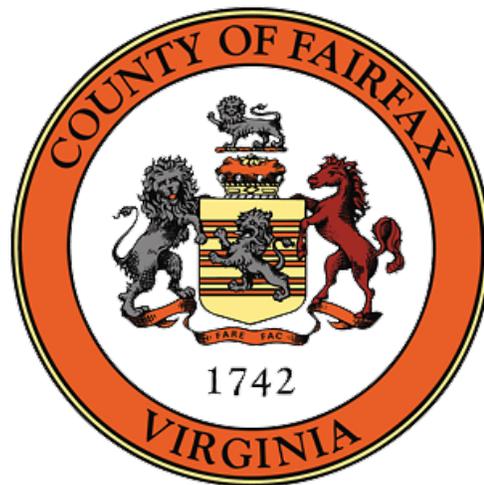


OFFICE OF FINANCIAL & PROGRAM AUDIT



March 2014

Quarterly Report

FAIRFAX COUNTY BOARD OF SUPERVISORS
AUDITOR OF THE BOARD

www.fairfaxcounty.gov/boardauditor/

Table of Contents

EXECUTIVE SUMMARY	2
STUDY BRIEFINGS.....	4
CENTRAL WAREHOUSE INTERNAL CONTROLS REVIEW	4
FOCUS REPORTS SURVEY	9
RETIREMENT ADMINISTRATION DISCLOSURES.....	14
DULLES METRORAIL PROJECT STATUS.....	22
FOLLOW-UP AND OTHER ONGOING ACTIVITIES	25
EMPLOYEE RECRUITMENT STATISTICS	25
APPENDIX	26
LIST OF ACRONYMS.....	28

Office of Financial & Program Audit

QUARTERLY REPORT

EXECUTIVE SUMMARY

Central Warehouse Internal Controls Review

We conducted a review of internal control procedures and building security at the Fairfax County Public Schools (FCPS)/County Central Warehouse in response to concerns raised by the Fairfax County Board of Supervisors over a recent case of FCPS employee theft. Both FCPS and the County maintain and manage surplus property at the Central Warehouse. During fiscal year 2013, the sale and disposal of surplus property generated nearly \$4 million in combined revenues for FCPS and the County. Internal controls are a system of standardized activities that are designed to safeguard assets, minimize risk, and enhance accurate reporting. We found that neither FCPS nor the County had developed adequate internal control procedures for their respective Central Warehouse operations. In addition, previous and current security assessments have revealed longstanding security weaknesses on the County's side of the warehouse. We recommended that the responsible departments develop procedures that address the five basic types of internal controls and take steps to address security weaknesses at the Central Warehouse.

FOCUS Reports Survey

To determine whether the standard reports in FOCUS are meeting users' business needs, our office and the Department of Information Technology (DIT) conducted an online survey of FOCUS users. The survey respondents' overall satisfaction with the standard reports in FOCUS was evenly divided between very satisfied or satisfied (38%), very dissatisfied or dissatisfied (27%), and neutral (35%). More than half of the survey respondents reported that they use other systems and applications to supplement the standard reports in FOCUS. In addition, 60% of survey respondents reported that they manage and maintain data outside of FOCUS on at least 25 different external (shadow) systems and applications. We recommended refresher trainings on FOCUS reports and adequate controls over external (shadow) systems and applications (such as Excel) that are used to manage and maintain data outside of FOCUS.

Retirement Administration Disclosures

The Fairfax County Retirement Administration manages three separate defined benefit retirement systems: (1) Employees' Retirement System, (2) Uniformed Retirement System, and (3) Police Officers Retirement System. The Employees' System is the largest of the County's three retirement systems, with \$3.4 billion in net assets and over 23,000 members. The funded ratio represents the amount of money that is available to pay for the long-term financial obligations of a retirement fund. A funded ratio of less than 100% means that a retirement fund has an "unfunded liability." The funded ratio for the Employees' System was 71.6% as of July 1, 2012. The rates of return on investments are an important part of the overall funding picture for a retirement system. The Employees' System has met the assumed rate of return for eight of the past 10 years. Based on our review of the Employees' System Comprehensive Annual Financial Report (CAFRs), we posed five questions to Retirement Administration staff regarding disclosures related to high risk investment instruments (derivatives and below-investment-grade fixed income holdings). The Retirement Administration's responses to our questions are presented in our report.

Dulles Metrorail Project Status

As of January 2014, construction for Phase 1 was 99% complete. Actual Phase 1 costs were \$2.759 billion as of January 2014, which represents 83% of the total \$3.343 billion budget for Phase 1. Construction for each of the five new stations was 99% complete. In February 2014, MWAA announced that the Project's Phase 1 prime contractor (Dulles Transit Partners) had not met the contract requirements for substantial completion. Specifically, MWAA determined that 7 of the 12 contract criteria for substantial completion were deficient. MWAA instructed Dulles Transit Partners to provide a plan for addressing the deficiencies "as quickly as possible." As of the date of our report, Phase 1 of the project had not yet achieved the substantial completion milestone and MWAA project officials would not provide an estimated date for substantial completion.

STUDY BRIEFINGS

CENTRAL WAREHOUSE INTERNAL CONTROLS REVIEW

Overview

The Fairfax County Public Schools (FCPS) and Fairfax County Government share a 750,000 square foot central warehouse facility located in Springfield.¹ Both FCPS and the County maintain and manage surplus property at the Central Warehouse. Surplus property includes office furniture, equipment, vehicles, computers, cell phones, televisions, and other electronic devices. During fiscal year 2013, the sale and disposal of surplus property generated nearly \$4 million in combined revenues for FCPS and the County. As noted in the table below, primary operations at the Central Warehouse are divided into two distinct sections: FCPS' side and the County's side.

**Primary Central Warehouse Operations
Fairfax County Public Schools and Fairfax County Government**

	Fairfax County Public Schools	Fairfax County Government
Department	Office of Procurement Services	Purchasing and Supply Management
Square Footage	546,000 sq. ft.	136,000 sq. ft.
Staff Positions	55	12
Type of Stock	Inventory	Consigned Goods
Tracking System	FOCUS (supplemented with Excel spreadsheets)	Excel Spreadsheets
General Activities	<ul style="list-style-type: none"> • Manage inventory of basic supplies for instructional, administrative, and custodial services. • Assemble and distribute science kits for the Instructional Program Service Center. • Manage internal mail services and provides central oversight of outgoing U.S. Mail. • Centrally manage the sale and disposal of surplus property. 	<ul style="list-style-type: none"> • Oversee the storage and distribution of consigned goods for county departments and agencies. • Store electronic voting machines and related elections equipment. • Pick-up, sort, and redistribute library books to the 23 Fairfax County Public Library branches and store library books for new and renovated facilities prior to being put into circulation. • Manage the sale and disposal of surplus property, as needed.
Surplus Property	<ul style="list-style-type: none"> • Online Public Auctions • Recycling/Disposal • Redistribution 	<ul style="list-style-type: none"> • Online Public Auctions • Recycling/Disposal • Redistribution

¹ Six departments and agencies maintain space in the Central Warehouse: (1) FCPS Office of Procurement Services, (2) Fairfax County Department of Purchasing and Supply Management, (3) Fairfax County Fire & Rescue, (4) Fairfax County Libraries –Archives, (5) Fairfax County Office of Elections, and (6) Fairfax County Health Department. In addition, three external entities (American Red Cross, Friends of the Library, and the Northern Virginia Senior Games) store property in the Central Warehouse under a space agreement with the County.

FCPS' surplus property is primarily sold, recycled, and disposed of at the Central Warehouse. Conversely, the County takes a decentralized approach to managing surplus property. Any department or agency can sell, recycle, and dispose of surplus property from any location. FCPS and the County use the same online public auction vendors to sell surplus property (Public Surplus® and Property Room®) and the same vendor for recycling surplus computer equipment (Creative Recycling Solutions), as needed. FCPS primarily sells surplus computer equipment through online public auctions while the County has elected to primarily recycle surplus computer equipment. The table below provides a summary of revenues generated from the sale and disposal of surplus property.

**Revenues Generated from Surplus Property
Fiscal Year 2013**

	Fairfax County Public Schools	Fairfax County Government
Surplus Property/Salvage	\$ 129,655	\$ 2,204,637
Surplus Vehicles	\$ 125,318	\$ 1,424,499
TOTAL	\$ 254,973	\$ 3,629,136

Source: Summary of fiscal year 2013 revenues posted to the surplus property general ledger accounts in FOCUS.

