely used an assumption to reflect expected salary increases due to promotion and merit. However, assumptions based on inflationary effects were not adopted until 1977, despite the fact that across-the-board salary increases have been common since the early 1970's.

The impact of adding an inflation assumption can be illustrated by an example drawn from an actuarial study of the Indiana Teachers Retirement System (Table 10). The study projected pension costs, and the associated funding requirements, over a 50 year period with all assumptions held constant except salary inflation. Three assumed rates of inflation were tested: zero percent, three percent, and six percent. Table 10 illustrates that if salary inflation were to average six percent, and no inflationary assumption were used in establishing contribution rates, the Indiana system would fall short of meeting its pension payment requirements by over \$2 billion in the last year of projection.

Table 10

IMPACT OF SALARY INFLATION ON PENSION COSTS
(Millions of Dollars)

Year	Estimates of Pension Costs		
	Assumes No Inflation	Assumes 3% Annual Inflation	Assumes 6% Annual Inflation
1975	\$ 48	\$ 48	\$ 48
1978	65	81	99
2000	113	200	355
2015	168	453	1,281
2025	169	602	2,215

Source: Indiana Legislative Council, Performance Audit of Public Employee Retirement Systems in Indiana, December, 1976.

The fact that VSRS did not use some salary inflation assumption in establishing employer contribution rates was noted as a potential problem in a 1971 actuarial study of the system. In 1974 the Division of the Budget expressed concern and was assured by the VSRS actuary that "excessive inflation over a finite period will not have deleterious long-range effects". VSRS, like many pension systems, also relied on a built-in hedge commonly used by actuaries. By purposely establishing the assumed rate of investment return at conservatively low levels, the Board expected to offset the effects of mild inflation in salaries. This course of action was recommended by the actuary in 1973 based on a study of actual VSRS experience between 1965 and 1970.

Based on the more recent 1972-1976 experience study, however, VSRS' actuary reversed his position on the need to include an inflation assumption for use in projecting salaries. In a statement to the Board in May, 1977, the actuary said that "since we believe inflation will be here for a while, we believe it would be prudent to make some provision for it by increasing the existing rates (assumption rates) by four percent per year". It is evident that between 1973 and 1977 the actuary changed his opinion about the need to account for inflation. However, according to Board members, they were not clearly alerted to this change, and little attention was given to the higher cost that would result from the new assumptions until well into the budgetary decision-making process.

The Board should formalize and clarify the actuary's role in educating and informing Board members about actuarial practices in use by VSRS. Legislation requires the actuary to carry out a number of studies. However, the Board should also hold the actuary strictly accountable for informing it in a timely fashion of all changing conditions which might affect the fund.

It is also important that the Board and consulting actuary meet regularly. Some states enact laws calling for a minimum number of meetings between the Board and actuary each year. At a minimum, the Board should establish a policy for the frequency of its meetings with the actuary.

Lack of Funding Measures

The Board and the actuary have not provided suitable measures of funding to serve as information for decision making, or to meet the demands of adequate public disclosure. Measures of funding include a wide variety of ways to test a pension system for the relationship between assets and liabilities--the solvency of the system--as well as tests of the current and future impact of decisions. Principal shortcomings in this area include: failure to disclose the unfunded liability of VSRS; delays in acting on recommendations for better actuarial information; and a lack of systematic, long-range cost projections.

Disclosure of Unfunded Liabilities. The nature of the unfunded liability, and the requirement that it be disclosed in financial statements, have been discussed previously. The unfunded liability is based on the actuarial assumptions and method of advanced funding used by the actuary. It is, therefore, an estimate and relative to the actuarial practices in use. Two calculations using acceptable methods can result in estimates of the unfunded liability that vary by as much as 50 percent. This fact makes comparisons with other pension systems based on the unfunded liability difficult and open to misinterpretation.

Nevertheless, the unfunded liability is of concern to VSRS, the legislature and the public. Of particular interest are changes in the unfunded liability over time. Changes in the liability of VSRS under constant assumptions and actuarial practices reflect actual change in the soundness of the retirement system. Even if the assumptions and practices are altered, the unfunded liability can be recomputed to test the impact of those alterations. Properly used, the unfunded liability estimate remains an important measure of the overall ability of a retirement system to meet its obligations to members.

At present the unfunded liability of VSRS is disclosed only in the biennial valuation study. The valuation study does not show year-to-year changes in liability or offer any analysis of the reasons for change. There is no evidence that more complete information is provided to the Board. Particularly important is the failure to disclose the unfunded liability, or any other measure of fiscal soundness, in the annual report. The absence of this information limits the usefulness of the annual report in fulfilling its primary purpose of maintaining the accountability of the Board to members, the legislature and the taxpayers.

VSRS should include a section in the annual report dealing with actuarial measures of the retirement fund, including the unfunded liability and other appropriate measures. The section should include a reasonably detailed analysis and interpretation of these measures and a candid appraisal of their meaning.

Improvements in Information for Decisions. The Board has moved slowly in adopting recommendations for better decision-making information. The 1971 actuarial study recommended two improvements in actuarial studies for use by the Board in decision making: administrative valuations and projections of liabilities and assets. Neither of the recommendations were adopted.

Administrative valuations test cost projections against changes in assumptions to determine the effect of various changes in the future. For example, it might project required increases in contribution rates if members began retiring at younger ages. The illustration from the Indiana system cited previously also shows how an administrative valuation is used. These valuations can be a valuable means of projecting "what-if" scenarios to alert the Board

to particularly sensitive areas. Adoption of the 1971 recommendation to develop administrative valuations could have prevented the serious delay in recognizing the importance of salary inflation in estimating the cost of retirement benefits.

The Board should obtain periodic administrative valuations of VSRS from the actuary. These should test major assumptions by substituting a range of possible values in the computation formula for contribution rates. The results of these tests will provide the Board with important information about actuarial assumptions and their impact on contribution rates and funding. Information from administrative valuations and other special studies should be included in the annual report section on actuarial practices.

Long-Range Cost Projections. VSRS is the major source of information about retirement costs. According to legislative staff, the administration of VSRS has been cooperative in responding to legislative requests for information. However, the material provided by VSRS generally addresses only the current budget period. The actuary provided the first systematic projection of future employer costs for a ten-year period during hearings on the 1978-1980 budget. These projections were not part of the standard reports but were done at the request of the Board of Trustees to better deal with the impact of the increase in contributions due to salary inflation and other factors.

Other states routinely project costs at least a decade in advance and sometimes through the end of the century. While such long-term projections are only estimates (based on current assumptions and subject to error), they are more useful than single biennium estimates with no projection of future cost. For example, the VSRS actuary's ten year projection of necessary contributions for teachers and State employees increases from \$208 million in the 1978-1980 biennium to over \$956 million in 1986-1988. Even if this projection is substantially inaccurate, the Governor and General Assembly must be alerted to the major impact such an increase will have on State budgets over the next decade.

The *Code* now requires an actuarial statement regarding the long-term effect of proposed legislative changes. VSRS should assume the responsibility for making long-range cost projections for all major pension related issues under consideration by the Governor or General Assembly. These long-range projections can be coupled with administrative valuations which test various assumptions and their impact over time, and proper disclosure of measures of funding adequacy, to provide a more adequate source of pension-related information than is currently available.

INVESTMENT OVERSIGHT

The Board maintains direct control over the investment section of VSRS with the Director's role limited to administrative coordination. The position of Investment Officer is filled by an experienced investment professional who is employed on contract at \$30,000 annually. The Investment Officer is responsible for maintaining routine contact with each manager, for collecting and interpreting data which can be used to assess manager performance, and for reporting to and advising the Board on investment decisions.

VSRS has greatly improved the management of its investments since 1970. The return on investment generally reflects this improved management, although stock investments have been disappointing. Most important, Board oversight has remained active.

Board Oversight

Board oversight of investment management is most heavily concentrated in three areas: investment policy, establishment of portfolio guidelines, and performance measurement.

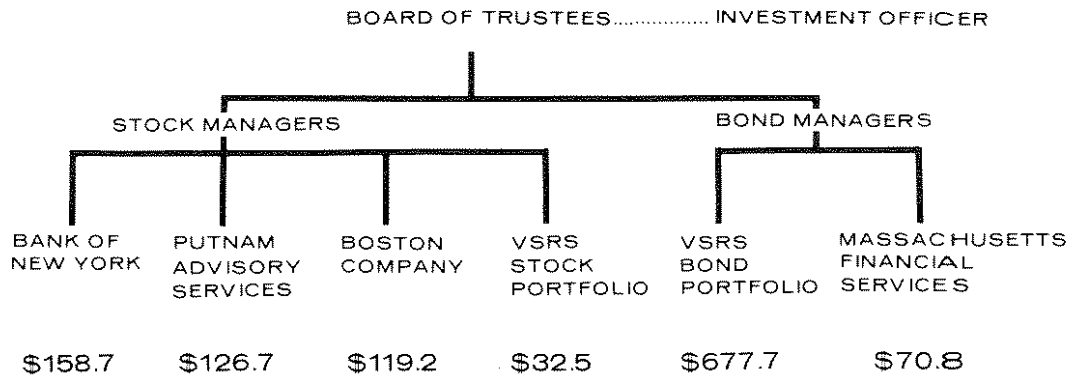
Investment Policy. The long-term objective of VSRS is to realize a satisfactory rate of return through both income and market appreciation. All investment decisions are subject to the legal doctrine of the "prudent man" which requires that trustees exercise the caution and discretion they would employ in their own affairs. Maintaining a high degree of safety of assets is emphasized, particularly for management of the in-house bond portfolio which constitutes about 53 percent of total assets.

Three major policies have influenced VSRS investment management since 1972. The first, implementation of the multiple management concept, was based on a consultant's plan for modernizing investment management. Multiple management means employing more than one manager in the two principal types of investments: fixed income bonds, and common and preferred stocks. VSRS presently employs four stock managers and two bond managers (Figure 4). The advantages of multiple management are greater security through diversification, access to more varied research and a source of comparison for performance assessment. Disadvantages include higher management costs and contradictory actions, or "reversals", which occur when one manager sells a security at the same time another is buying the same security.

The second major policy decision of the Board is encouragement of active trading by knowledgeable professional managers. Active trading can result in high turnover and higher costs through increased brokerage commissions. Turnover in the stock portfolio has averaged about 18 percent annually since 1973. The bond account has experienced heavy turnover: a 42 percent annual average

Figure 4

MARKET VALUE OF ASSETS ASSIGNED
TO VSRS INVESTMENT MANAGERS
(June 30, 1978, Millions of Dollars)



ASSETS SHOWN AT MARKET VALUE.
INCLUDES CASH NOT INVESTED AS OF JUNE 30, 1978.

Source: VSRS.

for the in-house account and almost 100 percent annually for bonds managed outside VSRS. The primary purpose of active turnover is an effort to continually upgrade the quality and yield of securities by using funds from one sale to purchase other issues of higher quality or yield.

It has been widely accepted that such active trading will produce higher returns than a passively managed portfolio. However, some investment experts question the value of active management by suggesting that, in a market environment dominated by professionals, the advantages of expertise are cancelled out or cannot offset the higher overhead cost of active management.

One alternative to active management in stocks is the concept of indexing. Indexing involves constructing a stock portfolio which closely parallels the stocks listed on one of the major indices such as the Standard and Poor 500. These stocks are held and, in effect, the portfolio is allowed to passively float along with the market. Washington State's two major pension systems are expected to approve indexing of one-half of their assets currently invested in stocks, while the other half continues to be actively managed.

The available data do not conclusively show whether actively managed portfolios will outperform indexed ones in the future. Indexing does commit the fund to doing no better than the average. The Board has discussed indexing as an alternative management approach, but has decided not to adopt the concept. This would

appear to be appropriate at the present time; however, the Board should review the experience of other states as information becomes available to determine whether a policy change is needed.

The third policy initiative is a long-term commitment to increasing the proportion of total assets invested in stocks. In 1971 VSRS had only 7 percent of the authorized 20 percent of total assets in stocks. The ceiling for stock investment, which is established by law, has been increased to 35 percent and then to 40 percent in 1978. The Board had requested a 50 percent ceiling for the 1978 legislation. In order to take advantage of the higher ceiling, the Board has consistently reinvested most of the new funds received each year from employer and employee contributions in stocks. As a result, 30 percent of VSRS assets are presently invested in stocks.

The decision to increase investments in stocks is supported by long-term trend analysis which shows that, although stocks are much more likely to experience periods of low returns or losses, over the period 1926-1976 stocks have consistently outperformed bonds by a wide margin. Since pension investment decisions should be based on long-term returns, the use of a 50 year trend analysis is appropriate.

The greater volatility of stocks confirms the need for a limit on investments in stocks as a proportion of total assets. The fixed maturities and interest yield of bonds allows VSRS to "program" investment income to meet the annual liabilities which will result in the future from increasing numbers of pensioners. By maintaining a well-structured bond portfolio, VSRS can ensure that stock holdings do not have to be sold at a possibly disadvantageous time to meet current pension payment requirements.

Portfolio Guidelines. Some general investment guidelines have been enacted into law. More specific guidelines imposed by the Board restrict investment managers in the amount of diversification they must maintain, the rated quality of securities, and the prohibition of certain types of purchase or sale procedures. The guidelines are based on a 1972 consultant's study and were updated in 1977 to reflect policy changes made since 1972.

Advisory texts on pension management, such as those published by the Municipal Finance Officers Association, stress that investment guidelines should balance the objective of avoiding undue risk with that of providing managers enough flexibility to make use of their professional expertise. Guidelines which are too constricting defeat the purpose of professional management. The original 1972 guidelines were developed with the assistance of management firms bidding on the VSRS contracts, and were judged by them to be generally acceptable. The changes since 1972 have not substantially altered the guidelines, and it appears that the existing Board policy in this area is reasonable.

One aspect of the guidelines needs to be clarified. Under conditions of the group life insurance contract between VSRS and Life of Virginia, \$55 million in VSRS assets are held and invested by Life of Virginia. The investment of these funds is determined exclusively by Life of Virginia thereby effectively placing the \$55 million outside the control of VSRS guidelines. Although there is no evidence that the investments of Life of Virginia are any less secure than those of VSRS managers, the Board of VSRS should request that Life of Virginia regularly report on the nature of their investments and, if the Board considers it necessary, abide by Board guidelines.

Performance Measurement. The heart of Board involvement in investment oversight is the measurement and tracking of manager performance. Performance objectives are established for managers by the Board. Since the current system was established in 1972, the Board has terminated the contracts of three of the original six managers based at least partially on performance which, in the Board's judgement, was not adequate.

The performance of each stock manager is compared to the Standard and Poor (S&P) 500 national index at monthly Board meetings. Additional data are available from nationally computed indices which reflect the performance of the general market or other large institutional investment funds comparable to VSRS. Individual managers are compared with each other, with national indices, and with the VSRS fund as a whole. Other comparative statistics are also used. For example, the in-house bond portfolio manager uses a variety of measures to assist him in tracking and evaluating performance. The Investment Officer has proved instrumental in providing a candid interpretation of the various measures, both verbally at meetings and in his annual report to the Board.

Overall, it would appear that the Board policies relating to investment management are reasonable and marked by a high degree of responsiveness to changing conditions. Performance measurement and reporting used by the Board, and the willingness of the Board to take action based on performance, indicate that this aspect of management oversight is particularly well developed. The investment returns experienced by VSRS tend to support past policy decisions, although some performance has been mixed.

Performance of Investments

As of December 31, 1977, 58 percent of VSRS assets available for investment were allocated to bonds and 29 percent were allocated to stocks (Table 11). The remainder consisted of cash, short-term securities, and special investments.

VSRS has earned a good return from bonds and most short-term securities since the management of investments was restructured in 1972. Return on stocks has been below expectations, but the

Table 11

INVESTMENTS OF THE VIRGINIA SUPPLEMENTAL
RETIREMENT SYSTEM
December 31, 1977 (Millions of Dollars)

<u>Type of Investment</u>	<u>Value</u> ¹	<u>Percent</u>
Bonds	\$ 717.7	57.5%
Stocks	361.8	29.0
Cash/Short-Term Securities	111.2	8.9
Special Investments	58.5	4.6
Subtotal	1,249.2	100.0%
Add: Advance Premium Deposit Fund	55.0 ²	
Total	\$1,304.2	

¹ Book value (cost net of amortization of premiums, discount, or deferred losses).

² VSRS assets held by Life of Virginia under terms of the group life insurance contract. The fund is limited to a maximum holding of \$55,000,000.

Source: VSRS Investment Review, 1977.

Board has taken positive action to improve the performance of the stock portfolio by terminating its contracts with the investment management firms whose performance has been poor.

Bonds. The bond portfolio appreciated through income and market changes by 36.6 percent between December 1974 and December 1977. This is a compound annual rate of 11.0 percent and is generally in line with a national index of long-term bonds over the same period. The steady appreciation has been accompanied by a marked increase in quality. The average rating of the portfolio increased from less than AA in 1974 to midway between AA and AAA in 1977. The performance of the bond portfolio has been generally in line with the Board's objectives of keeping pace with market trends while maintaining a high degree of safety.

The bond portfolio was upgraded through the sale of low grade securities and the purchase of bonds having higher yields. From a public relations standpoint, the active trading of low yield bonds was facilitated by the creation of an account for deferred losses.

Deferred losses result from bond sales when the funds from the sale of low yield bonds are used to purchase another issue

of better quality and yield. Under these circumstances, the loss incurred on a sale can be considered temporary and an "investment" in a better bond holding. VSRS policy since 1970 has been to defer this loss and amortize it against income of the purchased bond over the maturity period. At the end of fiscal 1977, VSRS carried deferred losses of \$55.3 million on its books as an asset.

The use of deferred losses and their inclusion on the books as an asset was criticized by the Comptroller in June 1977. In response, the Board stopped the use of deferred losses as of July 1, 1978, and the balance in the account will be amortized over seven years.

VSRS might have encountered considerable criticism from employee interest groups if losses on bonds had been realized at the time of the transaction. The low yield securities held by VSRS prior to 1972 were generally sold at substantial losses, while the benefits of purchasing higher yield bonds will become apparent only over several years. For this reason, the deferred loss account has served as a valuable house-cleaning tool.

However, deferred losses represent assets only in the most abstract sense and should be clearly explained in financial statements as long as there is a balance in the account. Also, the actuary uses the balance of the deferred loss account as an asset in valuation studies, which slightly inflates the value of current assets used to establish current contribution rates. While the difference is minor, the treatment of deferred losses as assets in the valuation studies should be reconsidered.

Stocks. Performance of VSRS stock investments has fallen short of the investment objectives of the Board. The stock portion of VSRS investments actually declined by three percent on a total return basis in FY 1977. This decline resulted from a drop in market value in excess of the \$11.3 million in income.

The original 1972 objective set for stock managers was to achieve significantly better results than the S&P 500 index. The objectives were downgraded in the 1977 revision to the 1972 guidelines, but still have not been met. VSRS has outperformed the index in only two of the last five years, and then only by narrow margins (Table 12).

The inability of VSRS to outperform the S&P 500 is characteristic of large investment funds over the last several years. Banks, insurance companies, other large pension systems, and mutual funds have all tended to trail the index. This is due in part to the heavy investment by large funds in the 50 largest corporations with reputations for long-term growth potential. Stock of these corporations has not done as well as anticipated in many cases, thereby depressing the performance of the large investment funds. On a comparative basis, VSRS generally outperformed most other large funds prior to 1977 when results were slightly below those of bank, insurance, and mutual funds.

Table 12

PERFORMANCE OF VSRS STOCK PORTFOLIO
 COMPARED TO THE S&P 500
 (1973-1977)

<u>Year</u>	<u>Percent Change</u>	
	<u>VSRS</u>	<u>S&P 500</u>
1973	-17.0%	-14.7%
1974	-25.2	-26.3
1975	+30.2	+36.9
1976	+18.1	+23.3
1977	- 7.6	- 7.9

Source: VSRS 1977 Investment Review,
 December, 1977.

Board members interviewed by JLARC staff agreed that stock performance has been disappointing since 1972, when it was decided to invest a greater portion of assets in stocks. The Board remains committed to increasing equity investments; however, changes in managers have been made. Contracts with two stock management firms employed by VSRS have been terminated, and an experiment is now underway to place a portion of the stock portfolio under the management of VSRS staff. Managing stocks in-house will probably reduce management costs, but additional experience will be necessary to determine whether in-house management results in equal or better returns.

Short-Term Investments. Short-term investments are managed by the Treasurer. These are investments of cash held as working capital or allocated to investment managers but not presently invested in securities. This cash is invested in short-term loans, Treasury bills or U. S. government notes with maturities ranging up to two years. The return available on invested cash is closely tied to the frequent changes in prevailing rates for short-term investments.

The Board has given consideration to transferring short-term management from the Treasurer to VSRS. This would probably require legislative clarification of the Treasurer's status as legal custodian of the VSRS fund. Also, VSRS would be less able to ensure that cash remains fully invested because the Treasurer controls the VSRS checking account. By projecting the cash flow requirements for the checking account, the Treasurer's office has been successful in keeping the fund fully invested with little or no idle cash.

Special Investments. Special investments include 70,192 shares of the Richmond, Fredericksburg and Potomac Railroad, and the value of VSRS loans outstanding to the State for the purchase

or construction of public buildings. These special investments are held by VSRS under specific legislation. Up to \$100 million in VSRS assets can be invested in the construction or acquisition of buildings for State office space. VSRS projects that by 1981 outstanding loans to the State will total \$96 million, or just under the present limit established by the *Code*.

The return on VSRS investments in State office buildings prior to 1973 averaged 4.6 percent. In 1973, legislation which the Board initiated was enacted to allow VSRS to establish interest rates for loans to the State at prevailing rates. These are computed based on yields of two or more long-term government securities. The three loans made since 1973 carry interest rates averaging 8.5 percent. It would appear that, although VSRS may have been subsidizing the construction or acquisition of State office space prior to 1973, the present interest rates provide a good return.

Measuring Total Return on Investments. The retirement system earned \$65.6 million in income from all investments in FY 1977. Table 13 shows total income and two different measures of the rate of return earned by VSRS.

Table 13
RATE OF RETURN ON VSRS MANAGED INVESTMENTS
FY 1977
(Millions of Dollars)

<u>Type of Asset</u>	<u>Average Amount Invested</u>	<u>Income</u>	<u>Rate of Return</u>	
			<u>(1) Income Only</u>	<u>(2) Income + Change in Market Value</u>
Cash/Short Term	\$ 57,752	\$ 3,445	5.97%	--%
Bonds	674,236	47,616	7.06	14.7
Stocks	319,270	11,307	3.54	- 3.0
Special Investments	45,148	3,214	7.12	--
Total	\$1,096,406	\$65,582	5.98%	9.01% ¹

¹
Weighted Average.

Source: VSRS Annual Investment Report, June 30, 1977.

A rate of return is a basic measure of management performance. Column (1) in Table 13 is based on income only (dividends and interest). Column (2) includes income plus appreciation or depreciation in market value of stocks and bonds, and is referred to as total rate of return. Short term and special investments are not considered marketable for performance measurement purposes and, therefore, are not shown in the total return computations.

Measuring return based on income only does not consider the change in value of marketable securities. Over three-quarters of VSRS investments are marketable and have the potential for capital gains and losses. For this reason, Column (2) in Table 13 is a better indication of overall management performance for the stock and bond portions of the portfolio. However, even total return data based on one year's statistics can seriously distort performance measurement due to several factors:

- stock prices are subject to changes in general economic conditions from year-to-year, so the time period chosen for review is critical;
- bond prices are linked to general inflation and higher interest rates, and the value of an issue may decline even though there has been no actual change in the quality of the security; and
- investment of pension funds is generally conservative with strong consideration given to security, diversification and long-term growth potential in addition to annual return.

In order to avoid distortion over the short term, the Board reviews data on general market trends and the activity of other large investment funds. This kind of trend analysis, in conjunction with reviews of the quality, maturity and diversification of the portfolio, offers the best type of performance assessment.

Overall, the return on VSRS investments in recent years has been reasonable. The Investment Officer estimates that return on all investments, including appreciation in market value, has averaged about 11 percent annually between December 1974 and December 1977. Some of this return is only potential profit, since market appreciation does not provide cash income unless the security is sold. Nevertheless, investment income contributed 28 percent of total VSRS income in 1977 and should be sufficient to meet the actuarial requirements of the retirement fund. Income from investments may also increase if the recent changes in the stock management firms are successful.

CONCLUSION

Active oversight by the Board of Trustees has achieved considerable modernization in investment management since 1970. Available evidence indicates that investment policies and oversight procedures are well developed. The Board is kept informed of manager performance and has taken action in response to performance measures.

Much of the improvement in investment management has resulted from the use of professional managers and advisors, including the Investment Officer who keeps the Board informed of investment performance, economic trends, and manager selection. This individual is employed on a consulting basis, and has discussed his possible retirement with Board members. The central role of the Investment Officer makes it essential that the Board be prepared with procedures to replace the Investment Officer should he choose to retire.

The management of investments is complex and professional opinions vary widely. Presently, the Board includes investment professionals and benefits from the advice of an experienced Investment Officer. However, additional sources of advice, particularly pertaining to long-term investment policy, would be valuable. The Board should consider using an investment advisory group to review investment plans and policies on a periodic basis. The responsibility for investment decisions would remain with the Board and an Investment Officer who can provide day-to-day review of performance.