Scope and Methodology

We conducted our review in response to concerns raised by the Fairfax County Board of Supervisors over a recent case of FCPS employee theft of surplus property at the Central Warehouse.² The scope of our review included an assessment of internal control procedures and building security at the FCPS/County Central Warehouse located in Springfield. Our assessment of internal control procedures was limited to the sections of the Central Warehouse operated by the FCPS Office of Procurement Services and the Fairfax County Department of Purchasing and Supply Management (DPSM). At our request, the Fairfax County Facilities Management Department (FMD) Security Office conducted a security assessment of access controls at the Central Warehouse. The County's security consultant (Securitas) conducted a previous security assessment of the Central Warehouse in August 2008. The August 2008 and February 2014 security assessments were limited to the County's side of the Central Warehouse.

We conducted walk-throughs of both sides of the Central Warehouse (FCPS and County) and interviewed warehouse staff and managers from Fairfax County DPSM and the FCPS Office of Procurement Services. In addition, we requested from the directors of the FCPS Office of Procurement Services and Fairfax County DPSM copies of all formal (written and approved) policies and procedures for warehouse staff. We reviewed Fairfax County Internal Procedural Memorandum No. 12-400, *Receiving and Storing Material at DPSM Warehouse*, dated January 25, 2012. We also reviewed surplus property sales reports from the online auction vendors (Public Surplus® and Property Room®) and summarized fiscal year 2013 revenues posted to the surplus property general ledger accounts in FOCUS, the enterprise resource management system for FCPS and the County.

² In January 2014, the former Fairfax County Public Schools (FCPS) Warehouse Operations Coordinator was arrested for allegedly taking surplus laptop computers from the Central Warehouse, refurbishing them, and selling them online through his personal account on eBay®. At the time of his arrest, police removed over 1,200 stolen computers from his home.

Internal Control Procedures

Internal controls are a system of standardized activities that are designed to safeguard assets, minimize risk, and enhance accurate reporting.³ As noted in the text box below, there are five basic types of internal control activities. To help ensure internal control activities are consistently applied, procedures should be formalized in writing and approved by management. However, we found that neither FCPS nor the County had developed adequate internal control procedures for their respective Central Warehouse operations.

Although FCPS has established a broad set of procedures for warehouse staff, the procedures do not adequately address the five basic types of internal control activities. The FCPS Office of Procurement Services is in the process of improving its warehouse procedures and developing new procedures to address control weaknesses related to the recent case of employee theft.

DPSM has a broad set of policies outlined in Internal Procedural Memorandum No 12-400: *Receiving and Storing Materials at DPSM Warehouse*. However, PM 12-400 does not establish specific internal control procedures for warehouse staff. For example, PM 12-400 states that warehouse staff should update the inventory list (an Excel spreadsheet), but does not specify which employees should have access to modify the Excel spreadsheet or how access should be controlled to prevent unauthorized modifications. In addition, PM 12-400 does not establish controls to safeguard high theft risk items, such as surplus computer equipment, cell phones (Blackberries), and ink cartridges. A single “auction lot” of surplus Blackberries can sell for as much as \$4,000. A single “auction lot” of surplus ink cartridges can sell for as much as \$3,000. Surplus cell phones are currently stored in a warehouse employee’s cubicle. Other high theft risk items are stored in an open area of the warehouse.

Security Weaknesses

In response to the recent case of FCPS employee theft at the Central Warehouse, the FCPS Procurement Services Office is working with the FCPS Office of Safety and Security to address security weaknesses. Specifically, FCPS is researching the costs and benefits associated with placing security cameras in key locations within their side of the Central Warehouse and installing cages for high theft risk items (such as laptops and other computer equipment).

Standard Internal Control Activities

Separation of Duties – Having two people perform a task together or splitting the task into separate parts to ensure that one person does not handle the complete assignment.

System of Authorizations – Only authorized or designated individuals have permission to complete certain tasks.

Physical Controls – Implement physical safeguards (such as locks, proximity cards, safes, and fences) to prohibit access to assets and records.

Independent Checks – Job rotations, mandatory vacations, periodic audits, and external reviews.

Documentation – Maintain a system of documents and records that provide an audit trail to help ensure that controls are placed in operation and suspicious activity can be identified.

³ It is important to note that internal control procedures alone cannot prevent fraud. Internal control procedures are one part of an overall internal control framework that should include an effective control environment and ongoing monitoring, as defined in the Committee of Sponsoring Organizations (COSO) Treadway Commission, *Internal Control – Integrated Framework*.

The Fairfax County Facilities Management Department (FMD) is responsible for building maintenance and security on the County's side of the Central Warehouse. In August 2008, the County's security consultant (Securitas) conducted an assessment of the Central Warehouse facility and made recommendations to improve security controls. At our request, the FMD Security Office conducted a follow-up security assessment of the County's side of the Central Warehouse. As noted in the table below, many of the security weaknesses reported in August 2008 have remained unaddressed nearly six years later.

**Selected Security Assessment Recommendations
County's Side of the Central Warehouse**

Recommendations	Reported August 2008	Reported February 2014
All doors leading into restricted areas within the Central Warehouse should be converted to Proximity Card readers that are tied into the County's existing system, with the capability of producing an audit trail.	X	X
Digital cameras should be placed to cover all four sides and entrances into the Central Warehouse. The cameras should have the capability of being monitored and recorded at the County's central security station.	X	X
All emergency and outside doors should be for exit only and should remain alarmed at all times.	X	X
Install a doorbell at the front entrance of the DPSM section of the Central Warehouse to alert staff if someone enters.		X
Install door alarm at the front entrance of the Fire & Rescue/County Archives section of the Central Warehouse to alert staff if someone enters.	X	X
Secure both the Archives and Fire & Rescue entrances to the Central Warehouse with card reader access. Persons without authorized access should remain in the entry foyer until an authorized employee allows entry.	X	X
Repair all broken intrusion devices.		X
Perform complete audit of the Central Warehouse intrusion system. The audit should test the functionality of the devices, current mapping/naming of devices and the current partitioning of alarms.		X
All interior cages should be raised to the ceiling or have a barrier placed at the top of the fence to prevent unauthorized entrance by climbing.		X
All high value and high theft risk items should be stored in a secure area.		X
Install cage to house pallets containing IT equipment and other electronic devices and peripherals that are staged to be picked up by the recycling vendor.		X
Identify and utilize an inventory management system to replace current manual tracking on Excel spreadsheets.		X
Routine maintenance of lighting fixtures should be scheduled and repairs made as required.	X	X

Source: Central Warehouse security assessment reports, dated August 2008 and February 2014, conducted by Securitas and the Fairfax County Facilities Management Department Security Office.

Recommendations:

The respective directors of the three departments listed below agreed with the findings and recommendations noted in our report.

Fairfax County Public Schools Office of Procurement Services

- Continue to work with the FCPS Office of Safety and Security to address security weaknesses at the Central Warehouse and implement related recommendations, as appropriate.
- Continue efforts to develop formal (documented and approved) internal control procedures for FCPS' Central Warehouse operations that address the five basic types of control activities: (1) Separation of Duties, (2) System of Authorizations, (3) Physical Safeguards, (4) Independent Checks, and (5) Documentation.

Fairfax County Department of Purchasing and Supply Management

- Implement appropriate safeguards and controls for high theft risk items, such as surplus computer equipment, cell phones (Blackberries), and ink cartridges.
- Continue efforts to research an alternate tracking system to replace the current process of tracking property and consignment stock on Excel spreadsheets, which do not have adequate user access controls or audit trails.
- Develop formal (documented and approved) internal control procedures for DPSM's Central Warehouse operations. The internal control procedures should address the five basic types of control activities: (1) Separation of Duties, (2) System of Authorizations, (3) Physical Safeguards, (4) Independent Checks, and (5) Documentation.

Fairfax County Facilities Management Department

- Take steps to address longstanding security weaknesses identified in previous and current security assessments of the County's side of the Central Warehouse.
- Update the space plans for the Central Warehouse (the space plans were last updated in November 2004).

FOCUS REPORTS SURVEY

Overview

In November 2011, the County implemented the first phase of an integrated SAP® Enterprise Resource Planning system known as “FOCUS” (Fairfax County Unified System). The mission of the FOCUS Implementation Project was to, “Replace finance, budget, procurement and human resources legacy systems with an integrated ERP system while promoting strategic business process improvements to meet the needs of Fairfax County and Fairfax County Public Schools now and in the future.”⁴ The County’s FOCUS-related expenditures and commitments total \$60 million, not including staff time and other internal costs.

The initial FOCUS contract included only baseline core reports. A dynamic reporting function that would allow users to customize their own ad-hoc system reports was not included in the contract and was not implemented. System reports are a critical component of an information technology system because they allow users to access information and data that are needed to support business functions. Effective system reports allow users and external reviewers to monitor and manage an organization’s financial position and operating status on the department level as well as enterprise-wide. System reports should be accurate, reliable, user friendly, and provide relevant information.