VSRS has had a series of actuarial reviews since 1971, including one presently being conducted for the General Assembly. Past reviews have found that the actuarial practices are, in general, appropriate. And, while there is no commonly accepted definition of what constitutes a well funded pension system, VSRS appears to be in a good position to remain able to meet its obligations to members.

Nevertheless, some underfunding of VSRS has occurred over the last ten years, and several questions about the actuarial practices now in use need to be answered. In order to maintain its oversight of actuarial practices, the Board should increase its communication with the consulting actuary. Communication has not been adequate in the past. The actuary is a technical advisor to the Board and must be held accountable for the provisions of accurate, timely advice. Formalization of the actuary's role, additional use of standardized funding measures, and long-range cost projections will strengthen Board oversight of VSRS funding.

IV. Field Services

VSRS provides field services to two groups: 235,000 active and retired members, and 745 participating employers. Field services include such activities as (1) informing members about retirement benefits, rights, and responsibilities, (2) providing direct member services such as processing refunds, arranging for direct deposit of annuity checks, and preretirement counseling, and (3) training agency personnel who are designated as *employer contacts* in the procedures for processing contributions, filling out VSRS forms, and handling information requests.

VSRS has given much attention to improving field services in recent years. A handbook for members describing benefits and procedures of VSRS is printed every two years. This important publication is supposed to be given to all new members. Newsletters issued periodically to active members and annually to retirees discuss current legislative changes and procedural reminders. An individual statement of contributions ("Member Benefit Profile") is sent annually to each member. Other noteworthy improvements include reducing the length of time required to process refunds and retirement applications. However, additional changes are needed in training the *employer contacts*, distributing publications, and providing counseling services to persons who are near retirement.

JLARC Surveys

Three principal data sources were used to assess the effectiveness of VSRS field services. First, questionnaires were mailed to a random sample of 527 active and 242 retired VSRS members. The surveys were designed to measure the attitude and knowledge of members regarding their retirement benefits and to identify any problems in the VSRS information distribution system.

Second, interviews were held with *employer contacts* in nine State agencies, eight school districts, and seven local governments to determine the effectiveness of the information and training provided by VSRS personnel. The 24 employers were selected to be representative of the various employing agencies that participate in VSRS.

Finally, member files were reviewed and VSRS staff were interviewed.

TRAINING EMPLOYER CONTACTS

The relationship between the VSRS headquarters and employers that participate in the retirement system is complex. A great deal of administrative responsibility is assigned to designated

employer contacts in each of 745 State agencies, school districts, and localities (Figure 5). The contact is usually a personnel and/or payroll employee who is responsible for retirement matters. For the purposes of this report, *employer contact* refers to the person or persons who perform these duties.

The *employer contact* has a wide range of duties. He or she helps employees complete VSRS forms, ensures that employee contributions are properly deducted from payrolls, and informs employees about retirement benefits, rights and responsibilities. Since VSRS does not keep up-to-date member address files, nearly all VSRS communications to members--publications, benefit profiles, benefit change notices--are distributed using the *employer contact* network.

Without a well trained and effective *employer contact*, VSRS is greatly hampered in its ability to ensure that proper procedures are followed, member contributions are properly accounted for, and members are well informed.

VSRS Training Seminars

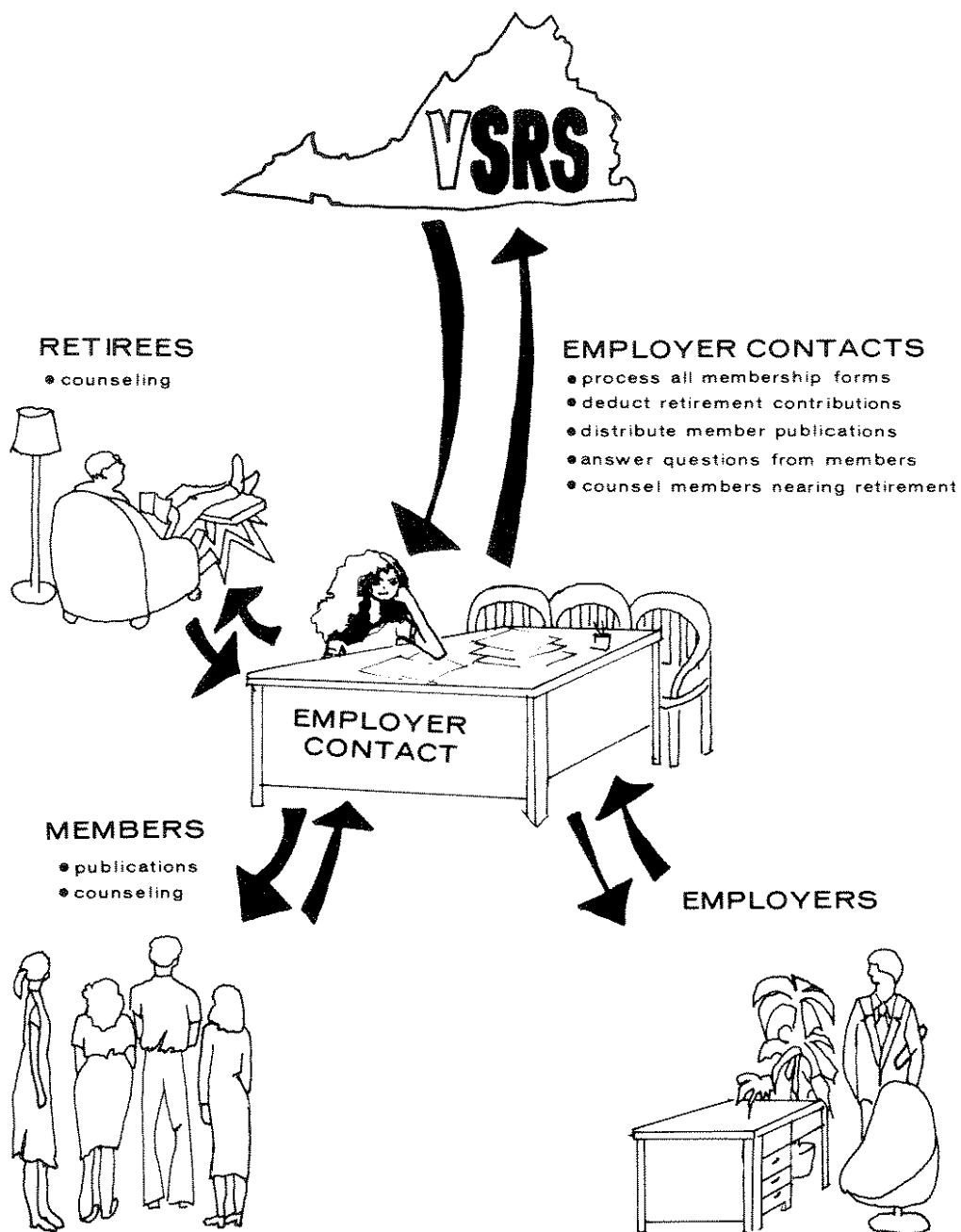
VSRS training of *employer contacts* is based on a series of 20-25 half-day seminars held annually in various locations throughout the State. These seminars are presented by as many as four VSRS personnel. The training consists of an oral briefing, a question-and-answer period, and distribution of seminar booklets. The seminars are well attended and popular, but they are an expensive training device (demanding 80-100 man-days annually) and do not achieve training needs.

Few *employer contacts* are satisfied with their own effectiveness and preparation. Of the 24 *contacts* interviewed by JLARC staff, 22 had attended at least one seminar, yet only four *contacts* believed they were fully able to carry out all assigned VSRS responsibilities. Five *contacts* stated that, although they had a general understanding of their assignment, they did not have enough information about specific VSRS procedures. Five *contacts* did not know the full nature of their duties--none of them knew they had responsibility for retirement counseling. Nearly all *employer contacts* said they felt uninformed about current changes in VSRS procedures and policies because updating was infrequent.

A principal weakness of using an annual seminar as the primary source of training is that *employer contacts* are not always able to attend when they are first assigned responsibility for retirement matters. Once a *contact* has missed a seminar, there is little opportunity for training through other methods. Two of the 24 *contacts* interviewed by JLARC had not attended a seminar, and neither had received other instructional materials. Without training (or detailed operational procedures), *employer contacts* cannot be expected to fulfill their responsibilities.

Figure 5

Central Role of the Employer Contact



Source: JLARC

In one small political subdivision there were five different payroll clerks in less than 12 months. Each new clerk was designated as the "employer contact". The present clerk has never received on-the-job training concerning VSRS procedures. She was hired after the last VSRS seminar and has not received or cannot find any instructional material from VSRS.

The clerk reported that she calls VSRS frequently for help but often receives contradictory or what she believes are confusing instructions. She was uninformed about basic procedural questions such as how to take insurance deductions for a partial pay period; whether VSRS contributions should be made for CETA employees; or who should get handbooks.

Lack of Written Instructions

Even if an *employer contact* attends an annual seminar, the training effort is hindered. The oral briefings are short and do not facilitate a comprehensive discussion of duties. There is a serious lack of detailed, written instructions to provide consistent guidance.

Written procedures and guidelines are necessary for *employer contacts*. Regular procedural updates are required to identify changes in procedures as they occur. Written instructions can also minimize misunderstanding and inconsistent applications which are a common problem in verbal communication.

VSRS now has two types of written material for *employer contacts*: booklets distributed during seminars, and an operations guide that is sent to all participating employers. However, some *contacts* do not have or have not received these materials. In addition, the operations guide is incomplete and out-of-date.

Seminar Booklets. VSRS supplements verbal seminar briefings with booklets. These contain broad outlines of procedures, rather than detailed instructions. The booklets are not frequently updated which limits their usefulness apart from the seminars.

The *employer contacts* interviewed by JLARC identified many topics which are not adequately addressed by the seminar booklets. Some of these topics relate to: purchasing retirement credit for prior service; acquiring health insurance coverage and withholding federal tax for retirees; applying for retirement; and reporting social security withholding.

Operations Guide. VSRS also relies on a guide to provide information to *employer contacts*. However, the guide is deficient because it is incomplete, is not routinely updated, and lacks a table of contents or index.

The most serious shortcoming of the guide is the fact that it is incomplete. The only detailed set of instructions it contains pertains to payroll reporting. No information is offered on deductions for social security, completion of VSRS forms, or the availability of VSRS publications or counseling services.

Even the detailed section of the guide which covers payroll reporting is incomplete. It does not instruct *employer contacts* on the proper reporting procedures for: (1) leaves of absence; (2) purchase of prior service credit; and (3) payment of employee contributions by employers.

The problems created by the lack of comprehensiveness are compounded by the fact that the guide is not routinely updated. In 1977, VSRS began advising *employer contacts* of procedural changes through a quarterly memo entitled "Update". Although four issues were published in 1977, none have been distributed in 1978.

Because VSRS has made no systematic effort since 1977 to keep the guide current, those now in use do not reflect the major changes in payroll reporting requirements that have occurred since the discovery of fraudulent disbursements within VSRS in February, 1978.

The inadequacy of the guide was confirmed by interviews. Half of the *employer contacts* interviewed did not have a guide, and those that did have one stated that it was of little value. In one case, a school district *contact* reported that she purchased a retirement manual from the Virginia Education Association that she thought was a more comprehensive and reliable source of information on retirement matters than the guide and seminar booklets published by VSRS.

The method presently used by VSRS to train and inform *employer contacts* should be changed. The seminars emphasize personal interaction between VSRS and the *contacts*. Although this technique may help to maintain good interpersonal relations and provide VSRS supervisors the opportunity for face-to-face meetings with some *employer contacts*, the seminars cannot be relied upon as the sole method to establish and maintain systematic, uniform procedures. Comprehensive written instructions are necessary.

Use of a Comprehensive Procedures Manual. VSRS needs to prepare a comprehensive procedures manual to replace both the current guide and seminar booklets. Separate manuals should be developed for State agencies, school districts and political subdivisions. The new procedures manual should be contained in a loose-leaf, three-ring binder and be indexed so that individual pages can be revised and inserted when policy or procedural changes occur. A detailed table of contents should be included. Each page should be numbered to control replacement of a revised page.

In order to ensure that all manuals are kept current, VSRS should prepare an annual list of changes and corresponding pages of the manual that were affected.

The revisions and the annual list of changes should be sent by first class mail to *employer contacts*. The name and address of each *contact* should be kept on file at VSRS and updated semi-annually.

VSRS staff might find it helpful to review the procedures manuals of other State agencies that have many field personnel. The Department of Rehabilitative Services, for example, uses a comprehensive procedures manual to ensure that policies and procedures are established and communicated to field personnel.