Scope and Methodology

To determine whether the standard reports in FOCUS are meeting users’ business needs, our office and the Department of Information Technology (DIT) conducted an online survey of FOCUS users. The purpose of the survey was to evaluate the effectiveness of the standard reports in FOCUS, solicit recommendations for improvement, and identify external systems and applications that are used to supplement FOCUS reporting functions. The scope of the survey included users with access to the standard reports in the FOCUS financial system module (FILO).⁵ The Department of Information Technology created the survey distribution list and controlled access to the survey instrument and survey responses. We received 336 valid responses representing approximately 20% of the total survey population of 1,786. Survey respondents represented 40 of the County’s 52 departments and agencies.

The FOCUS Reports Survey was conducted to supplement county management’s efforts to provide a comprehensive Post-Implementation Review of FOCUS, as requested by the Chairman of the Fairfax County Board of Supervisors during the January 2014 meeting.⁶ A complete copy of the survey instrument is included in the Appendix section of this report.

FOCUS Implementation Project Charter “Ten Guiding Principles”

1. Team Fairfax
2. One Business System
3. Processes that Fit the Software
4. Efficiencies Through Integration
5. Increase Capacity to Excel and Provide Maximum Value
6. Eliminate Silos
7. Seek Input and Ideas
8. Change is Good
9. Supported and Sustained Training
10. Failure is Not an Option

⁴ *FOCUS ERP Implementation Project Charter*, dated September 15, 2010. The current County Executive served as the Project Sponsor for the FOCUS Implementation Project. The FOCUS project team was composed of SAP consultants and staff and managers from the County and FCPS.

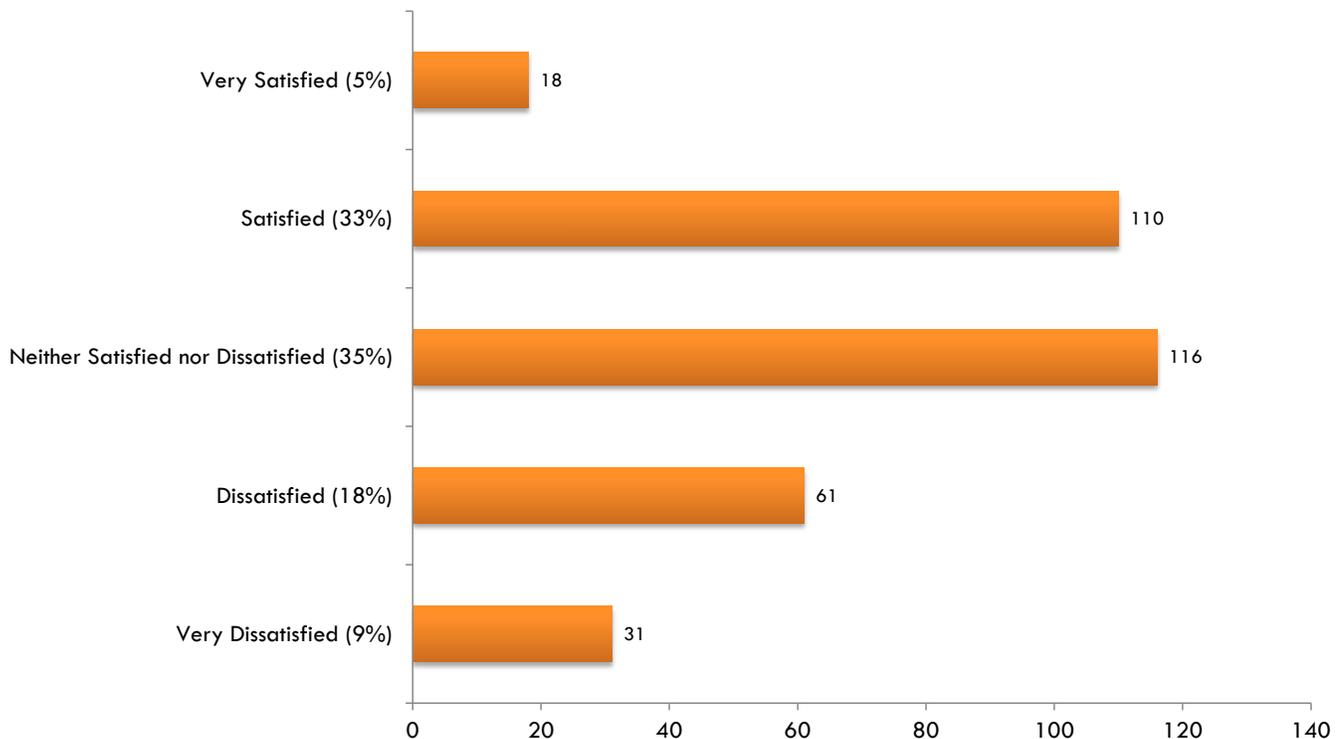
⁵ The survey excluded Fairfax County Public Schools (FCPS) FOCUS users.

⁶ In a Board Matter presented at the January 14, 2014 meeting, the Chairman of the Board directed the County Executive to provide a comprehensive Post-Implementation Review of FOCUS. The purpose of a Post-Implementation Review is to evaluate the functionality and performance of a system, as well as to assess the effectiveness of the development activities that produced the system. Post-Implementation Reviews are a common industry practice and are typically conducted six months after implementation.

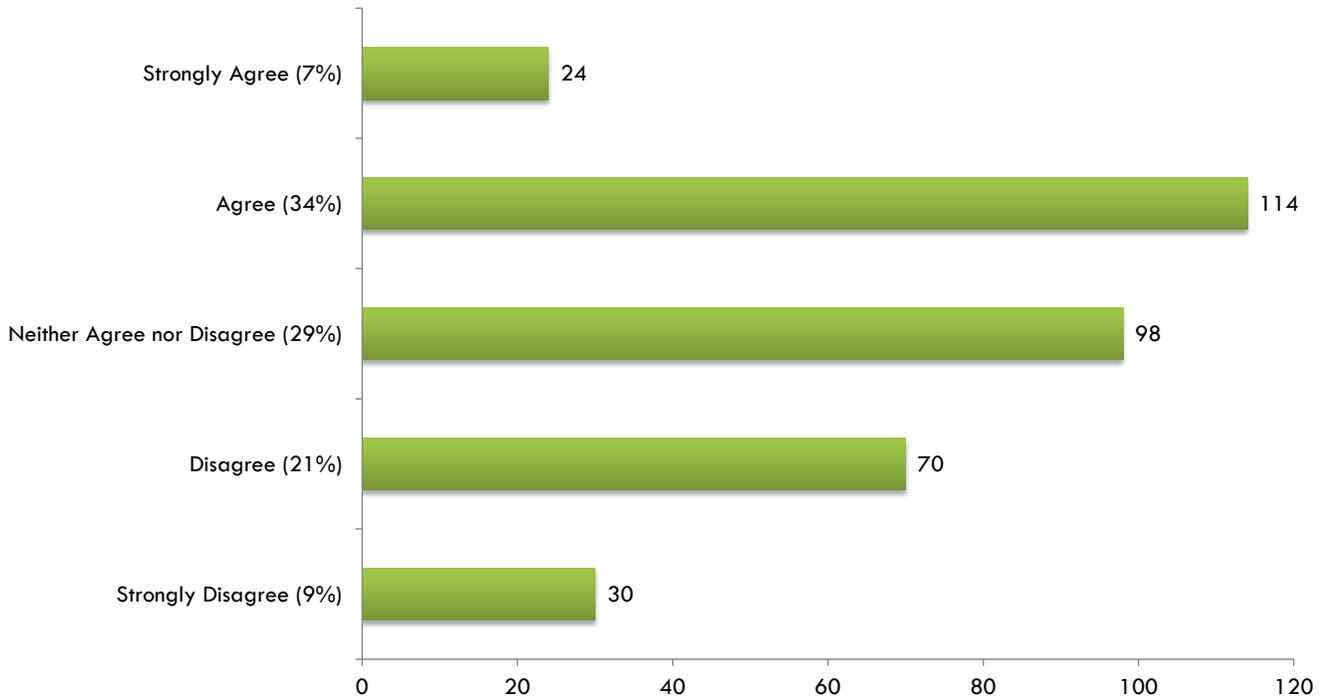
User Satisfaction with FOCUS Reports

The survey respondents' overall satisfaction with the standard reports in FOCUS was evenly divided between very satisfied or satisfied (38%), very dissatisfied or dissatisfied (27%), and neutral (35%). Many survey respondents noted a need for greater flexibility in the FOCUS reports, such as the ability to run ad-hoc reports that include all relevant data fields. Survey respondents reported having to run two or three separate FOCUS reports and combining that data into Excel spreadsheets in order to have all the data fields they need in one place. DIT and the FOCUS Business Support Group are in the process of developing a FOCUS Data Warehouse which will combine data fields from different FOCUS modules and other data sources to allow users to run ad-hoc customizable reports.