By providing a comprehensive procedures manual, VSRS would eliminate the need for annual seminars. The Field Services staff would then be free to provide a wider range of services to *contacts*. Field Services staff could provide intensive on-site training to *contacts* in new participating agencies and could troubleshoot where necessary.

Lack of Written Policies and Procedures

The complex nature of many field reporting requirements calls for clearly defined policies and procedures for *employer contacts*. However, in at least two areas policies or procedures are not firmly established.

As a result of lack of policy, guidance provided to *contacts* by VSRS staff is sometimes inconsistent. For example:

Teachers often perform extracurricular duties and receive payment in addition to their regular salaries. But, VSRS has no written policy on whether retirement contributions and life insurance premiums should be deducted from this additional pay. Nor is there a clearly defined policy on whether this additional income should be included as salary for purposes of computing the member's retirement benefit. Whether or not to include extracurricular pay could affect the size of the benefit at retirement because the benefit is based on a member's earnings. In any event, some teachers could now be making unnecessary retirement contributions.

During a training seminar in 1977, several "employer contacts" from school districts asked for clarification on this point. They were unable to get an answer during the seminar.

Later, one "employer contact" called the retirement system. VSRS staff quoted from a seminar

booklet: "Salary does not include...overtime pay and payments of a temporary nature." This statement was interpreted to mean that any duty that occurs after normal teaching hours is overtime duty and, therefore, not subject to the normal deductions or considered during the computation of retirement benefits. Teachers in this school district do not make contributions based on extracurricular pay.

Another "employer contact" from a different school district was told by VSRS staff that all earnings were subject to deductions for retirement and life insurance. Teachers in this school district do have deductions made from their extracurricular duty pay and receive credit for all earnings for the purpose of computing their retirement benefit.

The case example clearly indicates the importance of written policies and procedures. Differences in the definition of income could result in varying retirement benefits for members whose employment and salary histories are identical. Furthermore, in some of these cases, teachers may be making unnecessary retirement contributions.

An area that lacks procedures for *employer contacts* is the collection of life insurance premiums from employees on leaves of absence. VSRS handbooks and newsletters state that employees on leave of absence may retain life insurance coverage for up to 12 months if they pay their premiums in advance. Employees are advised to arrange these payments through their employer.

However, written materials for *employer contacts* do not contain procedures for notifying employees of the premium amounts and due dates. The only reference to leaves of absence is in a 1977 seminar booklet which states:

"We (VSRS) are in the process of devising a form which would advise employees of their rights while on leave of absence as regards VSRS. You may wish to devise your own agency form to include other benefits such as health care coverage, etc."

VSRS has not developed this form.

This lack of established procedures has led to inconsistency in methods of notification. Fourteen of the 24 *contacts* interviewed by JLARC stated that they gave employees written notification of premium amounts and due dates. Five *contacts* advised employees verbally; and the rest gave either oral or written notification, depending on the situation. The following case example illustrates that complicated legal questions might arise when there is a lack of well-defined procedures regarding leaves of absence.

An employee was granted an extended leave of absence because of illness. On her last day of active employment, she received verbal and written notification from the personnel office that she could pay her health and life insurance premiums in advance.

The written notification stated the exact amount due per month and the date due for health insurance but did not give specifics about the amount and due date for life insurance premiums.

The health insurance premiums were paid. The life insurance premiums were not paid and coverage lapsed in 31 days. The employee died after coverage lapsed.

Her husband filed a claim as beneficiary, but because the policy had lapsed, payment was refused. The husband contends that his wife was not properly informed of her obligation to pay premiums and may file a legal suit for payment.

There is also a need for procedures which define the extent to which employers should make an effort to locate employees on leave of absence. For example, an employee on leave of absence was hospitalized before he was informed that life insurance premiums should be paid in advance. The letter of notification was returned to the employer as "undeliverable" and the employer made no further effort to contact the man. He died after the policy lapsed, and his survivors may sue the employer.

It is clear that *employer contacts* are expected to perform many duties which have important implications to VSRS and to members. In order to fulfill these important responsibilities, there must be clearly defined policies and consistent, written procedures on how to carry out those policies. While preparing a new comprehensive procedures manual, VSRS should review areas in which the retirement system interacts with employers. Detailed policies and procedures defining those relationships should be developed and explained wherever they are lacking.

INFORMATION AND COUNSELING

VSRS is responsible for keeping members informed about their benefits, rights and obligations under the retirement system. Information on benefits is provided through VSRS publications and through a counseling service. Active members receive a handbook, newsletter, and annual statement of contributions. Retired members receive an annual newsletter.

Members also may request professional VSRS counseling service. VSRS responds to requests for information by letter, over the telephone and from individuals who visit the VSRS office. VSRS personnel also attend meetings and seminars related to retirement sponsored by various groups throughout the State.

Publications and counseling services are vital to a well informed membership. However, a substantial number of members report they have not received important publications. VSRS also needs to further develop its counseling resources.

Importance of Information for Members

The typical member of VSRS is 39 years old and has contributed to the retirement system for about eight and one-half years. Despite the relatively young age, about three-quarters of the respondents to the JLARC member survey said they planned to receive a pension from the system. This finding suggests a high level of dependence on VSRS and a consequent need for accurate information.

Results of the survey confirm that the two major sources of information, VSRS publications and the *employer contacts*, are valued by members and contribute to a greater understanding of the system. In many cases, however, members have not received publications and are unaware there is an *employer contact*. In these cases, members were found to be less confident and knowledgeable about benefits and responsibilities. In a test of basic knowledge concerning pension benefits, the typical member answered fewer than five of eight questions correctly. (A summary of survey results is shown in Figure 6.)

For example, the JLARC survey found:

Member Confidence. Over one-half of the members do not feel informed about how to apply for benefits. A similar proportion indicated that they do not feel adequately informed about the nature of their pension benefits.

Receipt of Handbooks. Almost one-third of the membership said they had not received the VSRS handbook, which is supposed to be provided to all members and serve as the basic source of information. These individuals scored significantly lower on the test of basic knowledge than members who said they received handbooks.

Awareness of "Contact". Almost one-half of the membership was not aware of a designated *employer contact*. These members also scored significantly lower on a test of basic knowledge.

Figure 6

Test of Members' Knowledge of VSRS Benefits

% Responding	% Responding
1. The VSRS member contribution rate is:	5. Are retired members eligible to receive cost-of-living increases from VSRS?
• 1% of annual salary 6%	★ Yes 53% No 8 Don't Know 39
★ • 5% of annual salary 59	
• 10% of annual salary 2	6. How long must you be a VSRS member before you become 'vested'? That is, after how many years of service can you stop working in a position covered by the Virginia Supplemental Retirement System and still be eligible to receive a pension when you reach retirement age?
• None of the above 6	★ • 5 years 46%
• Don't know 27	• 10 years 9
2. In addition to the employee contribution, does either the State or your employer make a contribution to the Virginia Supplemental Retirement System?	• 15 years 2
★ Yes 67% No 9 Don't Know 24	• None of the above 6
	• Don't know 37
3. It is possible to retire before the normal retirement age, although the amount of your benefit will be reduced. What is the earliest age at which you can receive a service retirement pension?	7. Does VSRS provide for disability retirement?
• 50 years 6%	★ Yes 60% No 4 Don't Know 36
★ • 55 years 33	
• 60 years 22	8. Which statement concerning the refund of your VSRS contributions is true?
• None of the above 12	• It is not possible to receive a refund of the money you contributed until you become 65 years old 1%
• Don't know 27	★ • You can receive a refund of the money you contributed plus interest only after leaving employment in a position covered by VSRS and then, only by applying for a refund 67
4. The amount of your initial VSRS retirement benefit is:	• You will automatically receive a refund of the money you contributed plus interest when you leave your present job 8
• The same amount that you receive from Social Security 1%	• You may receive a refund of the money you contributed plus interest at any time upon written request 8
• Based on the amount of your VSRS contributions plus interest 16	• None of the above 1
★ • An amount based on your years of service as a VSRS member and your final average salary (the average of your three highest years earnings) 63	• Don't know 15
• None of the above 1	
• Don't know 19	

Correct responses ★

Mean Score = 4.3

Source: JLARC Member Survey

Need for More Information. One-third of the membership said they needed more information about VSRS but felt they didn't know how to obtain it. This group was much less likely to have received a handbook and was usually unaware of the *employer contact*.

Member handbooks are not as valuable as they could be because distribution procedures do not ensure each new member is given a handbook. For the past year, handbooks have not been available for distribution from VSRS. Some *employer contacts* are unaware of the importance of the handbook and consequently do not make sufficient efforts to distribute them. In one locality, JLARC staff found that handbooks and other VSRS publications were not distributed but simply stored in a closet.

VSRS should make a special effort to get handbooks to the large number of members who do not presently have them. Sufficient copies of the handbook should be printed and distributed to participating agencies with the necessary instructions to *contacts* to ensure that they are distributed. A summary of changes could be prepared in years when handbooks are not reprinted. It might be appropriate for VSRS to mail a copy of the handbook to each new VSRS member when the initial VSRS enrollment form is received. In this way, each member will be sure to get a handbook and this important benefit of employment will be highlighted.

Counseling Services

VSRS provides two levels of counseling services to members, particularly those approaching retirement. The first level consists of routine estimates of benefits and assistance in selecting one of the four possible options for payment of annuities. Most requests for counseling received by VSRS are of this routine type. The second level of service includes more extensive counseling that addresses the many financial, social, and emotional aspects of retirement. Although VSRS recognizes the need for both levels, it is not presently organized to ensure that the most appropriate type of counseling is always provided.

Routine Assistance. When a request for a benefit estimate is received by mail, it is referred to one of two administrative units--the Field Services section or Benefit Programs section. The Field Services section employs a professional counselor who has broad counseling responsibilities. The Benefit Programs section is staffed by clerical personnel who calculate benefit estimates.

VSRS personnel offer different explanations as to how the responsibility for routine assistance of this type is divided between the two sections. Staff in the Benefit Programs section contend they are responsible for answering mailed requests from persons who are within one year of retirement. Mailed requests

from persons who have more than a year before retirement are supposed to be sent to the professional counselor in the Field Services section.

In contrast, the Field Services section staff describe the division of responsibility as based on whether or not a written application for retirement has been received. According to this staff the Benefit Programs section will process benefit requests in those cases where a formal retirement application has been received; if no application has been received, the Field Services section responds. In any case, the present division of responsibilities for routine counseling between the clerks in the Benefit Programs section and the professional counselor in Field Services appears to be artificial.

Comprehensive Retirement Counseling. Comprehensive pre-retirement counseling was identified as a needed service in 1971. Retired members who responded to the JLARC survey listed nine areas ranging from tax information to legal aid in which they needed more information before they retired.

The only types of broad-based counseling for VSRS members are those initiated by the employer. JLARC learned that several of the large State agencies and school districts conduct day-long seminars to which they invite their employees who are within one or two years of retirement.

For example, the Division of Motor Vehicles (DMV) conducts an annual seminar at its Richmond headquarters which is usually attended by about 100 employees who are nearing retirement. The program includes presentations by VSRS, Blue Cross/Blue Shield, Social Security and Medicare, the Internal Revenue Service, and the American Association of Retired Persons (AARP). Although seminars such as DMV's are valuable, most VSRS employers do not have the facilities or personnel to conduct such programs.

Employer contacts told JLARC they would be interested in helping to develop regional programs similar to those held by DMV. *Contacts* suggested that a knowledgeable coordinator would be helpful in organizing these seminars.

Improved Counseling Services. VSRS should seek to improve the effectiveness of both routine and comprehensive counseling services. Since most requests are for benefit estimates, they should be directed to the Benefit Programs section which routinely performs this type of work. Use of the professional counselor to provide routine benefit estimates is not cost-effective and should be avoided. Moreover, assignment of benefit calculations to the Benefit Programs section would make the counselor available for the skilled counseling services which she has been trained to provide.

The Retirement Counselor has participated in most of the employer-organized seminars and has the educational background and

counseling experience necessary to develop similar programs in other areas of the State. The counselor could establish training programs for *employer contacts* or, preferably, enlist the assistance of employers in organizing larger regional seminars. By assuming this leadership role for organizing regional seminars, VSRS would reach many members and could help ease the problems that occur at retirement.

Assignment of responsibilities for routine assistance to the Benefit Programs section would provide a more effective division of duties and offer the opportunity for the counselor to develop more comprehensive services. However, VSRS should ensure that procedures are established on how to handle routine written and personal requests. Without proper procedures and training of Benefit Programs staff, members might not be properly served. One instance of inadequate service was observed during the course of this review.

A retiree and his wife drove about 30 miles from a nearby county to VSRS to complete procedures for direct deposit of his annuity check.

Since the Retirement Counselor was not available, the receptionist asked a clerk from the Benefit Programs section to help the couple.

The retiree said he wished to start direct deposit of his check and showed the clerk his bank deposit account number. The clerk instructed the retiree to write a letter to VSRS requesting the transaction.

The retiree then asked for information about how he could obtain Blue Cross coverage. He was told that he would have to contact Blue Cross for this information but was not given a phone number or any additional information.

The direct deposit procedure is started by completion of a brief form which appears in the annual newsletter to retirees. If the Retirement Counselor had been available, she could have given this form to the retiree to complete. The counselor could also have given the retiree information about Blue Cross enrollment procedures.

PROCESSING MEMBER SERVICES

Most VSRS services are well regarded by members. Services for active members generally involve the purchase of retirement credit based on prior service, and refunds of member contributions for individuals who withdraw from VSRS. JLARC interviews and

survey results indicate that most member requests are processed within a reasonable time period.

VSRS also offers retired members a number of services that are designed to provide convenience and decrease confusion at retirement. These services include an annual newsletter; an annual statement of income; direct bank deposit of retirement checks; and automatic payroll deductions for federal withholding tax and Blue Cross/ Blue Shield (BC/BS) premiums. With the exception of the procedures for deducting BC/BS premiums, these services are rated favorably by retirees.

Deductions for Blue Cross/Blue Shield Premiums

The current procedures for beginning automatic payroll deductions for BC/BS premiums are confusing and complex. *Employer contacts* interviewed by JLARC staff indicated that retired employees request more assistance with these procedures than with any other matter related to retirement. VSRS has been aware of the difficulties experienced by retirees but maintains that the problem must be resolved by Blue Cross and the Department of Personnel and Training (DPT).

At retirement, State employees may transfer their BC/BS coverage to the Virginia State Supplemental Retirement Association Group (VSSRA) and request automatic premium deductions from their annuity checks. Nearly 8,500 State retirees receive this service. However, the transfer from the active State group, (which provides coverage when the employee is working), to the VSSRA group takes several months to complete, and involves much correspondence between BC/BS and the retiree (Figure 7).

Complex Procedures. VSRS, BC/BS and State agencies confirmed that there are two areas of concern for retirees. First, there is a 60-90 day delay between retirement and the commencement of deductions for VSSRA group coverage. Records at BC/BS indicated that in some cases, four or five months passed before the transfer was completed. Second, a retired member must prepay at least two months' premiums to maintain continuous coverage. In one case, a retiree had to pay \$471.00 to maintain coverage.

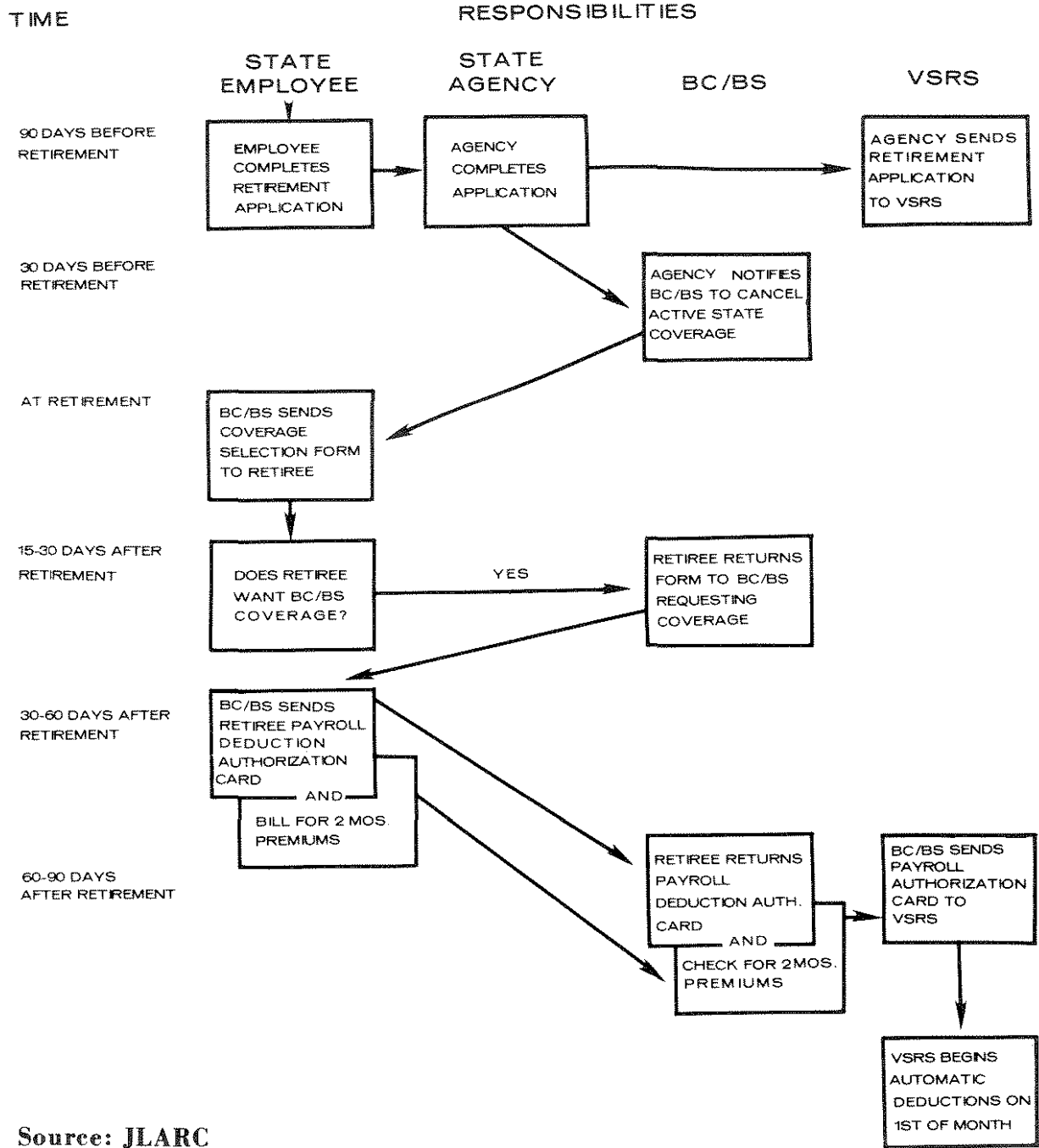
A possible result of the present, cumbersome procedure is that hospital and physician claims may be denied if a retiree fails to prepay premiums on time. For example:

A man retired from State employment on December 30, 1977. BC/BS did not receive notice of his retirement until mid-January. On January 17, 1978, BC/BS sent him the standard VSSRA enrollment information. He returned the form, indicating selection of BC/BS coverage, on January 25, 1978.

Figure 7

Procedures for Transferring Blue Cross/ Blue Shield Coverage for State Retirees

August 1978



Source: JLARC

On January 27 he was suddenly hospitalized. Because BC/BS had deleted him from the active State group on December 30, and he had not yet paid the interim bill for two months' coverage for the VSSRA group, the man was listed as "cancelled" on the BC/BS computer. His preliminary hospital bills were denied.

The man learned of the denials while hospitalized and was forced to contact BC/BS from his hospital bed. After BC/BS spoke with the hospital billing clerk, the matter was quickly and satisfactorily resolved.

According to the coordinator of State programs at BC/BS, this case is not an isolated example. BC/BS is aware of the problem and often must intervene to ensure that bills are paid. However, this intervention does little to eliminate the anxiety experienced by the retiree.

Proposals for Correcting the Problem. Since 1972, BC/BS and DPT have been discussing alternative procedures for simplifying the transfer. In 1977, three written proposals were developed but no further action was taken. As a result of discussion of this issue during the exit interview portion of the JLARC review, VSRS staff met for the first time with representatives of BC/BS and DPT to collectively consider the problem. A proposal was drafted which would ensure that most retirees would not have a lapse in coverage. However, they would still have to prepay one or two months' premiums.

VSRS has limited its involvement in the past and during current discussions because it maintains that the problem is not between VSRS and BC/BS. However, VSRS is an important party in the process. VSRS offers the service to retirees; VSRS is authorized by the retiree to deduct premiums from the monthly annuity; and VSRS submits to BC/BS personal checks from those retirees whose monthly annuities do not cover the premiums.

Because VSRS offers the service of making annuity deductions, it should take active leadership in developing procedures to simplify the health insurance transfer. If necessary, VSRS should make required adjustments to its own operations to help accelerate the process.

CONCLUSION

VSRS has greatly improved its field services since 1971. Publications and counseling services have been expanded and are valued by the VSRS membership. These assets can be even better utilized by additional attention to the distribution of employee handbooks, and restructuring of counseling responsibilities. There

is a need for more comprehensive counseling of persons approaching retirement. VSRS should take an active role in making this kind of counseling available to its membership.

VSRS can greatly improve its training and informational programs for the 745 State agencies, school districts and local jurisdictions which participate in the retirement system. These employers are responsible for a wide variety of functions. Without well-trained, reliable *contacts*, VSRS cannot ensure that its publications are received or that member contributions are properly accounted for. There is a serious lack of clearly defined, written instructions to help participating employers fulfill their responsibilities. In some cases no policies have been established to guide employers.

In order to better assist employers, VSRS should develop a comprehensive procedures manual. A manual is the only reliable way to keep employers informed about complex and often changing procedures.

COMPARISON OF BALANCE SHEET FORMATS

VSRSASSETS

Cash
 Investments¹
 Accrued Interest Purchased
 Equity in Pooled Assets

TOTALSLIABILITIES

Reserve for Members

FUND BALANCES

Trust Fund A
 Trust Fund B
 Member Contribution Account
 Retirement Allowance Account
 Undistributed Income
 State Account
 Teacher Account
 Other Account

TOTALSMFOAASSETS

Cash
 Receivables
 Accounts Receivable
 Accrued Interest Receivable
 Accrued Dividends Receivable
 Investments
 Equipment and Fixtures
 Actuarial Liability to be Funded

TOTAL ASSETSLIABILITIES AND RESERVES

Current Liabilities
 Accrued Social Security Taxes
 Accrued Salaries
 Accrued Benefits Payable
 Accounts Payable
 Member Reserves
 Annuitant Reserves
 Employer Reserves
 Annuity
 Accumulated
 To Be Provided
 Disability
 Death
 Administrative Expenses
 Total Employer Reserves
 Undistributed Income

TOTAL LIABILITIES AND RESERVE

¹ Net, includes unamortized premiums, discount and deferred gains and losses.

Source: VSRS and MFOA; Public Employee Retirement Administration.

Appendix 2

TECHNICAL APPENDIX

JLARC conducted two surveys of VSRS members to develop information on the attitudes and knowledge of the membership. One survey was taken of active members (persons still employed), and the other of retired members. The surveys had two secondary purposes: (1) a test of the communication process between VSRS and its members, and (2) a test to verify the existence and employment of individuals shown to be members on VSRS records. The latter test was carried out in conjunction with the fraud audit of the Auditor of Public Accounts.

JLARC also conducted structured interviews with 24 employers which participate in VSRS. Participating employers have a number of procedural responsibilities and act as a conduit between VSRS and individual members. The interviews were designed to evaluate the type of training services and information provided by VSRS to participating employers.

Member Surveys

Two random samples were drawn from VSRS membership records. The resulting sample sizes were: 527 active members (from a population of approximately 206,000), and 242 retired members (from a population of approximately 28,000). Questionnaires were developed, pretested, and distributed to the sampled members. An example of the questionnaire used for active members is shown on pages 74 and 75. The questionnaire for retired members was similar.

Questionnaires for active members were distributed in May in the same method used by VSRS to distribute publications. This provided a test of the communication process relied on by VSRS to inform its active members. Retired members received a mailed questionnaire sent to the address used for monthly annuity checks.

A total of 596 questionnaires were returned, distributed as follows:

Active Members: 394 of 527 were returned (74.7%)
Retired Members: 202 of 242 were returned (83.5%)

Several tests were made to compare the source of returns with known distributions. These tests were done to ensure that characteristics of sampled cases closely paralleled the VSRS membership at large. An example is shown in Table A-1. The test results confirm that sample returns provide a good representation of all VSRS members.

Ordinarily, the high rate of questionnaire return for both active and retired members, coupled with comparisons of sampled returns with known distributions, would not necessitate a phone follow-up of nonrespondents. However, VSRS recently experienced a

Table A-1

TYPE OF EMPLOYER FOR ACTIVE MEMBERS

<u>Employer</u>	<u>Actual Distribution of all VSRS Members</u>	<u>Distribution of JLARC Sample Returns</u>
State Agency	39%	41%
School District	38%	38%
Local Government	23%	21%
Total	100%	100%

Source: JLARC.

fraud which involved disbursement of funds to individuals who were not members of the retirement system. Therefore, JLARC followed up on all nonrespondents to verify that the individual identified on VSRS records existed and was, in fact, a member of the retirement system. In the course of the phone follow-up, JLARC verbally administered selected parts of the questionnaire to nonrespondents. A comparison of the follow-up responses to the returned questionnaires further confirmed the representativeness of the membership sample.