Survey Question #10: Overall, how satisfied are you with the standard reports in FOCUS?



Survey Question #2: Do the standard reports in FOCUS effectively provide the information you need to support your department/agency's business needs?



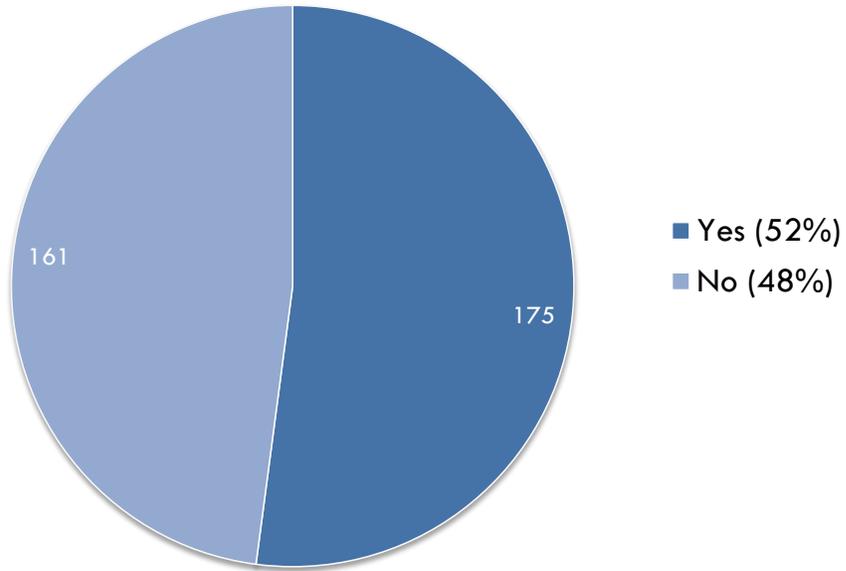
Reliance on External (Shadow) Systems and Excel Spreadsheets

More than half of the survey respondents reported that they use other systems and applications to supplement the standard reports in FOCUS. In addition, 60% of survey respondents reported that they manage and maintain data outside of FOCUS on at least 25 different external (shadow) systems and applications. “Shadow systems” are small scale databases or spreadsheets that are developed for and by end users, outside the direct control of an organization’s information technology department.⁷

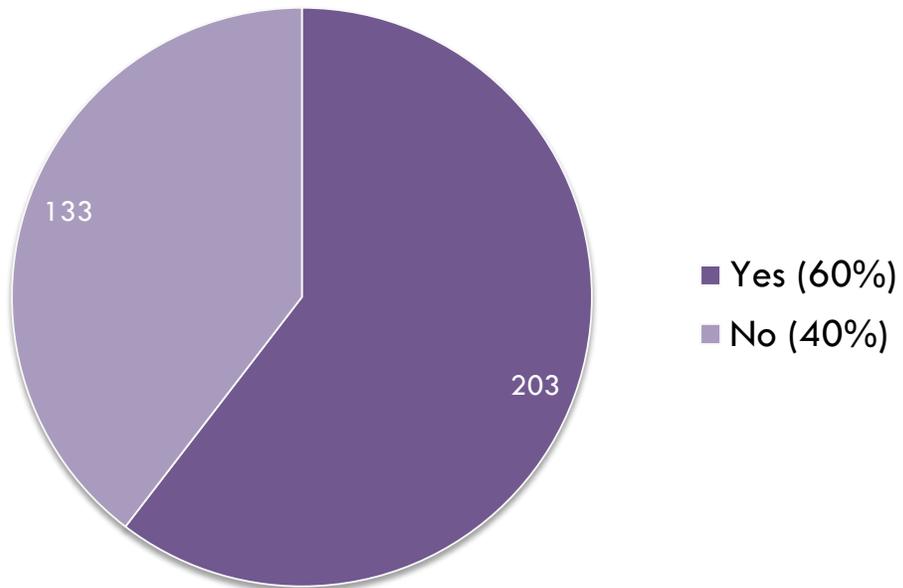
Of the respondents who answered “yes” to questions related to use of external systems, more than half reported using Excel spreadsheets to manage financial data (revenues and expenditures), human resources data, contract data, grants data, and cash proffer data. Because Excel spreadsheets do not have the access controls or audit trails of a standard information technology system, a heavy reliance on Excel spreadsheets increases the potential risk for errors, misstatements, and omissions. Specifically, unauthorized modifications to transactions and amounts cannot be adequately traced and formula errors may go unnoticed. Therefore, it is important for departments and agencies to ensure that they have implemented appropriate controls over their Excel spreadsheets.

⁷ *Shadow Systems = Shadow Risks*, Scott Rogerson, ISACA Now, 2/16/2012.

Survey Question #4: Do you use other systems or applications to supplement the standard reports in FOCUS?



Survey Question #7: Do you currently maintain and manage data outside of the FOCUS system?



Recommendations:

- The FOCUS Business Support Group should continue to seek input from departments, agencies, business process owners, and FOCUS training staff to help identify recommendations for improvements, as appropriate, and provide refresher trainings on the standard reports in FOCUS that incorporate real examples and best practices.
- The Department of Information Technology should work with the departments and agencies that maintain critical financial and operational data in various external (shadow) systems and incorporate that data into the FOCUS Data Warehouse that is currently under development.
- All departments and agencies should ensure that appropriate controls (such as user access controls, version management, and error checking) over Excel spreadsheets and other external (shadow) systems are in place and operating effectively.

RETIREMENT ADMINISTRATION DISCLOSURES

Overview

The Fairfax County Retirement Administration manages three separate defined benefit retirement systems: (1) Employees' Retirement System, (2) Uniformed Retirement System, and (3) Police Officers Retirement System. The three systems provide retirement benefits to vested current and former County employees and are funded through annual contributions from employees and the County's General Fund.⁸ In fiscal year 2013, the County contributed a combined total of \$215 million to the three retirement systems. The Employees' System is the largest of the County's three retirement systems, with \$3.4 billion in net assets and over 23,000 members.

Fairfax County Retirement Systems Fiscal Year 2013

	Employees' Retirement System	Uniformed Retirement System	Police Officers Retirement System
Membership	23,166	3,142	2,258
County Contributions	\$ 127,448,018	\$ 53,722,160	\$ 34,011,347
Net Assets Held for Retirement Benefits	\$ 3,353,932,103	\$ 1,318,814,003	\$ 1,102,522,083

Source: Fiscal year 2013 Comprehensive Annual Financial Reports (CAFRs) for the Employees' Retirement System, Uniformed Retirement System, and Police Officers Retirement System.

Each of the County's three retirement systems has a separate Board of Trustees composed of members appointed by the Fairfax County Board of Supervisors, ex officio members, and elected members. The Trustees are responsible for overseeing the investment programs, hiring investment managers, monitoring investment performance, and complying with all applicable laws, rules, regulations, and ethical standards. Virginia Code §51-803 requires the Trustees to invest Retirement System assets with the care, skill, and diligence that a prudent person acting in a like capacity would use. Virginia Code also requires the Trustees to diversify the investments to minimize the risk of large losses. Although the County's Retirement Systems are not subject to the requirements of the Employment Retirement Income Security Act (ERISA), the Trustees endeavor to comply with the spirit of ERISA to the extent that it does not conflict with Virginia Code.

Retirement Administration staff (which includes the Executive Director and Chief Investment Officer) are responsible for assisting the Trustees in fulfilling their fiduciary responsibilities, ensuring the timely delivery of services and benefits, preparing the annual financial reports, serving as the primary interface between the Trustees and the investment managers, and reporting the quarterly and longer term performance of each investment manager to the Trustees.

⁸ All retirement benefits vest after five years of service. The Systems' benefits are established and may be amended by County ordinance.

Scope and Methodology

The scope of our study included a review of information presented in the Comprehensive Annual Financial Reports (CAFRs) for the Employees' Retirement System, which is the largest of the County's three retirement systems. The purpose of this review was to provide information on funding levels, investment returns, and disclosures related to certain types of high-risk investment instruments, such as derivatives.⁹

The Retirement Administration contracts with an accounting firm (KPMG) to conduct an annual financial audit of the financial statements and related disclosures reported in the Employees' System CAFR. At the conclusion of the annual financial audit, KPMG determines whether the financial statements and related disclosures are in accordance with Generally Accepted Accounting Principles (GAAP), in all material respects. KPMG has consistently issued unqualified (clean) audit opinions on the financial statements and related disclosures reported in the Employees' System CAFRs. Therefore, we relied on the information reported in the Employees' Retirement System CAFRs for our study.

We also reviewed the financial disclosure requirements set forth in Government Accounting Standards Board (GASB) Statement No 53, *Accounting and Financial Reporting for Derivative Instruments* and the Employees' Retirement System Investment Policy Statement, dated January 18, 2012. In addition, we reviewed Virginia Code §51-803, which establishes the requirements and responsibilities related to retirement fund investments, and the January 2014 credit report on Fairfax County prepared by Moody's Investors Service. We obtained information related to national benchmarks for retirement system funding from reports and studies published by the Pew Center on the States and the Center for Retirement Research at Boston College. We also reviewed the Montgomery County Office of Legislative Oversight Follow-up Report on Questions related to the County Government's Retirement Plans, dated January 19, 2011.

Funded Ratios

The funded ratio represents the amount of money that is available to pay for the long-term financial obligations of a retirement fund. Specifically, the funded ratio is the actuarial value of assets expressed as a percentage of actuarial liabilities. A funded ratio of less than 100% means that a retirement fund's long-term financial obligations (liabilities) exceed the amount of money it has to pay for those obligations (assets).¹⁰ When a funded ratio is less than 100%, the difference between the actual funded ratio and 100% represents an "unfunded liability." The funded ratio for the Employees' System was 71.6% as of July 1, 2012.

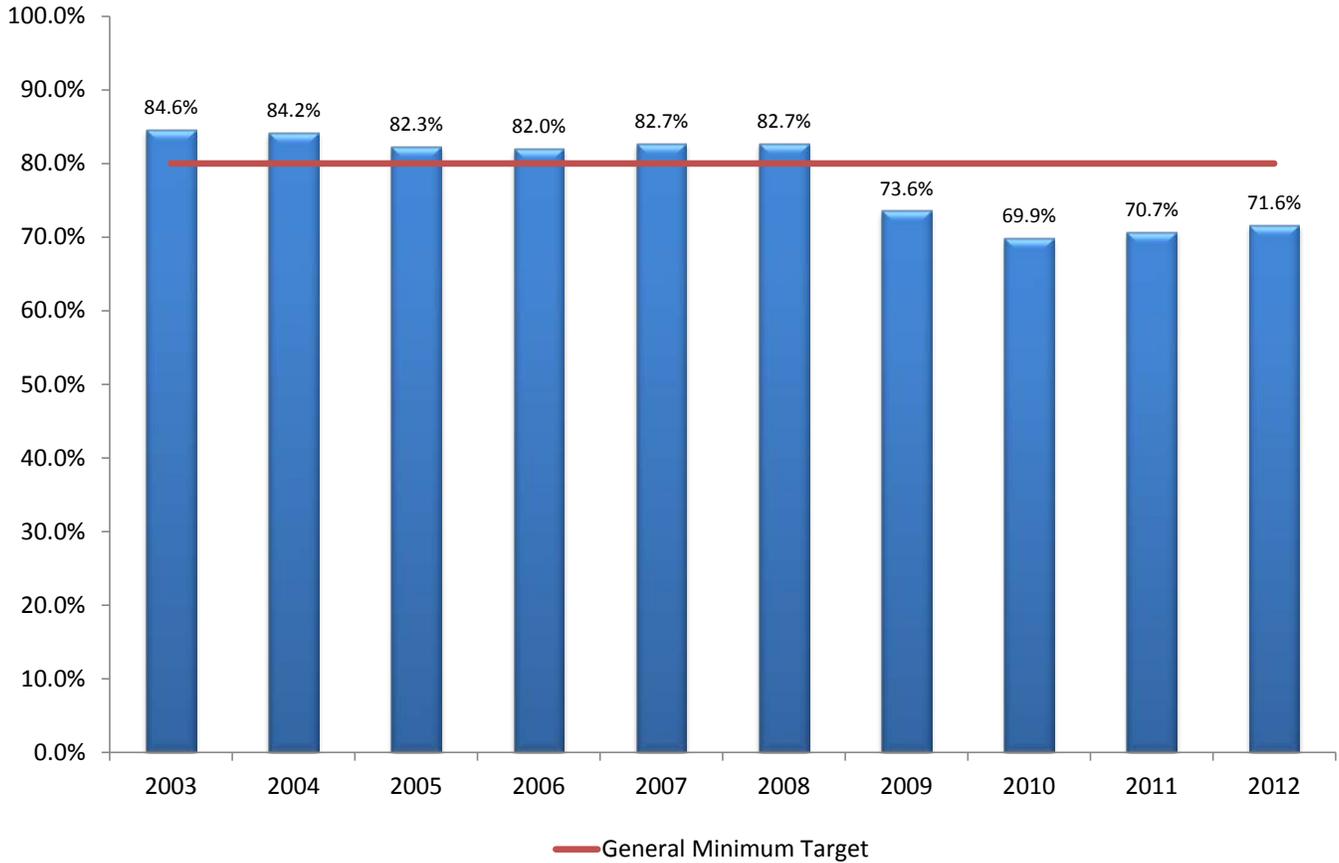
In January 2014, Moody's issued a "negative outlook" for Fairfax County. Moody's cited upcoming budget gaps and the additional costs associated with addressing the Retirement Systems' unfunded liabilities. During the recent presentation of the County's Fiscal Year 2015 Advertised Budget, the County Executive announced a plan to gradually increase the level of funding for the Retirement Systems to 100% by the end of the decade, starting in fiscal year 2015.

⁹ GASB Statement No. 53 defines derivatives as financial arrangements with values or cash payments that are based on what happens in separate transactions, agreements, or rates. Derivatives must have two primary characteristics: (1) the financial arrangements are leveraged – they require minimal or initial investment on the part of a government but can achieve changes in value (gains or losses) that can far exceed the initial investment, and (2) the financial arrangements can be settled early with a cash payment or the transfer of an equivalent asset.

¹⁰ Montgomery County Office of Legislative Oversight Follow-up Report on Questions related to the County Government's Retirement Plans, January 19, 2011.

The following chart presents the funded ratios for the Employees' System as of July 1, 2003 through July 1, 2012.

**Employees' Retirement System Funded Ratios
July 1, 2003 through July 1, 2012**

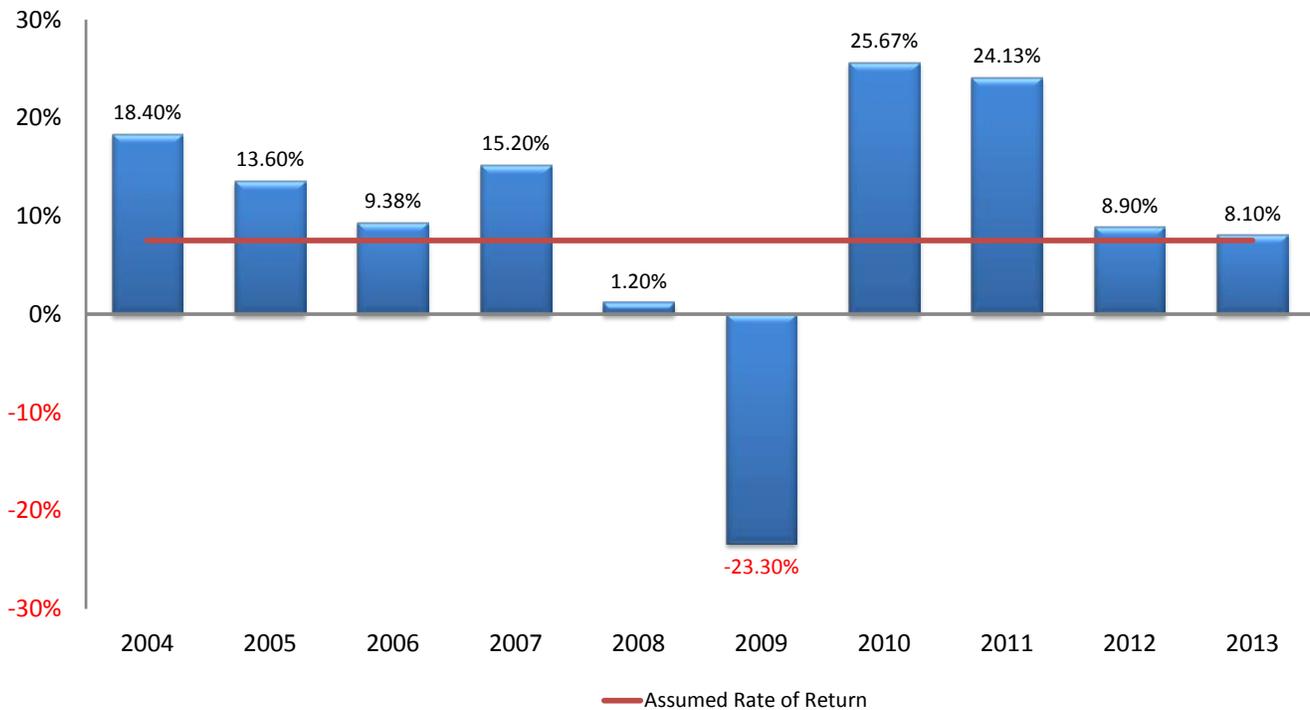


Source: "Schedule of Funding Progress" reported in the Employees' System Comprehensive Annual Financial Reports (CAFRs) for fiscal years 2004 through 2013. We obtained the 80% general minimum target ratio from the Center for Retirement Research at Boston College, *The Funding of State and Local Pensions: 2009-2013*. Specific minimum target ratios depend on the individual characteristics of a particular retirement plan.