JLARC was able to either reach each sampled member by mail or phone, or verify that the individual was employed in a job covered by VSRS. This does not rule out the possibility of a falsified response, but does serve as a partial check of the validity of VSRS records.

Structured Interviews

Approximately 745 State agencies, school districts, local governments, and public authorities participate in VSRS. Each participating employer has one or more individuals who are designated to work with VSRS in processing applications, accounting for member and employer contributions, and informing members of their rights, benefits, and responsibilities under the retirement system.

In order to evaluate the important role of these designated individuals, JLARC conducted extensive structured interviews with 46 individuals in 24 of the 745 participating employers. These 24 were selected to be representative of all employers. The selection process used location, size, and type of employer as criteria in establishing representativeness (Table A-2).

Table A-2

DISTRIBUTION OF EMPLOYERS FOR JLARC INTERVIEWS

	<u>RICHMOND AREA</u>			<u>NORTHERN VIRGINIA</u>		
	<u>Small</u>	<u>Medium</u>	<u>Large</u>	<u>Small</u>	<u>Medium</u>	<u>Large</u>
State Agency		xx	xxx		x	
School	x		x		x	
Locality		x		x		

	<u>TIDEWATER AREA</u>			<u>SOUTHWESTERN VIRGINIA</u>		
	<u>Small</u>	<u>Medium</u>	<u>Large</u>	<u>Small</u>	<u>Medium</u>	<u>Large</u>
State Agency		x				x
School		x	x		x	x
Locality				x	xx	

	<u>SHENANDOAH VALLEY</u>		
	<u>Small</u>	<u>Medium</u>	<u>Large</u>
State Agency		x	
School			x
Locality	x		x

N = 24

Source: JLARC.

Interviews were structured around 47 questions pertaining to VSRS personnel and payroll duties. Individuals were asked to assess the training and assistance they received from VSRS, the availability and quality of member publications, and their own effectiveness in fulfilling their VSRS responsibilities. They were also asked to suggest areas where VSRS could provide greater assistance to employers.



**COMMONWEALTH OF VIRGINIA
JOINT LEGISLATIVE
AUDIT AND REVIEW
COMMISSION
P. O. Box 713
Richmond, Virginia
23206**

May 16, 1978

Dear VSRS Member:

The Joint Legislative Audit and Review Commission is reviewing the way the Virginia Supplemental Retirement System (VSRS) serves its members. As part of that review, we are sampling member knowledge and opinion about VSRS and retirement benefits.

Your name was one of a selected number picked at random from VSRS files to be sent this two-part questionnaire. It is important that you answer each question and that you return the questionnaire promptly. Please take a few minutes to complete the survey now and return it in the preaddressed, stamped envelope.

Part I asks some basic questions about you and your opinion about VSRS. Part II is a short test of your knowledge about retirement benefits. If you wish us to send you a copy of your corrected test results, please be sure to fill in the name and address section at the end of Part II.

We are confident the answers you give to this survey will help improve VSRS member service. Thank you very much for your assistance.

Sincerely,

Ray D. Pethtel
Director

Part I. Member Information

This section is about you and information provided you as a member of the Virginia Supplemental Retirement System (VSRS). Please check or fill in the appropriate response.

1. Are you presently employed by:

- State of Virginia ()
- City, County, or Town ()
- Public School System ()
- Other _____ ()
(Specify)

2. In which city or county is your principal place of work?

3. What is your birth date?

_____ (month) _____ (day) _____ (year)

4. What is your current occupational status?

- Professional ()
- Clerical ()
- Skilled ()
- Semiskilled ()
- Unskilled ()

5. How long have you been a VSRS member? _____ years

6. When you retire, do you plan on receiving a VSRS pension?

- Yes, within the next year. ()
- Yes, someday, but not within the next year. ()
- No ()
- Don't know ()

7a. Do you feel adequately informed about your VSRS benefits?

Yes () No ()

b. Do you feel adequately informed about what you must do to go about applying for VSRS benefits?

Yes () No ()

8. Which of the statements below most accurately indicates how you feel about information concerning your VSRS benefits?

- I don't need or care about benefit information at this time. ()
- I would like to have more information about my benefits but don't know just how to get it. ()
- I get all the information I need about my benefits from friends and co-workers. ()
- If I need to know more about my benefits, I know how to go about obtaining the information. ()
- I have all the information I need about my benefits. ()
- I was not aware I was a VSRS member. ()

9a. Have you ever asked for information about your benefits, your account, or some other retirement concern from the main office of the Virginia Supplemental Retirement System in Richmond?

Yes () No ()

b. If yes, was your question satisfactorily answered?

Yes () No ()

c. If your question was not satisfactorily answered, please explain.

10a. Has your employer appointed one person to whom you may go when you have questions about VSRS?

- Yes ()
- Yes, there is someone whom I can ask, but I don't know that he/she is appointed as such. ()
- No ()
- Don't know ()

b. If yes, have you ever asked for information about your benefits, your account, or some other retirement concern from this contact person?

Yes () No ()

c. If you did ask, was your question answered satisfactorily?

Yes () No ()

d. If your question was not answered to your satisfaction, please explain.

11a. Have you ever attended a meeting at which the VSRS presented information about the retirement system?

Yes () No ()

b. If yes, was the meeting helpful?

Very Helpful () Somewhat Helpful () Not Helpful ()

12. Please check which of the following VSRS documents you have received, have read, and whether or not you found them helpful.

	Received		Read		If read, Helpful	
	Yes	No	Yes	No	Yes	No
Memo to Members (Newsletter)	()	()	()	()	()	()
Member Benefit Profile	()	()	()	()	()	()
(A statement of contributions and benefits)	()	()	()	()	()	()
Handbook for Members	()	()	()	()	()	()

Part II. Knowledge of Virginia Supplemental Retirement System Benefits

This section tests your knowledge of VSRS benefits. Please check the correct answer for each of the following questions. If you wish to receive a scored copy of your test results on this section, please enter your name and address in the space provided at the end of this questionnaire.

1. The VSRS member contribution rate is:
 - 1% of annual salary ()
 - 5% of annual salary ()
 - 10% of annual salary ()
 - None of the above ()
 - Don't know ()
2. In addition to the employee contribution, does either the State or your employer make a contribution to the Virginia Supplemental Retirement System?

Yes () No () Don't Know ()
3. It is possible to retire before the normal retirement age, although the amount of your benefit will be reduced. What is the earliest age at which you can receive a service retirement pension?
 - 50 years ()
 - 55 years ()
 - 60 years ()
 - None of the above ()
 - Don't know ()
4. The amount of your initial VSRS retirement benefit is:
 - The same amount that you receive from Social Security. ()
 - Based on the amount of your VSRS contributions plus interest ()
 - An amount based on your years of service as a VSRS member and your final average salary (the average of your three highest years earnings). ()
 - None of the above. ()
 - Don't know. ()
5. Are retired members eligible to receive cost-of-living increases from VSRS?

Yes () No () Don't Know ()
6. How long must you be a VSRS member before you become "vested"? That is, after how many years of service can you stop working in a position covered by the Virginia Supplemental Retirement System and still be eligible to receive a pension when you reach retirement age?
 - 5 years ()
 - 10 years ()
 - 15 years ()
 - None of the above ()
 - Don't know ()
7. Does VSRS provide for disability retirement?

Yes () No () Don't Know ()
8. Which statement concerning the refund of your VSRS contributions is true?
 - It is not possible to receive a refund of the money you contributed until you become 65 years old. ()
 - You can receive a refund of the money you contributed plus interest only after leaving employment in a position covered by VSRS and then, only by applying for a refund. ()
 - You will automatically receive a refund of the money you contributed plus interest when you leave your present job. ()
 - You may receive a refund of the money you contributed plus interest at any time upon written request. ()
 - None of the above. ()
 - Don't know. ()
9. Do you participate in the Group Life Insurance Program administered by VSRS?

Yes () No () Don't Know ()
10. If you participate in the Group Life Insurance Program, how much regular life insurance coverage do you have?
 - \$1,000 for each year that you have worked in a position covered by VSRS. ()
 - One-fourth of your present annual salary rounded up to the nearest thousand dollars ()
 - The same amount as your present annual salary rounded up to the nearest thousand dollars ()
 - Double your present annual salary rounded up to the nearest thousand dollars. ()
 - None of the above. ()
 - Don't know. ()
11. What services provided by VSRS have been most valuable to you?
12. What services do you feel are needed but are not provided by VSRS?
13. Please use the space provided below for any additional comments you wish to make. Attach an additional sheet if necessary.

Thank you for your cooperation.
If scored test results are desired, fill in here

Name _____
Street _____
City _____
State _____ Zip _____



COMMONWEALTH of VIRGINIA

GLEN D. POND
DIRECTOR

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Virginia Supplemental Retirement System

*Eleven North Sixth Street
Richmond, Virginia*

MAILING ADDRESS:
POST OFFICE BOX 3-X
RICHMOND, VIRGINIA 23207
TELEPHONE (804) 786-3831

September 30, 1978

*The Honorable Ray D. Pethtel, Director
Joint Legislative Audit and Review Commission
Suite 1100, 910 Capitol Street
Richmond, Virginia 23219*

Dear Ray:

Enclosed is the VSRS response to the exposure draft of the Management Review of the Virginia Supplemental Retirement System. The response represents many hours of serious examination, consideration and reflection.

The report and subsequent deliberations will ultimately assist VSRS in its continuing effort to serve those to whom it is responsible.

VSRS is available to elaborate on this response to whatever degree is appropriate.

Sincerely,

A handwritten signature in black ink, appearing to read "Glen D. Pond".

*Glen D. Pond
Director*

GDP/cal

Enclosures

INTRODUCTION AND REVIEW OF RECOMMENDATIONS

The Virginia Supplemental Retirement System ("VSRS") is a financially sound, well-managed public retirement system that provides retirement benefits for 238,000 employees and retirees of State and local government. It is managed by an active Board of Trustees who oversee the receipt, investment and disbursement of employer and employee contributions mandated by the Virginia Supplemental Retirement Act.

Day to day management of the VSRS is the responsibility of a trained professional Director who maintains regular contact with the System's supervisory and clerical employees, and who reports regularly to the Board of Trustees on matters pertaining to the planning and implementation of statutory requirements and Board policies.

As in any large financial operation whose funds and resources are limited, there are areas in which there are deficiencies. None, however, threatens the soundness of the System, and all receive the direct attention of the Board of Trustees as deemed necessary, and in the order of priorities necessitated by finite human and economic resources.

The numerous limitations imposed on the operation of the System should be considered when reviewing the JLARC report. More positive recognition of the practical realities place the numerous observations and recommendations in a considerably different light. In many instances, critical analysis leads to entirely different conclusions in light of the practicalities involved. Those practicalities include the following:

- (1) The size, scope and complexity of VSRS has dramatically increased in recent years. Ten years ago there were 118,000 active members. Today there are 210,000 - - a 78% increase. The number of retirees has almost tripled and the Trust Fund has more than tripled. Such growth demanded that immediate attention be given to initiating new approaches and programs throughout the System. Unfortunately, the System was limited by lack of staff and budget.
- (2) VSRS has been chronically understaffed. There are only two state retirement systems, out of 46 states for which data was available, that operate with a lower staff to active membership ratio than VSRS. If VSRS met the average ratio found in state retirement systems, it would now have a staff of 128 full-time employees rather than 65.

- (3) VSRS has not had sufficient funds budgeted to allow it to keep pace with the rapid growth in membership. When the present Director was initially employed by VSRS, crowded physical facilities hampered the day-to-day operations of the System, the primary record system for active and retired members was in a state of chaos due to abortive attempts to computerize the system, and a lack of modern office equipment seriously slowed all processing.

The initial part of this response will address the specific items identified as recommendations in the Report Summary of the JLARC Management Review. Next, the response will consider major points of the report. The conclusion of the response will outline significant achievements and improvements.

Recommendation 1:

Financial Practices

VSRS concurs in the recommendations under financial practices. Redesigning the accounting system and general financial practices has been a top priority of the Board and Director for over two years and will continue to be until a sophisticated system is in place and functioning.

Recommendation 2:

Financial Leadership

Peat, Marwick, Mitchell and Co. indicated to VSRS, when the incumbent Financial Manager was employed, that he possessed the necessary skills and abilities and was the most qualified applicant for the position. There is little question that dramatic innovation and change have not occurred since his employment. Conditions have been so abnormal during the past year, however, that VSRS is unable to concur with the JLARC conclusion.