Investment Rates of Return

The rates of return on investments are an important part of the overall funding picture for a retirement system. The assumed rate of return is one of several key assumptions that directly affect the actuaries' calculation of the recommended annual County contribution.¹¹ During fiscal years 2004 through 2013, the County's actuaries assumed that the Employees' System investments would earn 7.5% annually. As shown in the chart below, the Employees' System has met the assumed rate of return for eight of the past 10 years. In fiscal year 2009, Employees' System had a negative investment return of -23.30%, which means that the System had an overall loss in that year.

**Employees' Retirement System Investment Rates of Return
June 30, 2004 through June 30, 2013**



Source: Actual investment rates of return reported in the Employees' System Comprehensive Annual Financial Reports (CAFRs). We obtained the assumed rate of return of 7.5% from the actuary reports included in the "Actuarial Section" of the CAFRs.

¹¹ Montgomery County Office of Legislative Oversight Follow-up Report on Questions related to the County Government's Retirement Plans dated January 19, 2011.

Retirement Administration Responses

Based on our review of the Employees' System Comprehensive Annual Financial Report (CAFRs), we posed five questions to Retirement Administration staff regarding disclosures related to high risk investment instruments (derivatives and below-investment-grade fixed income holdings). The following tables represent our questions and the responses from Retirement Administration staff with our minor edits in brackets and the footnotes we added for clarification.

<p>Question 1:</p>	<p>Page 22 of the Employees' System Fiscal Year 2013 Comprehensive Annual Financial Report (CAFR) states, "In accordance with the Board's investment policies, the System regularly invests in derivative financial instruments with off-balance-sheet risk..."</p> <p>Please provide the page number and/or section of the Employees' System Investment Policy Statement that specifically covers investments in derivatives with off-balance-sheet risk.</p>
<p>RA Staff Response:</p>	<p>The following disclosure is on Page 3 of the ERS [Employees' Retirement System] Investment Policy Statement:</p> <p><i>"Risk parity The System follows a risk parity approach to diversify Beta (asset class) risk and returns. Using futures, the System increases the allocation to low risk and return asset classes and reduces the relative allocation to high risk, higher return asset classes.</i></p> <p><i>In implementing a risk parity approach, the System must use leverage to increase the return potential from low risk asset classes. This is implemented using futures which increases the portfolio's risk adjusted return from all asset classes combined together. By using futures, the System's economic exposure or weighting to Beta commonly exceeds 100% of the value of the portfolio's assets. "¹²</i></p> <p>The policy language above does not specifically reference the term derivative financial instrument with off balance sheet risk but does reference the use of futures which is part of this category. Clifton [Investment Management Company] will buy and sell futures to gain exposure to markets for us at the portfolio level.¹³ Individual Investment Manager contracts include specific guidelines and restrictions to the use of derivatives by that manager for the pool of assets under their control.</p>

¹² The term "Beta" refers to the measure of an investment instrument's price volatility in relation to the overall market. Investment instruments that have a beta greater than 1(100%) have greater price volatility than the overall market and are more risky.

¹³ The Retirement Administration contracts with the Clifton Group Investment Management Company (Clifton) to provide futures-and options-based investment management and risk management services.

Question 2:	What information does Retirement Administration staff provide to the Trustees regarding derivatives with off-balance-sheet risk? How often do you provide the information and in what form (e.g. reports, presentations)? Please provide examples.
RA Staff Response:	<p>The Board [of Trustees] is provided with several primary sources of information regarding derivative use.</p> <ul style="list-style-type: none"> • The annual CAFR [Comprehensive Annual Financial Report]. • Monthly Market Value reports that provide detail on the Clifton [Investment Management Group] Futures Exposures. • Quarterly Investment Manager Reports distributed to all Board [of Trustees] members. • Presentations by Investment Managers to the Board [of Trustees]. • Staff Presentations on Asset Allocation. • Due Diligence meetings at manager offices.

Question 3:	<p>Page 22 of the Employees' System Fiscal Year 2013 CAFR states, "Gains and losses on derivative securities are determined based on fair market values as determined by our custodian and recorded in the Statement of Changes in Plan Net Position."</p> <p>Please provide the realized gains and losses on derivative securities for fiscal years 2010, 2011, 2012, and 2013 (preferably by category: futures, currency forwards, options, and swaps).¹⁴</p>																														
RA Staff Response:	<p>We have asked our custodian to provide this information. We do not commonly break this out separately.</p> <table border="1" data-bbox="402 1327 1435 1579"> <thead> <tr> <th>Derivative Type</th> <th>2013 Realized Gain/(Loss)</th> <th>2012 Realized Gain/(Loss)</th> <th>2011 Realized Gain/(Loss)</th> <th>2010 Realized Gain/(Loss)</th> </tr> </thead> <tbody> <tr> <td>FOREIGN EXCHANGE Total</td> <td>\$ (382,416)</td> <td>\$(1,759,604)</td> <td>\$5,044,709</td> <td>\$ (181,360)</td> </tr> <tr> <td>FUTURE Total</td> <td>30,862,162</td> <td>21,850,069</td> <td>29,958,158</td> <td>22,123,574</td> </tr> <tr> <td>OPTIONS Total</td> <td>117,980</td> <td>91,086</td> <td>(120,888)</td> <td>1,744</td> </tr> <tr> <td>SWAPS Total</td> <td><u>17,735,875</u></td> <td><u>(29,210,035)</u></td> <td><u>34,960,466</u></td> <td><u>(6,599,021)</u></td> </tr> <tr> <td>Grand Total</td> <td>\$48,333,601</td> <td>\$(9,028,485)</td> <td>\$69,842,445</td> <td>\$15,344,937</td> </tr> </tbody> </table>	Derivative Type	2013 Realized Gain/(Loss)	2012 Realized Gain/(Loss)	2011 Realized Gain/(Loss)	2010 Realized Gain/(Loss)	FOREIGN EXCHANGE Total	\$ (382,416)	\$(1,759,604)	\$5,044,709	\$ (181,360)	FUTURE Total	30,862,162	21,850,069	29,958,158	22,123,574	OPTIONS Total	117,980	91,086	(120,888)	1,744	SWAPS Total	<u>17,735,875</u>	<u>(29,210,035)</u>	<u>34,960,466</u>	<u>(6,599,021)</u>	Grand Total	\$48,333,601	\$(9,028,485)	\$69,842,445	\$15,344,937
Derivative Type	2013 Realized Gain/(Loss)	2012 Realized Gain/(Loss)	2011 Realized Gain/(Loss)	2010 Realized Gain/(Loss)																											
FOREIGN EXCHANGE Total	\$ (382,416)	\$(1,759,604)	\$5,044,709	\$ (181,360)																											
FUTURE Total	30,862,162	21,850,069	29,958,158	22,123,574																											
OPTIONS Total	117,980	91,086	(120,888)	1,744																											
SWAPS Total	<u>17,735,875</u>	<u>(29,210,035)</u>	<u>34,960,466</u>	<u>(6,599,021)</u>																											
Grand Total	\$48,333,601	\$(9,028,485)	\$69,842,445	\$15,344,937																											

¹⁴ The Employees' Retirement System invests in four basic categories of derivatives: (1) Futures, (2) Currency Forwards, (3) Options, and (4) Swaps. Futures are contract agreements to buy or sell a product for a specific price on a specific future date. Currency Forwards are foreign exchange contracts that are commitments to purchase or sell a foreign currency at a future date and at a negotiated price. Options are contracts that provide the holder with the right, but not the obligation, to purchase (call) or sell (put) a financial instrument at a future price and time. Swaps are contracts in which two parties agree to exchange one stream of payments for another over an agreed upon period of time.