Recommendation 3:

Planning and Reporting

As acknowledged in the JLARC report, there were many original problems in the System. Additional ones have been created by growth of the System within the past decade. In the exercise of its statutory discretion, due to budgetary, staff and other limitations, the Board has necessarily focused primary attention on the most critical areas. In the selection

of these areas, the Board and the Director have acted on their perceptions of the most needed changes. In this regard the Board has specifically;

- 1) updated investment practices and procedures,
- 2) recommended legislation to facilitate efficient management,
- 3) authorized the Director to request additional positions and personnel,
- 4) engaged an accounting firm to design and implement a computerized accounting system which is currently being developed,
- 5) engaged actuaries to review and report on the actuarial performance of the System, and
- 6) engaged independent consultants to review management operations and criticize them.

Recommendation 4:

Personnel Administration

VSRS basically concurs with the recommendation and would like to suggest that as part of this recommendation the position of Personnel Administrator be added to the VSRS staff.

Recommendation 5:

Member Records

VSRS concurs with the recommendations. Most of the specifics are either being implemented or are in the planning stage.

Recommendation 6:

ADP System Design

Peat, Marwick, Mitchell and Co. has had a team of specialists working on a completely new accounting and control system for VSRS for over a year. The system is expected to be fully operational in July of 1979. Before being adopted, by statute, it will have the approval of the Comptroller and Auditor of Public Accounts and be compatible with the Commonwealth's new central accounting system, which is also being installed by Peat, Marwick, Mitchell and Co.

Recommendation 7:

Training Employer Contacts

The training seminars, as well as alternative training methods, will be evaluated for effectiveness. New manuals for personnel officers have been developed and manuals for payroll personnel are being developed.

Recommendation 8:

Publications

VSRS agrees that the distribution process should be evaluated and improved where possible.

Recommendation 9:

Counseling Services

The basic structure of this recommendation has been VSRS practice for several years.

Recommendation 10:

Blue Cross Deductions

VSRS agrees and when a satisfactory proposal is developed every effort shall be made to implement it as soon as possible.

Recommendation 11:

Actuarial Advice

The Board took initial steps to address the substance of this recommendation several months ago. That which is not in effect will be carefully reviewed by the Board.

Recommendation 12:

Investment Oversight

VSRS concurs with the recommendation.

Recommendation 13:

Legislative Retirement Commission

The Legislature should give careful consideration to this recommendation. Information presented to VSRS indicates both good and bad experience with such commissions in other states. As is indicated in the report, legislative oversight has been quite active and effective since 1970. A permanent sub-committee, composed of members of the House Appropriations Committee and the Senate Finance Committee, with overlapping representation may be the best course for Virginia.

REVIEW OF REPORT

Financial Management

The initial paragraphs under Financial Management list points that are well taken. VSRS is a very large financial institution that demands an extremely modern and sophisticated accounting system.

The earliest effort to begin the modernization process occurred in 1974 with the encouraged retirement of the chief accountant. In June 1974, the Director suggested to the Board the need for engaging the Martin Segal firm to perform a follow-up to their 1971 study in order to provide VSRS management with additional guidance and direction.

An attempt to have the position of chief accountant reallocated to a higher classification, in order to attract a more highly qualified individual, was submitted in April of 1974. VSRS was advised by the Division of Personnel that the existing position was appropriate for the size and volume of the agency and, therefore, the request was denied.

In addition, the Board of Trustees and the Director have requested an audit on numerous occasions. Each time VSRS was advised that the audit for 1971-1972 was in progress and, upon completion of that audit, the ensuing years would be audited.

In the Spring of 1976, representatives of the Martin Segal firm visited VSRS and agreed to conduct a follow-up review of the Administrative Management of VSRS. In a letter of June 4, 1976, James R. Gunning, Senior Vice President of the Segal Company, recommended that an independent accounting firm should be employed to assist in developing an accounting system. In August of 1976, the Trustees began the process that resulted in the selection of the Peat, Marwick, Mitchell firm, which is developing this program.

Lack of Financial Controls

In September 1975, the Surety Bond on all VSRS employees was increased from \$5,000 to \$100,000 per employee. An adequate Surety Bond is a widely acknowledged financial control.

The weaknesses and areas of concern that the Auditor of Public Accounts has brought to the attention of VSRS management have been carefully evaluated and either resolved or are being resolved by VSRS staff.

The reference to the Ten Million Dollar discrepancy between the two primary VSRS member accounts results from a time delay. The reason for this difference is readily explainable and understood by the Auditor of Public Accounts.

Condition of Financial Statements

The report states that, ". . . according to the Auditor of Public Accounts, audit staff have been assigned to VSRS almost continually since 1972;

but the poor condition of financial and accounting records have prevented the completion of an audit". In response to inquiries from VSRS the Auditor of Public Accounts indicated that problems with timely audits were associated with the insufficient staff of the Auditor of Public Accounts.

Lack of Leadership in Financial Management

This section contains the statement,

"Although several of the accounting staff report they were concerned about the lack of control in financial and accounting procedures, and brought their concern to the attention of the Director, adequate financial controls were not installed."

No "accounting staff" member acknowledges having made such a statement. The former supervisor to the predecessor of the VSRS ADP department, indicated that she had, in August or September of 1973, advised the Director that, in her opinion, shortcuts were being taken in the transfer of data from the old system to the new system.

It is quite likely that this individual did raise concern regarding the design of the new system. At that time there was great turmoil between the old and the new and the system designers assured the Director that the expressed concerns were unwarranted.

The report states that the Department of Personnel and Training records indicate VSRS received 34 of the 39 requested position modifications since July of 1973. Many of these modifications to existing positions were approved with substantial reductions in either classification level or salary level. Of the position modifications that were denied by Personnel and Training, the most important one in the context of the report was the request to have the top accounting position reallocated to a higher classification in order to permit VSRS to employ a more qualified individual.

Additionally, about 50% of the VSRS requests for new positions during this period were removed in the State budgeting process.

On June 22, 1977, the Director forwarded the request for the establishment of the position of Financial Manager to the Personnel Office. On July 1, at 1:00 p.m., three representatives of the Peat, Marwick, Mitchell and Co. firm, along with the Deputy Director and Director met with the Director of Personnel, in his office in an attempt to impress upon him the importance of the VSRS request and the need for prompt action.

On July 8, at 9:00 a.m. two representatives of the Personnel Office met at the VSRS office with three representatives of the Peat, Marwick, Mitchell and Co. firm, along with the Deputy Director and Director in an extended review of this position.

On July 13, the Director met with the Board of Trustees and indicated concern that even with the two meetings with Personnel and with the assistance of Peat, Marwick, Mitchell and Co. VSRS still was uncertain

as to the course Personnel might take in approving the position. The Board specifically requested that the Director compose a letter from the Board Chairman to the Director of Personnel expressing the serious concern of the Board over any potential problems in obtaining this classification.

In the report a phrase is quoted from that July 14 letter. The cited phrase is a part of a sentence which followed an expression of concern that Personnel was requesting that VSRS discontinue efforts to fill the vacant Operations Manager position, pending a Personnel job audit. The sentence was drafted by the Director to impress to the greatest extent possible the System's concern that not only was the Financial Manager position imperative but also the filling of the Operations Manager position was essential. The full sentence is as follows:

"I must say the Board is greatly alarmed at this news, particularly in light of information from the Auditor's Office as well as from Peat, Marwick, Mitchell, and Co. that there is a serious and frightening lack of proper financial control in the Retirement System."

The report states that the request for the Financial Manager position was approved by the Division of Personnel two days before the Board letter was written. The VSRS notification from the Personnel Office that the position had been approved was dated August 22, 1977.

Exception Reporting

Current procedures provide for exception reports to be generated any time a payroll is out of balance. The JLARC report states that the Judicial Retirement System payroll has been out of balance for two years. VSRS records do not reflect this condition. In addition, employees of the Supreme Court offer no confirmation of this problem.

It is stated that when a name and Social Security number do not match, VSRS sends a copy of a list to the employer for correction. Two copies of the history list are sent to the employer for correction along with instructions to make the correction, retain a file copy and return the original to VSRS. In cases of non-compliance this procedure is then supplemented by follow-up correspondence.

In many cases an employee terminates before a correction can be completed. If the employer cannot locate the terminated employee, the Federal exception list continues to display the name.

Maintenance of Member Records

Since the time when files were lining the corridors of the Finance Building, VSRS has been concerned that records be made secure and that appropriate back-up information be established. With the exception of the named beneficiary, the necessary back-up data for the vast majority of VSRS members is secure. The new system under development will provide

the needed back-up.

Board Oversight

The VSRS assets held and invested by the Life of Virginia are done so with the approval of the Board of VSRS under specific authority granted by the Legislature under Section 51-111.67:7.

The funds were established to pre-fund the death benefits of future retirees. The funds are not held in a separate account, but are invested in the insurance company's General Account and are comingled with other funds of the Company. The investment of these funds by Life of Virginia is governed and controlled by the statutory provision of Chapter 5, Section 38.1-179-217, of the Insurance Laws of the Commonwealth. The Life of Virginia reports annually to the Board of Trustees on the investment performance of the VSRS funds, which the Company is holding.

Field Services

Member services are provided by three subdivisions of the Operations Division. The Benefit Programs Department provides services to retired members, the Membership and Office Services Department processes refunds and applications for the purchase of prior service and the Field Services Department provides members with general information about VSRS as well as personal counseling.

Lack of Written Policies and Procedures

The report states that, "While on leave, employees may retain group life insurance coverage up to one year provided that the premiums are paid in advance. However, how members become informed of the need to pay the premiums in advance is not clear".

Each of the three issues of the VSRS Handbook state the appropriate procedure and articles were published in four different Newsletters (April 1974, Fall 1975, Spring 1976, Winter 1978) explaining this procedure.

In addition, each new employee receives an insurance Certificate which also explains the procedures to be followed in the event of a leave of absence. The two cases mentioned in the report are the only two such cases the Director has been apprised of since July, 1973.

Information and Counseling

The 1978 Handbook to Members has been distributed subsequent to the JLARC survey. VSRS will sample the membership to determine whether there is a distribution problem with these Handbooks.

Counseling Services

VSRS provides counseling services to members. Members may request pre-retirement information in writing, by visiting the VSRS office or by telephone.

When a member writes for assistance, the Benefit Programs Department handles the request from people who are within one year of retirement. The Field Services Department takes those requests from individuals who are more than one year away from retirement. This distinction is somewhat arbitrary but not without sound reasoning. The Benefit Programs Department processes the final benefit; therefore, it is best that estimates for individuals who are nearing retirement be developed by Benefit Programs Department personnel. This process is relatively clean, clearly understood by both departments and under normal circumstances provides no difficulties.

In the case cited in the JLARC report, it is unknown whether all the necessary information was available in order to provide on-the-spot assistance. VSRS makes every effort to provide adequate service. Statistics from the JLARC survey suggest that members are satisfactorily served.

Question 12(a) asked, "Have you ever asked for any information or assistance from the main office of the Virginia Supplemental Retirement System in Richmond in regard to your VSRS benefits?" 34% responded, "Yes", 39% responded, "No", and 23% responded that they had never had a question. (b). "If you responded "Yes", was the matter handled satisfactorily?" To this question 89% responded, "Yes".

IMPROVEMENTS AND ACCOMPLISHMENTS

In addition to the improvements outlined in the JLARC report, the VSRS has achieved many other significant accomplishments. Such as:

- Recommend review of the benefit structure which if accomplished will save untold millions for future generations.
- Recommended limit on post-retirement cost-of-living increases which saved the Commonwealth \$9 million in the 1978-1980 biennium. This saving will increase dramatically in future years.
- Revised disability retirement procedures which will prevent potential abuse and result in large dollar savings to the trust fund.
- Obtained qualification by Internal Revenue Service which will save retirees and their beneficiaries substantial amounts of taxes.
- Obtained IRS ruling which makes deferral of tax on employee contributions possible thus saving significant amounts of taxes to members.
- Recommended change in system for funding administrative expenses to more equitably assess all participating employers.
- Established a lock-box system for handling employer-employee contributions to provide direct deposit to the bank. (VSRS is the first State agency to adopt this procedure.)
- Implemented in-house equity management program.

JLARC ANALYSIS OF VSRS RESPONSE

We have reviewed the VSRS response to the draft management review. The text has been modified where necessary. Some additional comments on the VSRS response are in order to explain the context in which the management assessment was made.

PART I - INTRODUCTION AND REVIEW OF RECOMMENDATIONS

VSRS states that chronic understaffing limited operation of the system. The response compares the staff/member ratio of other state retirement systems as evidence of understaffing.

At the request of the Secretary of Administration and Finance, staff position requests were reviewed and 8 new positions were recommended for approval. However, several further points need to be made regarding staffing.