Question 4:	<p>Page 20 of the Fiscal Year 2012 Employees' System CAFR states, "As of June 30, 2012, the System held futures with net exposure of \$487.2 million."</p> <p>What was the total net exposure (\$ amount) of derivative securities held as of June 30 2013, 2012, 2011, and 2010 for the Employees' System?</p>
RA Staff Response:	<p>The reference on page 20 is to the net exposure to futures at Clifton [Investment Management Company]. In 2013 we improved the level of disclosure to include the small amount of futures held in separate accounts.</p> <p style="text-align: center;"><u>ERS FUTURES EXPOSURES</u></p> <p style="text-align: center;">2013 \$401.9 million 2012 \$487.2 million (Clifton only) 2011 \$540.3 million (Clifton only) 2010 \$376.3 million (Clifton only)</p> <p>We are not sure what to provide you as to "net exposure" for Swaps, foreign Currency forwards, and Options. Our 2013 CAFR includes detailed tables for these. Only the Swaps table includes a total for "Base Exposures" of a negative \$6.6 million.</p> <p>Historically the futures exposures we maintain with Clifton are the focus of the derivative disclosure staff makes to the Board [of Trustees] on a monthly basis since these are the largest most volatile positions.</p>

Question 5:	<p>Page 19 of the Employees' System Fiscal Year 2013 CAFR states, "The System's fixed income portfolio shall be, on average, comprised of high-quality issues and limits are imposed on investment managers' below-investment-grade holdings." As reported in the 2013 CAFR, approximately 41% of the total fixed income portfolio for the Employees' System was invested in below-investment-grade securities and 25.2% was invested in unrated securities.</p> <p>Is there a specific percentage limit set in policy for below-investment-grade securities in the fixed income portfolio? Do the limits address unrated securities?</p>
RA Staff Response:	<p>There is not a specific credit quality limit for fixed income in the ERS [Employees' Retirement System] Investment Policy nor do we address unrated securities.</p> <p>However, the investment guidelines do call for a target portfolio allocation to high yield exposures of 7.5% (see page 32 of 2013 CAFR). This is the main limit, so to speak, on investment quality in the Investment Policy. These high yield managers tend to hold only below investment grade securities and some portion in cash. These high yield managers have \$263.4 of asset under management at YE [year end] 2013 and represent the majority of non-investment grade exposure. Very roughly the \$263.4 million of AUM [Assets Under Management] represents 33% (versus 41% referenced above) of the below investment-grade securities of the total fixed income of \$797.0 million we report on page 20 of the CAFR for 2013. Please note not all of the \$263.4 million is reported in the \$797.0 million fixed income (some is cash).</p>

RA Staff Response (cont.)	We do have a couple of “non-high yield” fixed income managers that the Board [of Trustees] has authorized to hold non-investment grade fixed income securities based on specific investment guideline in each manager’s Investment Management Contract. There are limits, targets and minimums as to what securities the manager may hold in those accounts. Note only 6 of 14 fixed income managers in [the] Employees’ [System] have separately managed accounts.
---------------------------	---

Retirement Administration staff also provided the following general comments:

“Our CAFR’s [Comprehensive Annual Financial Report] derivative and fixed income disclosures are consistent with GAAP [Generally Accepted Accounting Principles] and provide detail mainly on the 60% of the Employees’ [Retirement System] portfolio assets that are managed in separate accounts. The CAFR has the added benefit of being audited but is issued only once a year. On a monthly basis, the Board [of Trustees] and staff monitor the exposures to risk and quality concentration in the portfolio across 100% of the portfolio. The portfolio’s asset allocation to broad asset categories is the primary tool we use and the ERS [Employees’ Retirement System] Investment Policy identifies the asset class targets and ranges. Our goal is to create a well diversified portfolio that has many sources of uncorrelated risk and returns. Historically the futures exposures we maintain with Clifton [Investment Management Group] are the focus of the derivative disclosure staff makes to the Board [of Trustees] on a monthly basis since these are the largest most volatile positions.”

DULLES METRORAIL PROJECT STATUS

Overview

The Dulles Metrorail Project is a 23-mile extension of the Metrorail system through the Dulles Corridor. The project is divided into two phases. Phase 1 of the project includes five new stations as well as improvements to the West Falls Church rail yard. Phase 2 of the project will include six new stations as well as a maintenance and storage facility at Dulles International Airport. The Metropolitan Washington Airports Authority (MWAA) is responsible for managing the Dulles Metrorail Project through the substantial completion of each phase, at which point the project will be turned over to the Washington Metropolitan Area Transit Authority (WMATA).

As shown in the table below, the total combined budget for Phase 1 and Phase 2 is currently \$6.5 billion. Funding for the project is provided through a combination of federal, state, and local sources. Fairfax County's baseline funding obligation for the project is 16.1% of total actual capital costs, notwithstanding construction costs related to parking garages.

Dulles Metrorail Project Budget*
As of January 2014

	PHASE 1	PHASE 2	TOTAL
Baseline Construction	2,443,450,279	2,226,784,385	4,670,234,664
Contingency	462,245,014	551,451,179	1,013,696,193
Total Capital Budget	2,905,695,293	2,778,235,564	5,683,930,857
Parking Garages (Fairfax and Loudoun)	N/A	348,215,194	348,215,194
Total Construction Budget	2,905,695,293	3,126,450,758	6,032,146,051
Project Finance Costs (MWAA)	438,184,571	N/A	438,184,571
Total Project Budget	\$ 3,343,879,864	\$ 3,126,450,758	\$ 6,470,330,622

*Project budget amounts reported in MWAA's Phase 1 and Phase 2 January 2014 Monthly Progress Reports and Quarterly Updates.

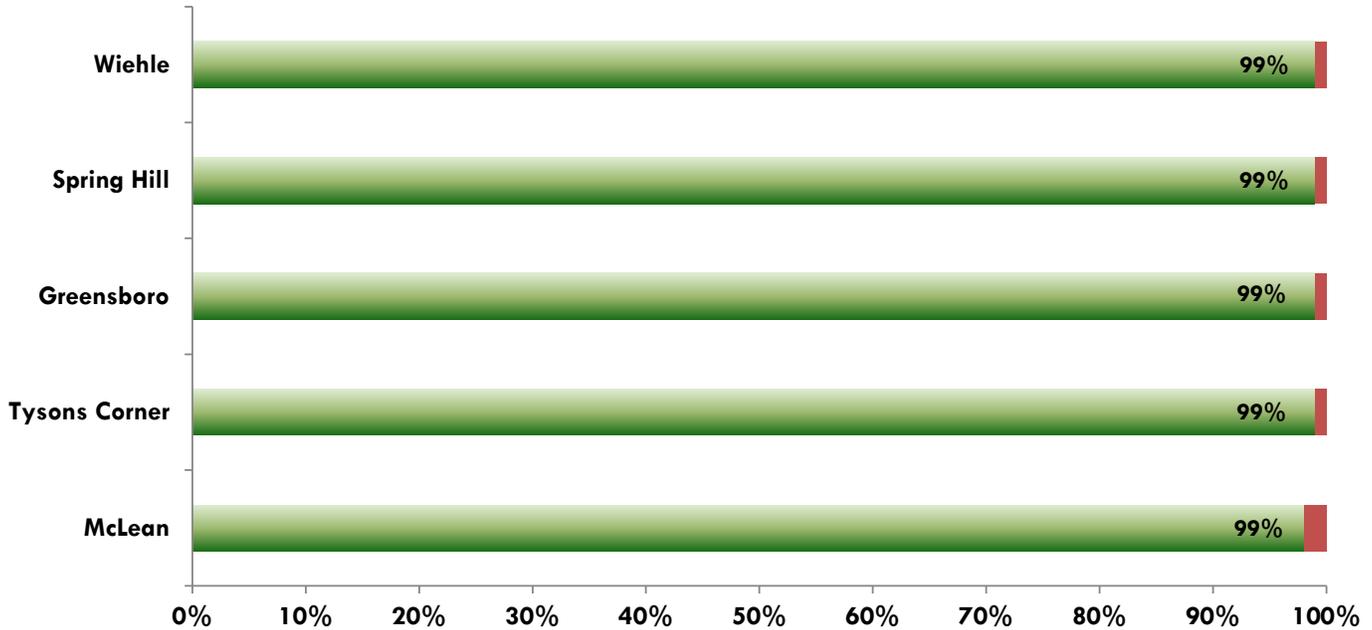
Project Progress

As of January 2014, construction for Phase 1 was 99% complete. Actual Phase 1 costs were \$2.759 billion as of January 2014, which represents 83% of the total \$3.343 billion budget for Phase 1.¹⁵ As of January 2014, the West Falls Church rail yard had an estimated completion date of March 2014. Site work and track work were 99% complete. The Service and Inspection Building for the West Falls Church rail yard was 99% complete and system testing was 60% complete. The initial delivery of the new 7000-series rail cars is scheduled for February 2014 with additional deliveries running through 2014 and 2015.

¹⁵ The total \$3.343 billion budget for Phase 1 includes \$438 million for budgeted project finance costs. The total \$2.759 billion in actual costs as of January 2014 includes \$150 million in actual project finance costs incurred by MWAA. We obtained project budget and cost information from MWAA's January 2014 Monthly Progress Report for Phase 1, which was issued in March 2014.

The following chart shows the percentage of completion for the five new Phase 1 stations as of January 2014.

**Dulles Metrorail Project
Phase 1 Station Construction Progress as of January 2014**



Project Schedule

Two critical dates for Phase I are the Scheduled Substantial Completion Date (SSCD) and Revenue Operations Date (ROD). The substantial completion date represents the point at which MWAA is ready to turn over the project to WMATA. The Revenue Operations Date is the point at which the Dulles Metrorail is ready for passenger service. The revenue operations date is projected to occur 90 calendar days after the scheduled substantial completion date.

The scheduled substantial completion date has been pushed back at least eight months from the original baseline date of July 31, 2013. The Project's prime contractor for Phase 1 (Dulles Transit Partners) has previously attributed the delays to holdups in subcontracting, a lack of access to construction sites, prolonged design, design revisions, permit approvals, adverse weather conditions, and coordination issues. However, MWAA's Project Team has attributed the delays to Dulles Transit Partners' inadequate planning and resources, as well as other performance issues.

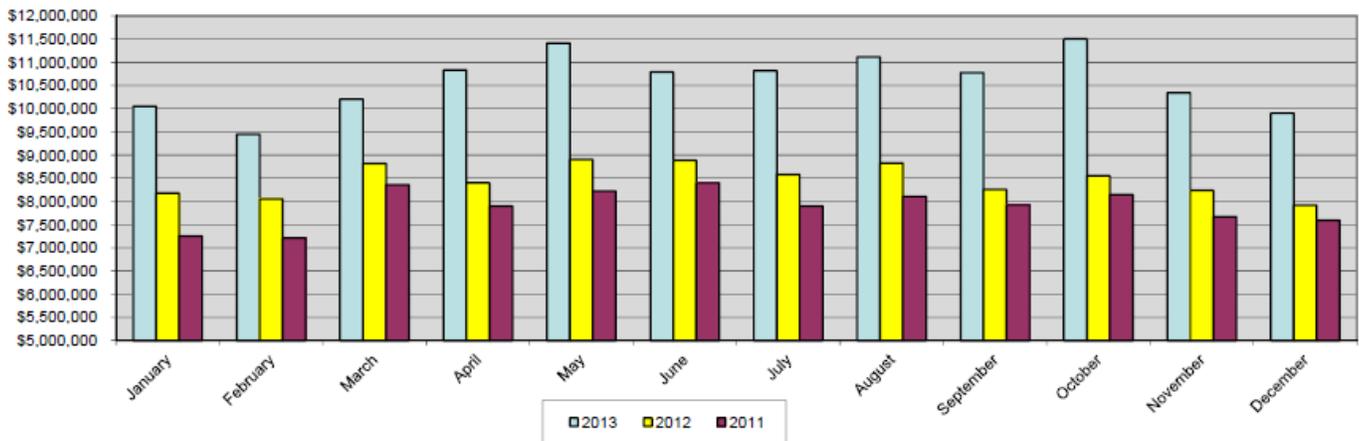
In its January 2014 Monthly Progress Report, MWAA reported a revised substantial completion date of January 31, 2014, which would result in projected revenue operations by May 2014. In early February 2014, Dulles Transit Partners reported that Phase 1 was substantially complete. However, after a 15-day review period, MWAA announced that Dulles Transit Partners had not met the contract requirements for substantial completion. Specifically, MWAA determined that 7 of the 12 contract criteria for substantial completion were deficient. MWAA instructed Dulles Transit Partners to provide a plan for addressing the deficiencies "as quickly as possible." As of the date of our report, Phase 1 of the project had not yet achieved the substantial completion milestone and MWAA project officials would not provide an estimated date for substantial completion.

Dulles Toll Road Revenue and Transaction Trends

Revenues generated from the Dulles Toll Road are the single most significant funding source for the Dulles Metrorail Project. More than half of the project's estimated \$6.5 billion in total costs will be supported through long-term debt obligations backed by toll road revenues. Dulles Toll Road revenues will be used to sustain debt service payments until the debt is retired in 2047. As of December 2013, MWAA reported that actual toll road revenues and transactions were consistent with budget estimates and toll road study projections.

MWAA's reported toll road revenues for calendar years 2011 through 2013 are presented in the chart below:

**Dulles Toll Road Revenues
Calendar Years 2011 - 2013**



Source: MWAA Dulles Corridor Enterprise December 2013 Financial Report, presented to the MWAA Board on February 19, 2014.

Audit and Oversight Activities

The Federal Transit Administration (FTA) has contracted with a private company (known as the Project Management Oversight Contractor) to provide ongoing monitoring and oversight of Phase 1. In addition, the FTA Office of the Inspector General (FTA OIG) has conducted audits of FTA's oversight of Phase 1 and the underlying assumptions used to develop MWAA's estimates of toll road revenues. The FTA Inspector General made recommendations to improve project oversight of Phase 1 and concluded that the toll road revenue estimates were generally reasonable. In January 2014, the FTA Inspector General issued an audit report on the financial management of Phase 1 and made recommendations to improve the oversight and management of Project grant expenditures. FTA and MWAA are in the process of developing a corrective action plan to address the findings noted in the Inspector General's report.

FOLLOW-UP AND OTHER ONGOING ACTIVITIES

EMPLOYEE RECRUITMENT STATISTICS

In March 2014, the Department of Human Resources implemented a new employee recruitment and applicant management system known as NEOGOV. Over 1,200 public sector organizations use NEOGOV including the City of Alexandria, Arlington County, Prince William County, and the Town of Vienna. NEOGOV replaced the County's old recruitment and applicant management system (AIMS Resume Builder), which had limited reporting capabilities. NEOGOV has expanded reporting capabilities and will allow for a more in-depth analysis of recruitment statistics. The Department of Human Resources is working with the FOCUS Business Support Group, the Department of Information Technology, and the system vendor to configure the new system. We will commence a review of employee recruitment statistics once the Department of Human Resources gains more experience with the new system and has collected a sufficient amount of new recruitment data to analyze.

APPENDIX



FOCUS Reports Survey

1. In which department/agency do you work?

2. Do the standard reports in FOCUS effectively provide the information you need to support your department/agency's business needs?

- Strongly Agree
 Agree
 Neither Agree nor Disagree
 Disagree
 Strongly Disagree

3. Which category of FOCUS reports do you use the most?

- Procurement (Contract/Vendor/Purchase Order)
 Funds Management
 Accounts Payable
 Accounts Receivable
 Asset Accounting
 Grants Management
 Projects Management
 General Ledger
 Human Resources
 Other

Please specify "Other" :

4. Do you use other systems or applications to supplement the standard reports in FOCUS?

- Yes
 No

5. If you answered "Yes" to the previous question, for what purpose do you use other systems or applications to supplement the standard reports in FOCUS?

- Audit and Review Functions
 Cash Proffers Management
 Contract Management
 Funds Management
 Grants Management
 Human Resources Management
 Project Management
 Asset Management
 Purchasing Management
 User Account Management
 Other

Please specify "Other" :

6. What systems or applications do you use to supplement the standard reports in FOCUS?

- Excel (spreadsheet)
- Access
- Not Applicable
- Other

Please specify "Other":

7. Do you currently maintain and manage data outside of the FOCUS system?

- Yes
- No

8. If you answered "Yes" to the previous question, what type of data do you manage outside of FOCUS?

- Revenue Data
- Expenditure Data
- Budget Data
- Cash Proffers Data
- Contract Data
- Assets Data
- Grants Data
- Project Management Data
- Personnel (Human Resources) Data
- Other

Please specify "Other":

9. What systems or applications do you use to manage data outside of FOCUS?

- Excel (spreadsheet)
- Access
- Not Applicable
- Other

Please specify "Other":

10. Overall, how satisfied are you with the standard reports in FOCUS?

- Very Satisfied
- Satisfied
- Neither Satisfied nor Dissatisfied
- Dissatisfied
- Very Dissatisfied

11. Please provide any comments, suggestions, or recommendations for improving the usefulness of FOCUS reports.

12. Please provide any general comments or suggestions you have regarding FOCUS.

LIST OF ACRONYMS

AUM	Assets Under Management
CAFR	Comprehensive Annual Financial Report
DIT	Department of Information Technology
DPSM	Department of Purchasing and Supply Management
ERISA	Employment Retirement Income Security Act
ERS	Employees' Retirement System
FCPS	Fairfax County Public Schools
FMD	Facilities Management Department
FOCUS	Fairfax County Unified System
FTA	Federal Transit Administration
GAAP	Generally Accepted Accounting Principles
GASB	Government Accounting Standards Board
MWAA	Metropolitan Washington Airports Authority
OFPA	Office of Financial and Program Audit (Auditor of the Board)
PMOC	Project Management Oversight Contractor
RA	Retirement Administration
ROD	Revenue Operations Date
SSCD	Scheduled Substantial Completion Date
WMATA	Washington Metropolitan Area Transit Authority