1. The management study of VSRS done in 1976 by Martin Segal Company found that "the overall size and level of staffing (at VSRS) appears to be appropriate at the present time..."
2. While VSRS may have had a lower ratio of staff to active members than other, comparably sized, state retirement systems in 1976 (latest data available), there is also wide variation in the organization and services provided which could affect the validity of the comparison.

VSRS should focus on better use of existing staff through the development of job descriptions, written procedures and an effective personnel evaluation process which can identify individuals with supervisory potential. Organizational planning should also be formalized.

JLARC Recommendations

VSRS concurs on 11 of the 13 recommendations contained in the JLARC report summary. The two recommendations in question are numbers 2 and 9.

Recommendation 2 - Financial Leadership. VSRS argues that conditions during the past year have not provided VSRS staff with the opportunity to demonstrate financial leadership and innovation. On the contrary, this period has been marked by (1) the discovery of fraud, (2) an extensive financial audit, (3) design of

an automated general accounting system by a private consultant, and (4) an in-depth management review.

This high level of activity and change related to the VSRS financial systems offered an ideal opportunity for strong leadership. The outgrowth of the past year's activities will condition the financial management structure of VSRS for the foreseeable future. Over the past six months, the needed leadership has not been demonstrated.

Recommendation 9 - Counseling Services. According to VSRS the basic structure of the JLARC recommendation has been in practice for several years.

Adoption of our recommendation would require a change in the organizational structure of VSRS. The counselor should assume new and expanded responsibilities for developing counseling programs for persons nearing retirement, and general informational programs for members.

PART II - REVIEW OF REPORT

Financial Management

The response identifies two actions which occurred in 1974 as evidence of early efforts to upgrade VSRS financial management.

In June 1974, Martin Segal Company was asked by VSRS to assess the progress made since the first Segal study (1971). In October 1976, Segal identified the lack of financial management as a serious deficiency. The evidence cited by Segal included the qualifications of staff then assigned to financial management and the quality of financial reports.

Although the Segal study was beneficial, we did not feel that it was an essential first step in identifying obvious weaknesses in financial management.

The second action cited by VSRS was an attempt in July 1974, to reallocate the senior accounting position from the level of an Accountant B to that of an Accountant C. The request was denied.

We believe that if the reallocation had been approved, an existing VSRS employee would have been appointed to the position. Nevertheless, even if another individual had been hired to fill the reallocated position, the action fell short of the organization level at which financial leadership was needed most, i.e., the Operations Manager.

The Operations Manager was assigned formal supervisory authority for the financial activities of VSRS. The incumbent was inexperienced in financial management, was occupied with the development of an automated data processing system, and was not sensitive to the need for basic financial controls. Without the establishment of a chief financial management position at a level comparable to the Operations Manager, the supervisory expertise required would not have been forthcoming.

Need for an Annual Audit

VSRS indicates that although it requested an annual audit on numerous occasions, the APA was not able to assign sufficient staff to complete a timely audit. In fact, the APA first had to assign audit staff to reconcile and correct the VSRS accounting records. The APA and a private CPA firm worked more than one calendar year to reconcile accounts and correct errors.

Reconciliation and maintenance of financial records is the responsibility of VSRS.

Actions of Department of Personnel and Training

VSRS states that the Department of Personnel and Training (DPT) made many modifications and substantial reductions in positions requested by VSRS. The record shows that of 39 requests made since 1973, 35 were approved, 25 as requested. Of the 10 which were modified, 8 involved one type of position (accounting machine operator).

VSRS also infers that the request for a financial manager position made in June 1977, was delayed by the Department of Personnel and Training since notification of approval was not received until August 22. The record shows that the request was made by VSRS on June 22, approved by DPT on July 12, and VSRS was notified by letter on July 15 of DPT approval.

Exception Reporting

A preliminary draft stated that the Judicial Retirement System *payrolls* were still out of balance. The text should have read that Judicial Retirement System *accounts* are still out of balance.

Lack of Written Policies and Procedures

Members are informed of the general policy that they have a right to retain life insurance coverage when they go on a leave of absence. The detailed procedure of how this is to be accomplished is the responsibility of the *employer contacts*. The contacts do not have clearly defined written procedures for this transaction. Legal liability questions can and have arisen.



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RAY D. PETHTEL
Director

September 28, 1978

The Honorable Charles B. Walker
Secretary of Administration and Finance
Ninth Street Office Building
Richmond, Virginia 23219

Dear Charles:

The JLARC management review of VSRS included an evaluation of personnel administration practices and staffing requirements based on an extensive series of desk audits and interviews with agency employees. I understand that you wished to have a detailed statement of the findings of that review for your immediate use. This letter has been prepared to respond to that request in two ways.

First, we reviewed staffing needs in line with the existing VSRS organization and duty assignments. Some changes seem to be appropriate. Second, we assessed VSRS requests for additional personnel actions now being considered by your office. Appropriate recommendations are included.

It should be clearly understood, however, that the comments outlined below may need to be modified after the development of a comprehensive organization plan for VSRS which we believe is a necessary prerequisite for any future personnel actions.

As noted in our report, VSRS should develop a plan which details the responsibilities of each functional division, describes internal relationships, and clearly identifies agency personnel requirements. The plan should be explicit about the number and type of positions needed and proposed duties.

Considering the qualifications stated above, our analysis is presented in two parts. The first part suggests personnel actions which are appropriate under the existing administrative organization. The second part is an analysis of specific personnel requests submitted by VSRS to your office in July, 1978.

EXISTING VSRS ORGANIZATION AND PERSONNEL ACTIONS

1. The salary range for the *Financial Manager* (position 62) should be upgraded.

One of the major deficiencies noted in our management review is the longstanding lack of financial leadership, a problem which was not resolved by the creation of the Financial Manager position. The relatively low salary range for this position (\$18,700-\$24,500) does not appear to be sufficient to attract and retain the level of financial expertise required.

At a minimum, the salary range for the Financial Manager should be comparable to that for fiscal directors in other State agencies (\$21,400-\$28,000). This salary range is justified because of VSRS' unique financial responsibilities.

2. The salary range for the *Retirement System Operations Manager* (position 40) should be reviewed.

This position supervises the largest VSRS department (27 positions) and is responsible for services to active members, retirees, and employers. Since the position was last reviewed in August, 1977, a fourth section has been added to the department. However, the salary range for the Operations Manager (\$14,400-\$19,600) is below that of a systems analyst who serves as the VSRS data processing manager (\$16,400-\$21,500) and supervises fewer employees. A higher salary range for this position might be appropriate given the expanded responsibilities of the Operations Manager.

3. The *Retirement System Special Services Assistant* (position 3) is an unnecessary position and should be abolished.

Current responsibilities for this position include administration of the State Police Officer and Judicial Retirement Systems and legislative liaison. However, these duties do not require full-time attention and could be incorporated into another existing position. The resulting savings (\$22,400 per year) could be used to offset the costs of other, more needed positions.

4. The position of *Retirement System Trust Funds Officer* (position 2) should be reclassified as an Accountant C.

The Trust Funds Officer has a salary range (approximately \$12,000-\$16,400) which is equivalent to that of an Accountant B. This position is responsible for the daily maintenance of VSRS financial records and the preparation of financial statements. The incumbent supervises six other personnel, including two State Trust

Funds Accountants. Reclassification of the Trust Funds Officer to Accountant C would be consistent with the supervisory responsibility and technical skills required of the position.

5. Nine clerical positions should be reclassified to better reflect the nature of the work performed.

This action would require the use of two classifications not currently used by VSRS: *Fiscal Technician* and *Retirement Analyst*.

Fiscal Technician is an existing State classification which requires individual initiative and responsibility in the handling of financial transactions. Several positions in the VSRS Operations Department could be appropriately reclassified as Fiscal Technicians. One of these, the Clerk D (position 30) who supervises payroll processing, is responsible for the accuracy of payrolls which support employee contributions of over \$100 million annually. Similarly, clerks who process refunds (positions 10, 11, 14 and 15) should also be so reclassified because their work involves complex procedures requiring careful reviews of several sets of financial records.

In addition, one of the three clerks (position 44) in the Social Security section could reasonably be reclassified as a Fiscal Technician. The Social Security section audits and corrects payments for employer/employee social security contributions. This individual would serve as troubleshooter for difficult or erroneous cases while the other two clerks process routine social security payments.

A new classification, Retirement Analyst, should be developed for three clerks (positions 41, 46 and 55) in the Benefit Programs section. These individuals prepare estimates of retirement benefits for members who request them. Preparing benefit estimates and advising members about retirement options require interpersonal skills, an understanding of the needs of persons nearing retirement, and a degree of judgement beyond that of a routine clerical job. Therefore, a salary range which exceeds that of a Clerk D should be considered.

6. The salary range of the Retirement System Counselor (position 43) should be reviewed.

The Counselor position should be used to plan and implement statewide pre-retirement seminars and coordinate services to retirees with organizations such as Blue Cross. These new duties would be an addition to existing counseling responsibilities and are necessary to improve counseling services provided to members and retirees. A higher salary range might be appropriate.

VSRS PERSONNEL REQUESTS

VSRS has requested eight new positions and four reclassifications to meet the needs of its proposed reorganization. One of these requests, reclassification of the Operations Manager, has been previously examined. Three new positions, Clerk D, Clerk-Typist C, and Internal Auditor, have already been approved.

7. The requested *Membership and Agency Services Supervisor* position appears justified, but the required qualifications should be more precisely defined.

The position will supervise the processing and auditing of payrolls received from employers and the processing of refunds to members. The position combines the function of two existing supervisors and entails responsibility for both repetitive and complex fiscal activities.

An accounting background would be appropriate for the Membership and Agency Services Supervisor. However, the VSRS request calls for four years of college but no specific accounting background. The need for accounting skills is evidenced on the request form itself which lists an Accountant B in the Finance Department as engaged in the same or similar work. VSRS should revise the qualifications for this position to include an accounting background.

8. Only one of two *State Trust Funds Accountants* requested for general accounting should be approved.

Both positions have been requested for the Accounting section of the Finance Department. One position is to assist in the maintenance of general and subsidiary ledger accounts for retirement, life insurance, and investments. The second Trust Fund Accountant would be responsible for assisting in the implementation of the new accounting system being designed by private consultants.

The accountant requested for the general and subsidiary ledger accounts appears needed. VSRS currently has two State Trust Fund Accountants. The last was added in 1974. Since that time, there has been substantial growth in the retirement system and the number of transactions. An additional accountant to handle general accounting needs would enable VSRS to maintain up-to-date financial records.

The need for the second Trust Fund Accountant, however, is questionable. The function of this position, as described in the request, is to work closely with the consultants and VSRS personnel to implement acceptable controls and to supervise implementation of the new accounting system. These responsibilities appear more

appropriate for the VSRS Financial Manager. Moreover, the function as described is only temporary, yet VSRS is requesting a permanent position.

9. The Accountant C position requested for the new Control section is needed and should be approved. The request for a State Trust Fund Accountant should not be approved, but consideration should be given to adding two Fiscal Technicians instead.

A major focus of the VSRS reorganization is the strengthening of financial controls through establishment of a Control section in the Finance Department.

An Accountant C position appears reasonable to head the Control section, provided the general accounting section is headed by a similar position (as recommended in Item 4). Comparable level supervisors are appropriate because control and general accounting are comparable functions.

Two Fiscal Technicians would be more appropriate than the requested State Trust Funds Accountant. The technician classification provides a sufficient skill level to review vouchers. Moreover, the addition of two positions will allow for a separation of duties in handling receipts and disbursements which is an essential component of effective control.

10. The requested reclassification of the Member Benefits Supervisor (position 23) and the Clerk-Messenger A (position 45) should be approved.

VSRS has requested reclassification of the Member Benefits Supervisor to a Benefit Programs Supervisor and the Clerk-Messenger A to a Clerk C. In each case, additional duties and responsibilities are listed in the new position description.

The Benefit Programs section will assume additional activities and increase by approximately four positions. The proposed Clerk C position will be responsible for important member files which include beneficiary information with legal standing.

11. The request to reclassify the Information Director (position 42) from A to B should not be approved.

The duties listed on the request form are not significantly different from existing responsibilities. Although some new responsibilities are given to the Information Director (preparation of the annual report, for example), other responsibilities, such as agency personnel director, are deleted. Also, although the duties described include supervision of the Retirement System Counselor, this individual is, in fact, a co-equal professional with minimal supervisory requirements.

The Honorable Charles B. Walker
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September 28, 1978

As previously noted, these recommendations represent a general analysis of VSRS personnel needs but are contingent on completion of a VSRS organization plan. The recommendations were developed in cooperation with representatives of MASD and the Auditor of Public Accounts, and are designed to give VSRS the necessary capability and expertise it needs to meet wide-ranging financial and service responsibilities.

With personal regards, I remain

Sincerely yours,



Ray D. Pethtel
Director

RDP:1h1

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